CHAPTER

1

ECONOMIC GROWTH OUTLOOK AND KEY CHALLENGES

The economic outlook for Asia and the Pacific in 2016 and 2017 is clouded by uncertainty. The region faces the prospects of either a continuation of the current moderate pace of economic growth or further deceleration if a number of emerging risks materialize more pronouncedly. Under the baseline scenario, growth in Asia-Pacific developing economies is forecast to remain at about 5% in 2016 and 2017, marginally higher than the estimate of 4.6% for 2015. However, if the risks come to fruition, a “low-growth scenario” could materialize in 2016. Among other implications that this negative outcome would hold for the region, would be a difficult start to the process of implementing the 2030 Agenda for Sustainable Development. Policymakers are advised therefore to proceed with prudence and pursue strategies that support sustained economic growth in a manner that promotes the overall well-being of societies in the region.

The key macroeconomic risks faced by Asia and the Pacific in the next couple of years are: a somewhat uncertain outlook for the economy of China against the backdrop of fragile global economic recovery; volatility in exchange rates, including that due to low oil prices for commodity exporters; growing levels of private household and corporate debt; and an ambiguous path of interest rate increases that may be pursued by the United States of America. The real extent of these risks is revealed when appreciating the interconnectedness of these apparently independent developments. For instance, a higher than expected decline in economic growth in China together with increases in interest rates set by the United States may lead to a string of exchange rate depreciations in the region, thereby increasing the financial vulnerabilities of economies that have extensive exposure to private debt denominated in foreign currencies and those that rely excessively on oil for their foreign exchange earnings.

Economic growth in China is forecast to continue its gradually moderating trend in coming years. On its own, this would be a positive development as it reflects that country's efforts to rebalance the economy in favour of domestic consumption. The concern, however, is whether the rebalancing can be managed in a manner that does not induce a shock to domestic macroeconomic stability and consequently to the regional and global economy given the country's considerable economic weight. As witnessed during 2015 and early 2016, differing views and uncertainty about the prospects for economic growth in China can lead to volatility in asset and currency markets in that country and beyond in addition to having dampening effects on growth in trade, thus creating uncertainty regarding global economic prospects.

Exchange rate depreciation in China carries the risk of spilling over into other regional economies, partly due to the herd behaviour of markets and partly due to the pressure faced by policymakers to compete with China. Many developing economies in the region, especially the commodity-exporting countries, are already experiencing significant depreciation due to steady declines in commodity prices − especially for oil − over the past year or so. At the start of 2016, oil prices fell to their lowest level since 2003. While lower prices may be beneficial for oil-importing countries in terms of keeping inflation low and creating higher levels of disposable income, such prices are detrimental to growth in the numerous commodity export-dependent economies in the region, underscoring the need for diversifying sources of growth.

In this context, the impact of monetary policy changes made by the United States vis-à-vis the outlook for the Asia-Pacific region will need to be well managed. For one, increases in interest rates in the United States could lead to increases in domestic financing costs in the region. Furthermore, uncertainty regarding the pace of increases in interest rates may act as another spur to outflows of portfolio capital, which would further dampen growth prospects. The risks associated with likely increases in domestic interest rates and capital outflows go beyond economic growth, as they relate also to sustained financial stability. Juxtaposing these developments against a strong rise in household and corporate debt in a number of developing economies in the region gives a better appreciation of underlying risks and their wide-ranging impacts. High levels of private debt, when compounded with declining exchange rates, rising interest rates and portfolio outflows, can threaten the solvency of domestic households, businesses and banks.

Even if these risks do not materialize, there are concerns that the current moderate pace of economic growth has been accompanied by phenomena that are impeding the region's progress towards achieving the Sustainable Development Goals. For instance, economic growth has not translated into commensurate increases in decent jobs for most economies. This is one of the reasons underlying signs of a slowdown in the pace of poverty reduction in the region. Similarly, inequalities – of both incomes and opportunities – continue to flourish in much of the region. More importantly, in broad terms the growth model being pursued in the region is underpinned by debt accumulation rather than productivity-driven increases in real wages.

These developments imply that even the moderate growth occurring in the region is failing to benefit adequately those sections of society who most need it, namely the poor. Despite the recent slowdown, high economic growth in previous years also brought with it the phenomenon of urbanization. The sheer pace and scale of urbanization is exerting enormous pressure on Governments to ensure inclusive and sustainable development in their economies. Furthermore, the challenges of urbanization are likely to increase in coming years. Another aspect of the increasing wealth in the region is the emergence of the "middle class" in many previously poor economies. While the rise of such a grouping is considered a positive outcome in terms of producing stronger domestic demand, it is important to remain cognizant of the risk posed by placing less emphasis on dealing with the challenges faced by the poor and the "transitional class" in such economies. Moreover, the challenges caused by a rising middle class go beyond the economic sphere; they have social and environmental consequences, too.

To ensure effective realization of the Sustainable Development Goals, economies in the region will need to strive both for higher economic growth and better-quality growth. As external demand is likely to remain weak in the near term, continued excessive reliance on exports to revive growth will not produce the desired results; economies will have to focus instead on boosting domestic demand. Similarly, ensuring that the quality of growth is beneficial will require internalizing various aspects of inclusiveness and sustainability in policymaking. The key tool available to Governments to achieve these objectives is fiscal policy. Monetary policy is unlikely to play a significant role in promoting growth due to uncertain conditions in financial markets that call for a prudent stance. Government development spending is currently a viable option for many economies because fiscal space remains available. However, to ensure consistent effectiveness, fiscal policy will have to be undertaken judiciously, supported by reforms to expand over time the "resource envelope".

Regional cooperation initiatives also provide domestic initiatives with valuable support to spur higher economic growth and achievement of the Sustainable Development Goals, especially for poorer economies with lower domestic capabilities. One promising area of regional cooperation is in new initiatives for the financing of infrastructure projects, with emphasis on physical infrastructure in the least developed economies. Such spending will contribute to increasing the long-term potential growth of these economies by positively influencing productivity as well as boosting short-term growth. Critically, infrastructure spending will also improve the inclusiveness of growth by providing job-rich growth. Another nascent area of cooperation is intergovernmental cooperation in energy and transport connectivity networks, such as the proposed "Asian Energy Highway" and the "Asia-Pacific Information Superhighway". Improving connectivity through the greater harmonization of such networks will improve efficiency and therefore reduce prices and increase access for poorer economies and sections of the populace within economies.

1. MACROECONOMIC OUTLOOK AND CHALLENGES

1.1. Economic growth constrained by weak trade and subdued domestic demand

The economic growth outlook for the developing economies in the region is broadly stable but clouded by uncertainty

Against an estimated growth rate of 4.6% in 2015, the rate in 2016 and 2017 is forecast to increase marginally to 4.8% and 5%, respectively (see table 1.1). Among the subregions, either declines or only moderate improvements in growth are expected to be seen in most of them over 2016 and 2017. The major positive change in forecast for those years concerns North and Central Asia owing mainly to the economy of the Russian Federation contracting by a smaller magnitude compared with contractions in the previous few years. The reason for the lack of a significant uptick in growth forecasts is the expected continuation of a number of factors buffeting the region. Chief among them are: fragile global economic recovery in most developed economies; a continued moderation in the Chinese economy; weak consumption and investment trends in major Asia-Pacific economies; and declining trends in labour and total factor productivity.

This baseline forecast is subject to a number of downside risks. If these occur, a "low-growth scenario" could materialize. Assessment of some of these risks is discussed briefly in box 1.1. On the other hand, there remains the possibility of an easing of some of the pressures assumed under the baseline case. Thus, a "high-growth scenario" for developing economies in the region is also outlined. However, under prevailing conditions, the probability of a high-growth scenario eventuating is relatively low.

Weak external demand continues to influence growth prospects of developing economies in the region

One important factor hindering faster economic growth of developing economies in Asia and the Pacific is the fragile recovery in the advanced economies. Despite a slightly rising trend since 2013, the growth outlook for advanced economies remains essentially flat (see figure 1.1). With the outlook for the European Union and Japan continuing to remain weak, alongside

Table 1.1 Rates of economic growth and inflation in the ESCAP region, 2015-2017

(Percentage)	Real GDP growth			Inflation[a]		
	2015[b]	2016[c]	2017[c]	2015[b]	2016[c]	2017[c]
East and North-East Asia[d]	**3.3**	**3.4**	**3.2**	**1.1**	**1.2**	**1.8**
East and North-East Asia (excluding Japan)[d]	**5.7**	**5.5**	**5.4**	**1.3**	**1.8**	**2.1**
China	6.9	6.5	6.3	1.4	1.8	2.1
Democratic People's Republic of Korea	..	..	..	..	..	..
Hong Kong, China	2.4	2.0	2.3	3.0	2.3	2.9
Japan	0.5	1.1	0.7	0.8	0.5	1.5
Macao, China	-20.3	-2.7	4.6	4.6	4.5	4.8
Mongolia	2.3	0.5	1.0	6.6	3.5	7.0
Republic of Korea	2.6	2.9	3.1	0.7	1.6	2.0
North and Central Asia[d]	**-2.6**	**-0.9**	**0.5**	**14.1**	**8.1**	**5.2**
North and Central Asia (excluding Russian Federation)[d]	**3.1**	**2.4**	**3.2**	**6.4**	**11.4**	**7.0**
Armenia	3.0	2.5	2.8	3.5	3.3	2.9
Azerbaijan	1.1	0.3	1.2	4.0	10.0	5.6
Georgia	2.8	2.7	3.0	4.0	5.1	4.5
Kazakhstan	1.2	0.5	1.5	6.6	14.7	7.5
Kyrgyzstan	3.5	2.5	4.0	6.6	8.0	4.5
Russian Federation	-3.7	-1.5	0.0	15.5	7.5	4.9
Tajikistan	6.0	5.0	5.2	5.5	8.0	6.5
Turkmenistan	6.7	5.4	6.5	7.0	7.6	5.9
Uzbekistan	8.0	7.8	8.0	10.0	11.5	10.5
Pacific[d]	**2.6**	**2.8**	**3.1**	**1.4**	**1.9**	**2.2**
Pacific island developing economies[d]	**6.5**	**3.4**	**2.7**	**3.3**	**4.4**	**4.5**
Cook Islands	-0.5	0.0	0.2	3.0	1.8	2.0
Fiji	4.0	2.2	3.1	1.4	3.0	3.0
Kiribati	3.0	1.8	2.0	1.4	0.3	0.8
Marshall Islands	-0.5	1.5	2.0	0.5	2.0	2.5
Micronesia (Federated States of)	-1.5	2.5	3.5	-1.1	-0.3	0.3
Nauru	-10.0	3.0	15.0	11.4	6.6	1.7
Palau	6.7	3.0	7.0	2.2	1.5	2.5
Papua New Guinea	9.9	4.3	2.4	5.1	6.0	6.0
Samoa	1.5	2.2	0.7	1.9	2.0	2.0
Solomon Islands	3.2	3.0	2.8	-0.3	4.4	5.7
Tonga	3.4	2.8	2.7	-0.7	-0.3	0.5
Tuvalu	2.0	3.5	3.0	2.0	3.5	2.0
Vanuatu	-1.0	2.5	3.8	2.5	1.9	2.4
Developed countries in the Pacific subregion	**2.6**	**2.8**	**3.1**	**1.4**	**1.9**	**2.2**
Australia	2.5	2.7	3.0	1.5	2.1	2.3
New Zealand	3.4	3.5	3.6	0.3	0.5	1.5
South and South-West Asia[d,e]	**5.7**	**5.9**	**6.3**	**6.6**	**6.8**	**6.6**
Afghanistan	2.0	3.0	4.0	-1.3	3.0	4.3
Bangladesh	6.5	6.8	7.0	6.4	6.2	6.5
Bhutan	5.9	6.5	6.6	6.6	5.0	6.5
India	7.6	7.6	7.8	5.0	5.2	5.6
Iran (Islamic Republic of)	0.8	4.4	5.1	13.6	12.5	12.8
Maldives	4.8	6.0	7.1	1.4	1.6	1.8
Nepal	3.4	2.2	4.5	7.2	9.5	8.0
Pakistan	4.2	4.5	4.8	4.6	4.0	5.0
Sri Lanka	4.9	5.4	5.9	3.8	4.5	5.0
Turkey	4.0	3.0	3.7	7.7	8.5	6.5
South-East Asia[d,e]	**4.3**	**4.5**	**4.8**	**2.5**	**2.4**	**2.8**
Brunei Darussalam	-1.2	2.0	3.0	-0.4	0.2	0.4
Cambodia	6.9	7.0	7.1	1.2	2.0	2.9
Indonesia	4.8	5.3	5.5	6.4	4.3	4.3
Lao People's Democratic Republic	6.4	7.0	7.0	1.3	2.0	2.3
Malaysia	5.0	4.4	4.8	2.1	2.8	2.8
Myanmar	8.5	8.5	8.0	10.7	9.5	8.5
Philippines	5.8	6.0	6.2	1.4	2.5	3.0
Singapore	2.0	2.0	2.5	-0.5	-0.5	0.5
Thailand	2.8	3.2	3.5	-0.9	0.5	1.5
Timor-Leste	4.3	5.0	5.6	1.0	2.0	3.0
Viet Nam	6.7	6.8	6.9	0.6	2.0	3.0
Memorandum items:						
Developing ESCAP economies[f]	**4.6**	**4.8**	**5.0**	**4.1**	**3.7**	**3.6**
Least developed countries	**6.2**	**6.4**	**6.7**	**5.9**	**6.2**	**6.3**
Landlocked developing countries	**3.1**	**2.5**	**3.4**	**6.0**	**10.8**	**6.9**
Small island developing States	**6.0**	**3.9**	**3.6**	**2.7**	**3.7**	**4.0**
Developed ESCAP economies[g]	**0.9**	**1.4**	**1.1**	**0.9**	**0.7**	**1.6**
Total ESCAP region	**3.3**	**3.5**	**3.6**	**3.0**	**2.7**	**2.9**

Sources: ESCAP, based on national sources; United Nations, Department of Economic and Social Affairs, *World Economic Situation and Prospects 2016* and its update (Sales No. E.16. II.C.2). Available from www.un.org/en/development/desa/policy/wesp/; International Monetary Fund, International Financial Statistics databases. Available from http://elibrary-data.imf.org; Asian Development Bank, *Asian Development Outlook 2016: Asia's Potential Growth* (Manila, ADB, 2016); CEIC Data. Available from www.ceicdata.com; and website of the Interstate Statistical Committee of the Commonwealth of Independent States. Available from www.cisstat.com.

a Changes in the consumer price index.
b Estimates.
c Forecasts (as of 31 March 2016).
d GDP figures at market prices in 2010 United States dollars (at 2005 prices) are used as weights to calculate the subregional aggregates.
e The estimates and forecasts for countries relate to fiscal years defined as follows: 2016 refers to fiscal year spanning the period from 1 April 2016 to 31 March 2017 in India, Myanmar; from 21 March 2016 to 20 March 2017 in Afghanistan and the Islamic Republic of Iran; from 1 July 2015 to 30 June 2016 in Bangladesh, Bhutan and Pakistan; and from 16 July 2015 to 15 July 2016 in Nepal.
f Developing ESCAP economies consists of all countries listed in the table excluding Australia, Japan and New Zealand.
g The group of developed ESCAP economies consists of Australia, Japan and New Zealand.

Box 1.1 Changing external economic conditions, alternative growth scenario and its impacts on emerging Asia-Pacific economies

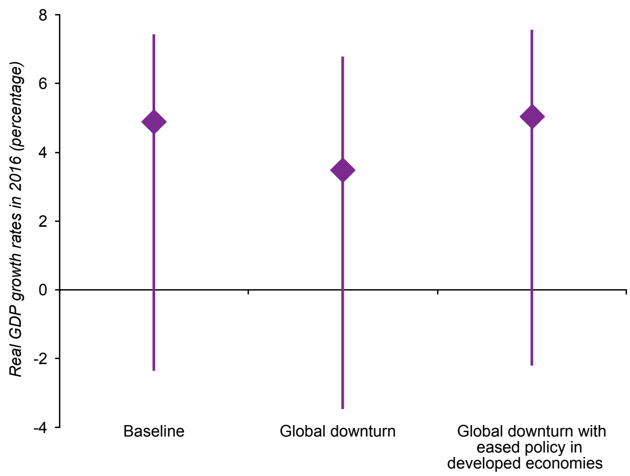
The external economic environment faced by the Asia-Pacific economies is clouded by several downside risks. In Europe, it is highly uncertain whether the package of monetary policy support measures announced in March 2016 would help to shore up domestic demand.[a] Uncertainty in Europe, which is a major trading partner of many Asia-Pacific economies, goes beyond macroeconomic risks. Among other factors are the possible exit of Greece from the euro zone and of the United Kingdom from the European Union, as well as different views on policies to handle the migrant crisis which could undermine the unity of the European Union. Similarly, in the United States the policy interest rate was increased in December 2015 for the first time in nearly a decade. How the United States economy will react to further likely interest rate increases is not clear, although the market's response so far has been mostly calm.[b]

A faster than expected pace of monetary policy normalization in the United States would imply relatively strong economic growth and job creation in that country. While stronger economic performance in the United States may revive opportunities for developing countries, such a situation could also dampen their economic prospects, including those in the Asia-Pacific region, by putting upward pressure on domestic interest rates. Many of these economies are already facing prospects of higher financing costs, greater risk of capital outflows and weaker currencies that may push up debt servicing costs. In Latin America, that region's economic growth is being negatively affected by a deep recession in Brazil, while growth in the Middle East is being held back by low oil prices and heightened geopolitical uncertainties. Low commodity prices are also constraining economic expansion in Africa. More broadly, developed and developing economies that rely on commodity exports could face a further deterioration in their terms of trade if global demand continues to weaken.

If some of these downside risks in the external environment materialize in 2016, economic growth in the Asia-Pacific region could turn out to be lower than currently projected in the baseline scenario. To quantify the impact of this alternative scenario, a simulation exercise is conducted using the Oxford Global Economic Model. In particular, the simulation exercise assumes that: (a) the global oil price and non-fuel commodity price index are 10% lower than their baseline levels due to subdued global economic activity;[c] (b) a country's world trade index, which is determined mainly by import demand in its major trading partners, declines by 3%; and (c) the risk premium on a country's debt (denominated in United States dollars) rises by 100 basis points as a result of a higher degree of risk aversion among global investors. It should be pointed out that the magnitude of these assumptions is modest relative to actual changes in the past.[d]

Under this scenario, output growth in 11 emerging Asia-Pacific economies in 2016 could be up to 1.4 percentage points lower than the baseline case (see figure below).[e] Although lower commodity prices would help to buoy economic growth in net energy-importing economies, a decline in merchandise exports and higher borrowing costs would constrain overall growth performance under this scenario.

Alternative growth scenarios for emerging Asia-Pacific economies in 2016



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

Note: The vertical lines show the ranges of real GDP growth rates in 11 emerging economies in the region in 2016. The dots on the lines represent the group-average growth rates. The baseline projections are based on growth forecasts in the Oxford Model.

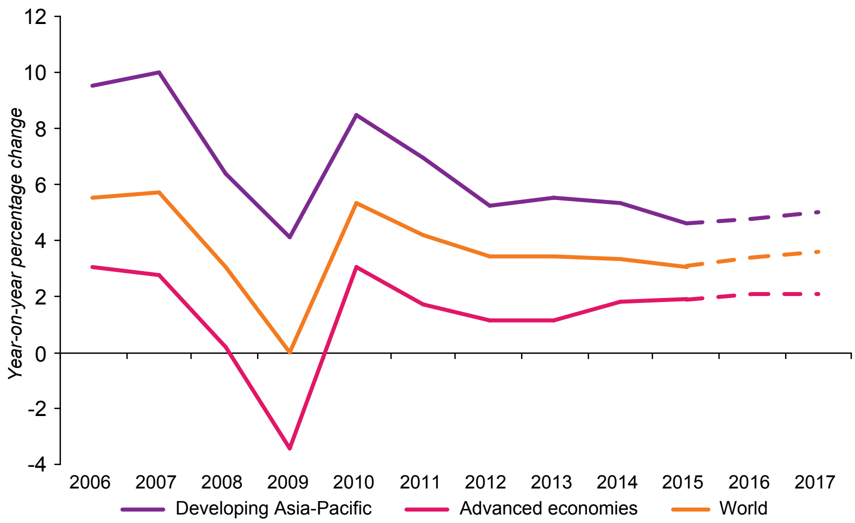
Box 1.1 *(continued)*

In the event that macroeconomic policy support in developed economies rises in response to the downturn, the baseline growth projections for emerging Asia-Pacific economies as a group would likely be sustained. More specifically, in a scenario under which it is assumed that the three shocks described above and that short-term interest rates in all developed economies are 50 basis points below their baseline levels in 2016, annual output growth in emerging Asia-Pacific economies would be about 0.2 percentage points higher than the baseline. This scenario is possible if monetary policy normalization in the United States moves forward at a slower pace than expected and the European Central Bank further reduces interest rates and/or introduces a bolder set of unconventional monetary policies to keep financing costs at unusually low levels.

a Among other measures, the package includes a €20 billion increase in the size of its asset-purchase programme to €80 billion a month, and reductions in the deposit rate from −0.3% to −0.4% and in the main policy rate from 0.05% to zero.
b The United States Federal Reserve made a projection in mid-March 2016 that the federal funds rate would rise from about 0.4% in 2015 to 0.9% in 2016 and 1.9% in 2017.
c In the baseline scenario, the global oil price is projected to decline by 31% in 2016, while the non-fuel commodity price index is expected to fall by 6%.
d For example, in 2015 the global oil price plunged by 47% and the global non-fuel commodity price index by 17%. Similarly, the global trade index declined by 12-15% in 2009 in China, India, Indonesia, Malaysia, the Philippines, the Russian Federation, Thailand and Turkey.
e The 11 economies are: China; Hong Kong, China; India; Indonesia; Malaysia; the Philippines; the Republic of Korea; the Russian Federation; Singapore; Thailand; and Turkey. Together, they account for about 92% of total output in developing Asia-Pacific economies.

somewhat stronger growth performance expected in the United States, the prospects of an export-led recovery in developing Asia-Pacific economies will remain broadly subdued. Economic growth in global developed economies stood at about 2% in both 2014 and 2015, with only a minor increase expected in 2016 (IMF, 2016a). Within developed economies in the Asia-Pacific region, the most disappointing outlook remains that of Japan. Its growth is expected to pick up modestly in 2016, albeit at the low rate of 1.1%. The outlook for the developed economies is expected to translate into further weakness in global export demand, thus negatively affecting manufacturing exports from the Asia-Pacific region. In taking into account the fact that the European Union is a leading export destination, capturing more than 16% of merchandise exports from Asia-Pacific economies, the grouping's persistently sluggish demand is a major factor explaining its modest trade growth. The estimated growth rate of merchandise exports from the Asia-Pacific region was

Figure 1.1 **Real growth in gross domestic product in developing economies in Asia and the Pacific, in advanced economies and in the world, 2006-2017**



Sources: ESCAP forecasts and International Monetary Fund, World Economic Outlook Databases. Available from www.imf.org/external/data.htm.

Note: The developing Asia-Pacific group comprises economies listed in table 1, excluding Australia, Japan and New Zealand. The advanced economies group is composed of the European Union and the United States as well as Australia, Japan and New Zealand.

only 2.3% in real terms in 2015 (ESCAP, 2015a). The situation was even worse for imports which declined by 2.4%. Particularly affected were the manufacturing export-dependent economies in East and North-East Asia and in South-East Asia (see figure 1.2).

More recently, global and regional demand has been further weakened by the moderation in growth of the Chinese economy, which has not only become a major exporter and importer in its own right but has also become a major trading partner for the rest of the region. The slowing demand had a stronger impact on price levels, and as a result there was a sharp decline of 9% and 14% in export prices and import prices, respectively. In considering these factors, ESCAP forecasts that the region is likely to stabilize its modest rate of trade growth at between 2% and 3% in 2016 for exports as well as imports in volume terms. On the positive side, despite the weakening of the prospects for trade growth, the Asia-Pacific region still holds on to its position as the largest merchandise trading region in the world, with its share of 40% in global exports and imports.

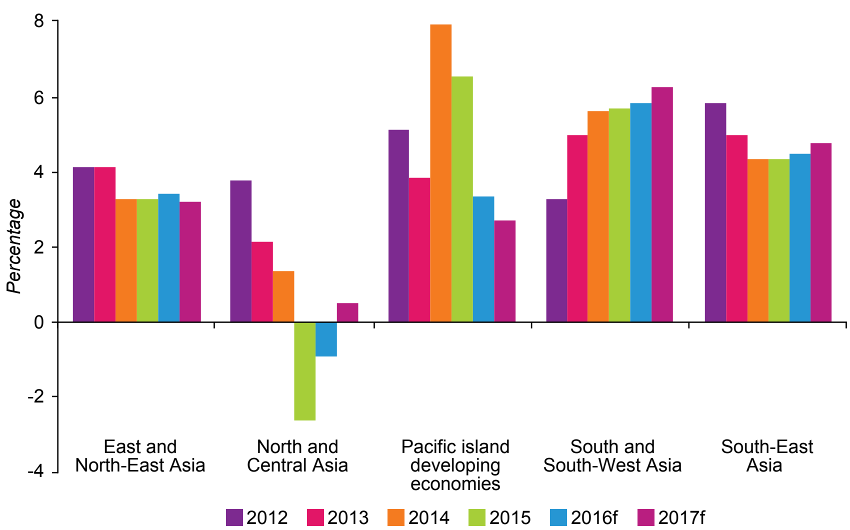
Moderating growth of the Chinese economy has further weakened global and regional demand

Economic growth in China is forecast to be around 6.5% for 2016 and 6.3% for 2017, continuing the moderating rate of economic expansion from an estimated increase to 6.9% in 2015. The growth moderation in China is being driven partly by a much-needed rebalancing to sustain growth in the medium term, away from investment and net exports and towards consumption, as well as away from manufacturing and towards services. Indeed, since 2013, while GDP growth has declined, the share of consumption in GDP growth has increased, while that of investment has decreased (see figure 1.3). It is expected that the Government will maintain its policy focus on rebalancing in coming years, provided that the growth moderation remains gradual, which would imply that monetary policy as well as fiscal policy will remain relatively restricted with regard to supporting investment.

Given the large weight of China in the GDP of the developing Asia-Pacific region – 40% of the total – even a small change in its GDP growth estimates would result in a considerable impact on the region's growth outlook. China has surpassed the United States to become the largest individual trading partner in the Asian and Pacific region, absorbing 13% of merchandise exports from the region as a whole.[1] In fact, China sources more than 40% of its imports from other Asia-Pacific countries. The growing importance of exports to China has been a major factor driving the rise in its share of intraregional exports from 48.9% in 2008 to 53% by 2015.

Manufacturing exporters in particular are experiencing an export recession owing to the drop in China's final exports, implying less demand for Asia-Pacific intermediates, as well as the slowdown in Chinese demand for final products (see figure 1.4). Among manufacturing economies in the region, China is the largest export market for Singapore, Taiwan Province of China, Thailand and the Republic of Korea in that

Figure 1.2 **Real growth in gross domestic product in subregions in Asia and the Pacific, 2012-2017**



Source: ESCAP forecasts.

Figure 1.3

Growth contributions in China, by expenditure, 2005-2015

Source: ESCAP, based on data from CEIC Data. Available from www.ceicdata.com (accessed 31 March 2016).

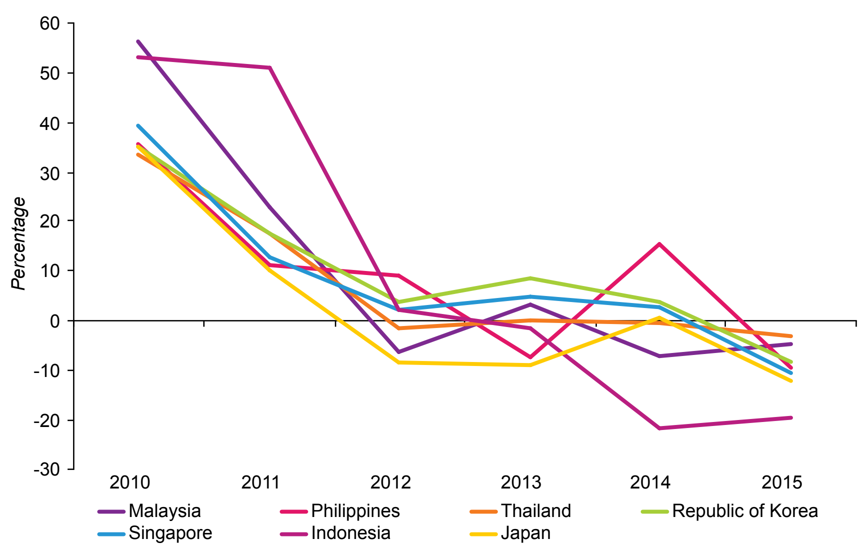
order, and the second largest market for Japan and Viet Nam. Exports of the Republic of Korea, Singapore and Thailand have contracted since July 2015 on a year-on-year basis.

Apart from the moderation in Chinese economic growth, another impact on the region's trade comes from weakening of the Chinese currency. Depreciation of the Chinese currency puts pressure on other currencies in the region to depreciate as well. This situation affects direct exports by the region's economies to major trading partners due to greater currency competition.

A decline in the Chinese currency, however, is not the only spur to currency competition. Depreciation of the Japanese currency since 2015, given its large export sector, has also played a role in the recent exchange rate depreciations observed in the region. Relatively weak economic growth prospects for China could also lead to investor uncertainty, leading to renewed bouts of capital outflows from regional economies, as seen in early 2016. The possible spillover effects on growth and other variables in the region resulting from developments in China in coming months are considered in box 1.2.

Figure 1.4

Percentage growth in exports to China for selected Asia-Pacific economies, 2010-2015



Source: ESCAP, based on data from CEIC Data. Available from www.ceicdata.com (accessed 31 March 2016).

Box 1.2

Spillovers from economic rebalancing and policy changes in China

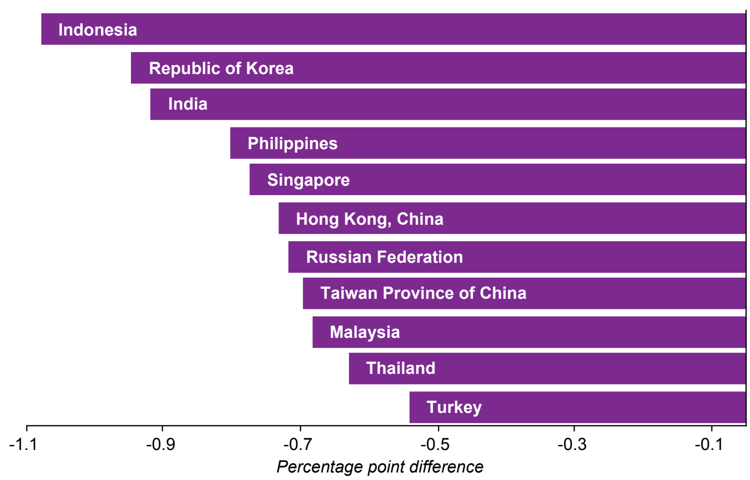
Given the importance of the Chinese economy to the region's economic prospects, an attempt is made to quantify the potential macroeconomic impact of China's ongoing economic rebalancing on other emerging Asia-Pacific economies. In particular, the discussion is focused on three issues: (a) implications of a declining role of manufacturing activity in China on oil-exporting economies; (b) impact of increased uncertainty that has coincided with China's growth moderation; and (c) assessment of possible currency competition, triggered by China's currency devaluation.

The main objective of China's efforts in the area of economic rebalancing is to reduce the country's reliance on the export-led manufacturing sector and mitigate carbon emissions. To capture this policy direction, a simulation scenario is constructed using the Oxford Global Economic Model. Under this scenario, it is assumed that the volume of oil input used in industry, which is mainly determined by manufacturing growth, is 20% lower than the baseline levels during 2016 and 2017.[a] As China's oil imports have a direct impact on the global oil stock and prices, under this scenario the global oil price decreases by about $3.50 per barrel. As a result, the value of merchandise exports in Indonesia, Malaysia and the Russian Federation, the three major oil exporters in the region, is estimated to decline by 1.7%, 3.6% and 9.5%, respectively, during 2016 and 2017. The combined export loss in these three countries is valued at about $34 billion over the two years relative to the baseline. Moreover, under the same scenario, the ratio of export prices to import prices in the Russian Federation is estimated to dip further to below 0.60 in 2016 and 2017 from 0.93 in 2014 and 0.72 in 2015. Such deterioration in the terms of trade would weaken that country's macroeconomic stability through depreciation pressure on the exchange rate, higher external debt servicing costs and higher inflation.

The moderating economic growth in China has led to uncertainty. Consequently, volatility in China's daily stock market index, a high-frequency variable that is very sensitive to changes in market sentiment, has increased since early 2015 relative to the preceding few years. Moreover, growing concerns over the pace of a growth moderation in China are often cited as one of the main reasons that explain the global share sell-offs in mid-2015 and early 2016. China's share prices plunged by about 25% in each of two periods: July-August 2015 and January 2016. During both periods, the stock market index in the United States decreased by only 3-4%, indicating that movements in stock market indices in several emerging Asia-Pacific economies are becoming more closely linked with China.

A decline in share prices coupled with a heightened degree of risk aversion and weaker market sentiments could have a substantial negative impact on economic growth. The following simulation scenario assumes that the magnitude of lower share prices mimics what was observed during the sell-offs in July-August 2015 and January 2016.[b] Additionally, it assumes that the market risk premium rises while market confidence deteriorates as a result of more volatile economic conditions.[c] Under this scenario, the annual GDP growth rates in India, Indonesia and the Republic of Korea are estimated to be 0.9-1.0 percentage points lower than the baseline forecasts (see figure A). In these three economies, annual real consumption could be 0.9-1.1% below the baseline levels, while fixed investment levels could decline by 1.3-2.3%.

Figure A
Economic growth impact of lower share prices and rising economic uncertainty



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

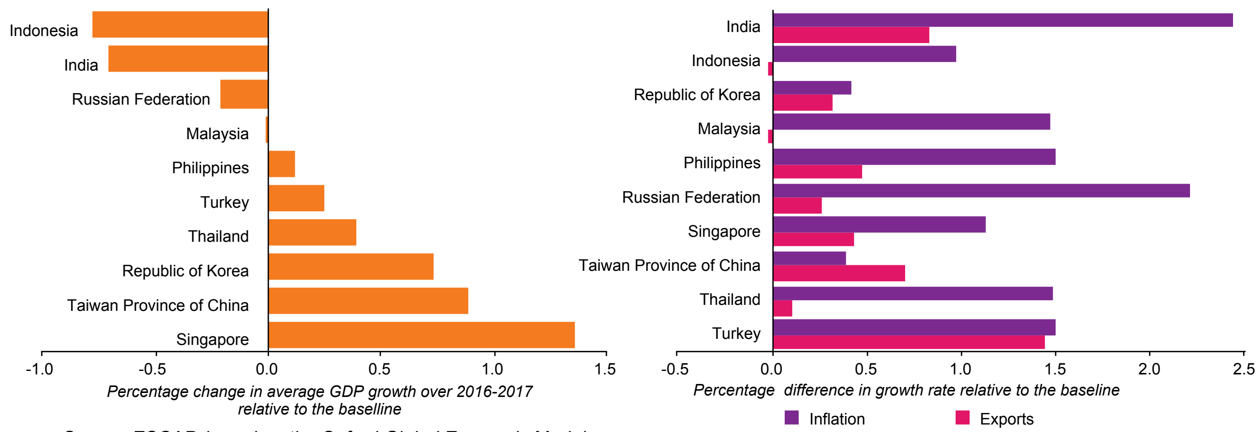
Box 1.2 *(continued)*

As part of its economic rebalancing, China has revised its exchange rate policy. The value of the Chinese currency is now based on a basket of currencies of China's main trading partners. In 2015, the renminbi lost about 4.2% of its value on top of the 1.9% depreciation experienced in 2014. The weaker currency could push other regional economies to pursue the same policy direction in order to maintain their export competitiveness. Such across-the-board currency depreciations may not be very helpful in boosting economic growth of the region, as the net effect of the perceived positive impact on exports would be marginal.

In fact, in a simulation scenario that assumes a 10% currency depreciation against the United States dollar in all major Asia-Pacific economies during 2016 and 2017,[d] economic growth in India, Indonesia and the Russian Federation declines relative to the baseline (see panel A in figure B). In India and the Russian Federation, while the weaker exchange rates help to improve the export of goods and services, the magnitude of the improvement is small, as anticipated (see panel B).[e] In contrast, exchange rate depreciations push up inflation rather notably because of the higher prices of imported goods and services, thus constraining household spending. Overall, although currency depreciations may lead to some growth acceleration in export-oriented economies, such as the Republic of Korea, Singapore and Taiwan Province of China, the real output level in emerging Asia-Pacific economies as a whole is estimated to be nearly $19 billion below the baseline during 2016 and 2017, given the below-baseline growth in large economies, such as India, Indonesia and the Russian Federation.

Figure B
Macroeconomic impact of a 10% across-the-board currency depreciation

Panel A. Real GDP growth rate **Panel B. Inflation and exports of goods and services**



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

The impact of China's economic rebalancing on smaller economies or those with lower income levels could be more noteworthy. For instance, in Mongolia almost 90% of exports go to China. In the Lao People's Democratic Republic, Turkmenistan and Viet Nam, exports of goods to China are also sizeable at 11-20% of those countries' GDP. In addition to such close economic linkages with China and the associated implications, these smaller economies are quite vulnerable owing to their relatively limited room for fiscal and monetary policy maneuverability.

[a] While large, this assumption is not unrealistic as a shock scenario. The volume of oil used by China's industry declined by 6.7% in 2010 and 0.5% in 2011 when the economy was still growing at 10.4% and 9.3%, respectively. The assumption also takes into account the Government's effort to promote greater use of non-fossil fuels and introduction of more stringent emissions standards.

[b] The average declines in share prices during the two episodes of global stock sell-offs are between 3% and 7% for most emerging Asia-Pacific economies, and higher at about 11% in Singapore and 14% in Hong Kong, China.

[c] More specifically, it is assumed that the gap between corporate and government bond rates and the United States treasury bills rate widens by 100 basis points and that the market confidence index falls by 10 points on a typical 0-100 point scale. Both shocks are assumed to last for one quarter. Under these assumptions, economic uncertainty dampens economic growth through lower investment and consumption amid higher financing costs and weaker market sentiments.

[d] This assumption is relatively modest. The currency depreciations recorded in 2015 were between 2.5% and 8.5% in India, the Philippines, the Republic of Korea, Singapore and Thailand, and much larger at about 13% in Indonesia, 19% in Malaysia and 24% in Turkey.

[e] Exports increased in most economies under this scenario due to greater import demand in the United States, as the United States dollar appreciated across all major regional currencies. More specifically, imports by the United States are assumed to increase by $61 billion during 2016 and 2017 relative to the baseline.

Fragile growth prospects have led to significant declines in commodity prices, adversely affecting commodity-dependent economies

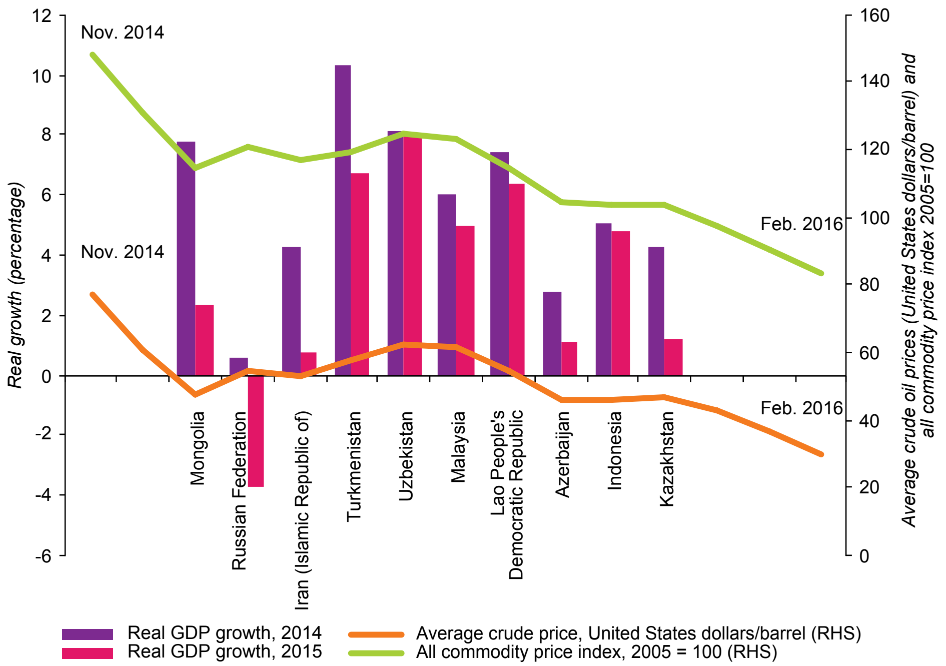
Taken together, growth moderation in China and overall weak global economic growth have had a particularly strong impact on commodity-dependent economies in the region. Global commodity prices have declined to levels last seen at the time the global financial and economic crisis started in 2008, with the most dramatic reductions being observed in the case of oil.[2] Although global demand and supply factors have played an important role in explaining these declines, the new and most pressing driver in the past year has been concerns over the prospects for the Chinese economy. Key among sectors of domestic investment in China that are expected to assume a lesser role in coming years are real estate investment and infrastructure spending in the more developed parts of the country. The need for raw material commodities in these sectors had been the key driver of China's emergence as the largest commodity importer in the world.

The major commodity-dependent subregion in Asia and the Pacific, which has been particularly affected by declines in commodities prices, is North and Central Asia, while Indonesia, Malaysia and Mongolia are the major economies in other subregions that are being negatively affected. Economies where commodities play a major role in exports have experienced the greatest declines in their GDP growth between 2014 and 2015. Figure 1.5 highlights how, among commodity-dependent economies, the sharp fall in oil and overall commodity prices during this period has coincided with the largest decline in GDP growth for Mongolia, followed by the Russian Federation, the Islamic Republic of Iran and Turkmenistan.

Domestic demand needs to support economic growth, though recently its growth has not lived up to its potential

Domestic demand in developing Asia-Pacific economies, with rising incomes and a younger population in most subregions, has more potential to support future economic growth than reliance on demand from developed economies. However, under the baseline scenario, the role of domestic demand is expected to remain relatively constrained. For instance, growth in domestic consumption and investment in some economies is likely to be negatively affected by the relatively high levels of household and corporate debt which have been accumulated over recent years, such as in Malaysia, the Republic of Korea and Thailand. In going forward, a larger share

Figure 1.5 **Effect of oil and commodity prices on growth of commodity-dependent economies in Asia-Pacific region, 2014-2016**



Sources: ESCAP, based on data from CEIC Data. Available from www.ceicdata.com (accessed 31 March 2016) and the Economist newspaper. Available from www.economist.com/blogs/graphicdetail/2015/08/commodity-dependency.

of household incomes and corporate profits will be directed towards debt payments, constraining further impetus to domestic demand.

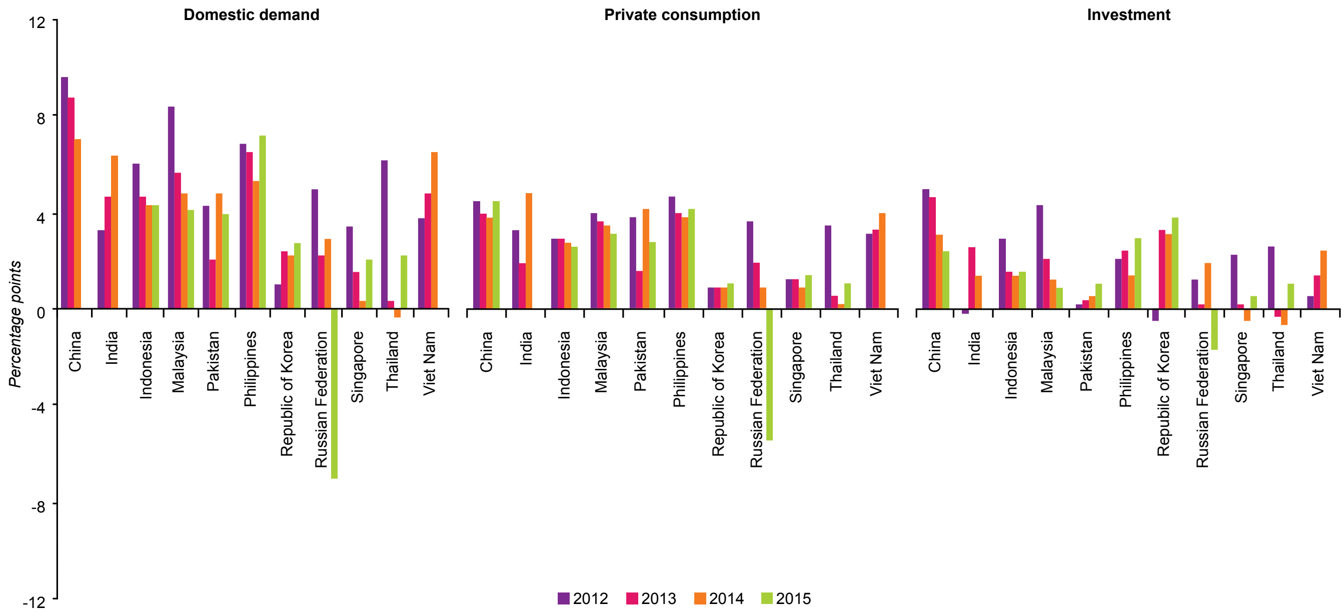
Indeed, between 2012 and 2014, private domestic demand in terms of percentage points of overall growth has been on a downward trend for, among others, China, Indonesia, Malaysia, Mongolia, the Russian Federation and Singapore. Furthermore, a number of countries with data available up to 2015 show a continuation of this trend, including Indonesia, Malaysia and the Russian Federation (see figure 1.6). This implies that, apart from muted exports, slowing domestic demand has also been an important driver of slowing growth in these economies. The factors driving the slowdown vary, depending on the particular element of private domestic demand.

Other than high household debt, as briefly discussed above, another factor dampening growth of private consumption in some economies is high inflation due to depreciating currencies. High inflation is eroding the purchasing power of households, which has been the case in Indonesia, Kazakhstan, Mongolia, the Russian Federation and Turkey, for example. For such economies, resolving the fundamental factors responsible for persistent currency depreciation pressures will be important. Other than a prudent monetary policy stance, reducing excessive reliance on a few commodities together with policies geared towards increasing real wages will help support private consumption.

In recent years, the contribution to economic growth from fixed investment has also declined for several major developing economies in the region, including China, India, Kazakhstan, Malaysia, Mongolia, Singapore, Sri Lanka, Thailand and Turkey. One reason is the relatively high interest rates in some countries due to both inflation and the need to preserve capital inflows, which hampers increases in credit for investment. This has been the case in India, Kazakhstan, Mongolia and Turkey, for example. In such cases, it will be necessary to maintain low and stable inflation and make effective use of macroprudential policies. Investment will also continue to be affected by the general uncertainty regarding the prospects for the global economy, with investors remaining wary of undertaking long-term decisions.

In this context, it is worth highlighting the risk emanating from gradual yet expected increases in interest rates in the United States. Such increases will put pressure on capital to flow out of the Asia-Pacific region and, as a consequence, could lead to higher interest rates in the region. The prospect of increases in domestic financing costs does not bode well for fixed investment growth. If economies choose to maintain their interest rates, they may experience higher exchange rate pressures. It is this tension in policy considerations that is increasing uncertainty – the ultimate deterrent to private investment.

Figure 1.6 **Growth of private domestic demand, private consumption and private investment in selected Asia-Pacific economies, 2012-2015**



Sources: ESCAP, based on national sources and CEIC Data. Available from www.ceicdata.com (accessed 31 March 2016).

In some countries, such as China, Malaysia, Singapore, Sri Lanka and Thailand, weak investment is linked to sluggish prospects for the leading export sector. For moderately middle-income countries such as these, it will be necessary to take measures to boost productivity, as discussed in chapter 3, by investing in skills development for the workforce. Lack of sufficient spending on infrastructure is the other main factor causing the decline in fixed investment, despite the enormous needs in many developing economies in the region.

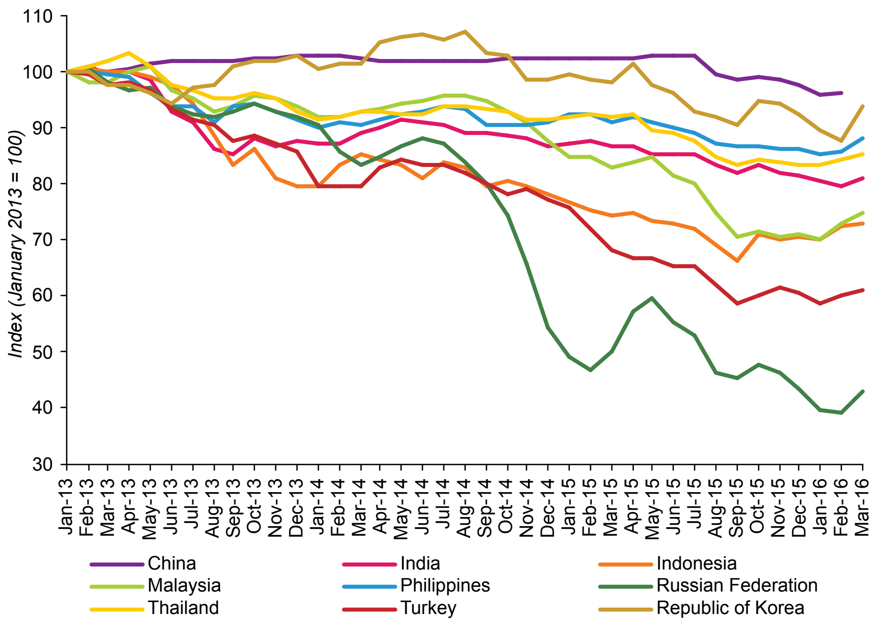
Some support for growth in domestic demand is likely to come from expected progress in reform policies of some major developing economies in the region. It is expected that India and Indonesia will both see greater implementation of their stated reform objectives, which are intended to boost domestic investment. These measures include simplification of regulatory structures and government infrastructure programmes. India is forecast to consolidate its growth rate of 7.6% in 2015, growing by 7.6% and 7.8% in 2016 and 2017 respectively. Indonesia is expected to increase its growth rate from 4.8% in 2015 to 5.3% in 2016 and 5.5% in 2017. Viet Nam is also expected to continue on its drive to divest its stakes in State-owned enterprises. It is assumed that the country will continue its strong growth performance, with growth likely to increase slightly from 6.7% in 2015 to 6.8% in 2016 and 6.9% in 2017.

1.2. Capital flow and exchange rate developments contribute to uncertainty

The region is experiencing a trend involving a general outflow of capital along with considerable volatility in financial markets

The prospects of stable international financial flows are riddled with uncertainty. Since 2015, there has been a trend involving a general outflow of capital from the region. This has led to significant volatility in asset markets as well as exchange rate depreciations (see figure 1.7). The outflow from the region is part of a trend in emerging markets globally. Global emerging markets suffered a net outflow of capital in 2015 for the first time since the 1980s, with the total outflow being $735 billion (Institute of International Finance, 2016).[3] Net short-term debt and bank outflows from China, combined with broad-based retrenchment in the Russian Federation, accounted for the bulk of the total outflow from the region in absolute terms. Even without these two economies, in 2015 Asian economies as a group also recorded the first net capital outflows in 10 years (Capital Economics, 2015). China posted record capital outflows of $676 billion in 2015. On the other hand, the capital outflow of the Russian Federation declined in 2015 by three times less than that of 2014, with $57 billion leaving the country instead of $153 billion (TASS, 2016).

Figure 1.7 **Exchange rate indices in selected Asia-Pacific economies, 2013-2016**



Source: ESCAP, based on data from CEIC Data. Available from www.ceicdata.com (accessed 31 March 2016).

Note: A declining trend represents depreciation and vice versa.

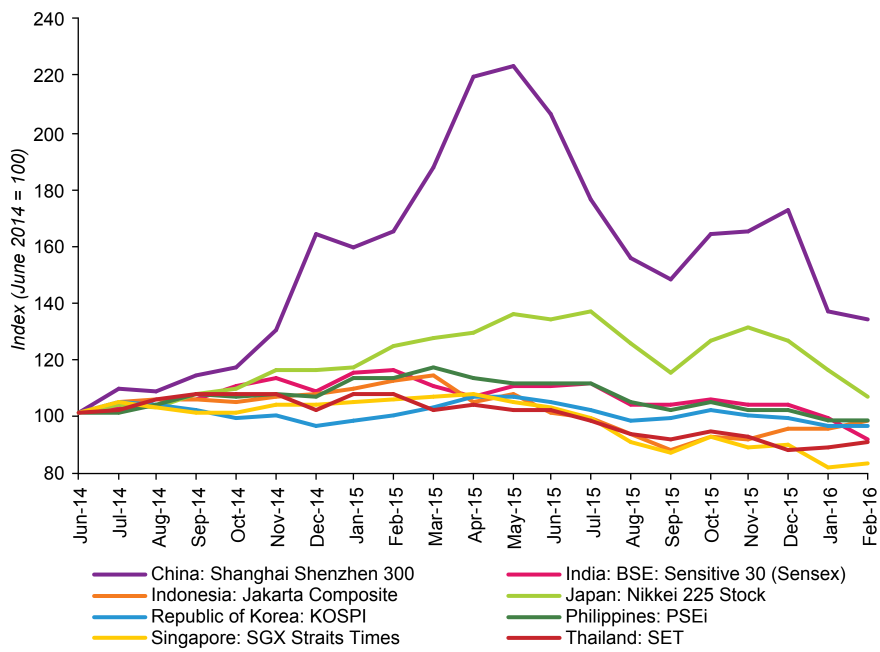
Divergence in economic growth and interest rate prospects of many regional economies with those of the United States are the key factors responsible for capital outflow from the region. Although financial markets had for some time already factored into their calculations the initial impact of the increase in the interest rate by the United States Federal Reserve in December 2015, uncertainty regarding the timing of further increases is likely to lead to volatility in financial markets in the region. Monetary policies of the central banks of the European Union and Japan on the other hand, including quantitative measures, are currently in easing mode as inflation has failed to increase sufficiently to reach targets. Indeed, at the end of January 2016 Japan announced further steps by imposing negative interest rates on deposits held by Japanese banks with the central bank, while the European Union decided in December 2015 that its bond-buying programme would be extended to March 2017. Such monetary easing policies are introducing fresh liquidity into global financial markets at a time when the United States is withdrawing liquidity, leading to considerable volatility in global capital flows and financial markets.

The other major reason for capital outflows from the region has been the weaker economic data from China and perceived related developments in the Chinese equity market. Decline in the Shanghai stock market in late 2015 and early 2016 spurred such concerns as they were interpreted by some investors as reflecting anxiety about the economy. However, it should be borne in mind that gyrations in the stock market do not necessarily reflect the state of the country's economy or its future outlook. For instance, when the stock market experienced a dramatic rise in the first half of 2015, China's economy was slowing down amid a slew of negative data.

Retail investors account for about 80% of China's stock market total, as opposed to much lower percentages in developed economies. Retail investors are possibly more prone to herd behaviour as opposed to institutional investors who tend to have greater knowledge of economic fundamentals. Furthermore, the frothy nature of stock markets is clear from the fact that the 40% decline in the equity market since its peak in mid-2015 still returned the market to roughly the same value as it had been at the start of 2015. Nevertheless, the fresh round of decline in equity values at the start of January 2016 did coincide with data on the continuing declining trend in the economy. The fall was triggered initially by the December 2015 manufacturing Purchasing Managers' Index reading, which was below expectations and therefore showed that industrial production had slowed for the tenth successive month.

The linkage between Chinese stock market movements and those of other major markets in the region can be seen from their co-movement at times of sharp declines in the former in the first two weeks of 2016 (see figure 1.8). While the Shanghai stock market fell by 15%, the Hang Seng Index of Hong Kong,

Figure 1.8 **Equity market performance of China and selected Asia-Pacific economies, 2014-2016**



Source: ESCAP, based on data from CEIC Data. Available from www.ceicdata.com (accessed 31 March 2016).

China declined by 9.2%, Japan's Topix fell by 6.5%, Taiwan Province of China's Taiex by 6.6%, and India's Sensex by 4.7%. For the broader MSCI Asia-Pacific stock market index, the first two weeks of 2016 ranked as having the poorest start since 2000. The falls experienced by Asian stock markets in response to those in China reflect to some extent the strength of export linkages in the region with China and the belief that equity market falls in China are a sign of increasing concerns regarding growth in the economy.

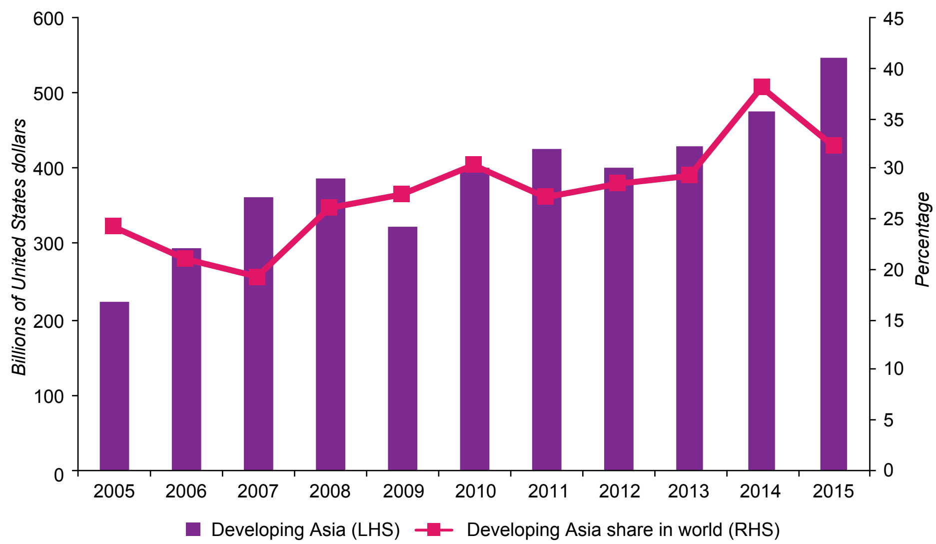
Another factor, which is also linked to China, driving capital outflows from the region has been movements in the country's currency. In the first week of January 2016, China allowed its currency to depreciate significantly, by a total of 1.5% against the United States dollar. In December 2015, China had already signalled that it would no longer consider currency stability in comparing it to the dollar and would instead consider the renminbi against a basket of 13 currencies. This change allows the renminbi to weaken more sharply against the dollar than in the past, which is especially pertinent in a period when the dollar is expected to strengthen as United States interest rates rise. Indeed, between the announcement of the basket in December 2015 and 11 January 2016, while the Chinese currency weakened 2.5% against the dollar, the renminbi weakened only 0.9% against the basket. However, uncertainty also exists regarding the future direction of currency moves by China as the central bank has used its foreign exchange reserves significantly since the depreciation of early January 2016. Reserves fell by $99.5 billion in January 2016 to $3.23 trillion after having fallen $513 billion in 2015, as the central bank had previously sought to maintain the dollar peg (Reuters, 2016).

Reflecting the linkage between regional currency markets and that of China, Asian currencies fell in tandem with the Chinese currency at the start of 2016. The Korean won declined by 3.1%, the Malaysian ringgit depreciated by 2.1%, and the Singapore dollar and Indonesian rupiah by about 1%. The decline in Asian currencies reflects concerns about export competition with China and other regional competitors in the face of depreciating currencies. Other than China, an important regional competitor which has seen its currency lose value has been Japan, experiencing a decline of 10% in the value of the yen against the dollar since mid-2014. Nevertheless, for less-advanced economies in the region, China remains a more direct export competitor than Japan due to the nature of the goods that it exports.

While portfolio flows are expected to decline, the outlook for foreign direct investment in the region is more positive

The share of the foreign direct investment (FDI) inflows into the Asia-Pacific region in global FDI flows has been on an increasing trend since 2005, although it declined in 2015. Asia and the Pacific as a whole received significant FDI inflows totalling $548 billion in 2015, a rise of 15% over that of 2014, according to the latest data available (see figure 1.9) (UNCTAD,

Figure 1.9 **Inflows of foreign direct investment into the Asia-Pacific region and their share in global inflows, 2005-2015**



Source: UNCTADstat.

Note: The UNCTAD grouping for "developing Asia" does not include ESCAP economies in North and Central Asia and in the Pacific. LHS = left-hand side; RHS = right-hand side.

2016). Hong Kong, China was the largest recipient of FDI in line with its position as a gateway to China, followed by China itself, Singapore and India in that order. The Asia-Pacific region has also continued to grow as a major outward investor, continuously increasing its share of global FDI outflow since 2010, with total FDI from the region reaching $563 billion in 2014, representing 41.6% of total global FDI outflow, according to the latest data available. The majority of outward investment came from China. Intraregional FDI is gaining more importance, with 60% of total greenfield investment coming from the Asia-Pacific region.

Foreign direct investment has benefited from an improved investment environment and deeper regional integration

There are various reasons behind the good performance of the region as whole. First, the investment environment has improved, with national and regional investment measures addressing liberalization, facilitation and promotion of FDI. This is true not only for large economies, such as China and India which pursued further liberalization, but also for smaller countries, such as Bangladesh, which despite being one of the least developed countries, has managed to attract a steady inflow of FDI for several decades as a result of its liberal investment policy and incentive regimes. Second, deeper levels of economic integration in Asia and the Pacific have helped to increase intraregional FDI flows as well as overall FDI flows to and from the region. Some examples include the recent establishment of the ASEAN Economic Community, the "one belt one road" initiative[4] and mega regional trade agreements, such as the proposed regional comprehensive economic partnership and the Trans-Pacific Partnership.

Despite the success of the region as a whole, uneven development between economies persists. Least developed countries in the Asia-Pacific region have improved their capacities over time, almost tripling FDI inflows into these countries within a decade, although the share is still relatively small overall. Nevertheless, they continue to rely on natural resources or labour-intensive industries and face a poor business climate, lack of infrastructure and government resources, as well as other macroeconomic and political constraints that prevent them from attracting higher levels of value-added FDI flows. These small and vulnerable economies could benefit considerably from FDI, but enhanced regional cooperation is needed for them to benefit from global and regional value chains.

1.3. Navigating monetary policy trade-offs remains challenging

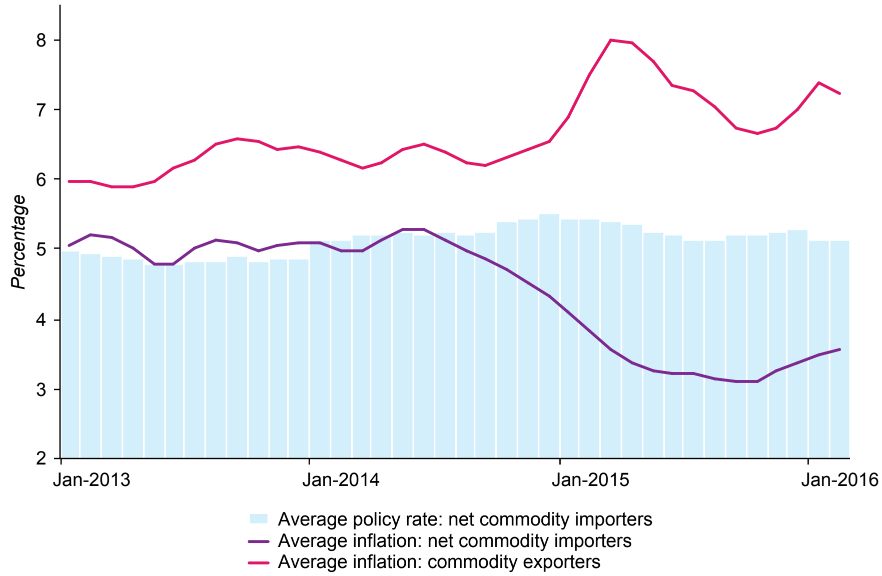
Inflation has declined in most economies in the region except in the commodity-dependent countries

Consumer inflation in developing Asia-Pacific economies was at a multi-decade low rate of 4.1% in 2015.[5] The deep plunge in global commodity prices, especially the prices for crude oil, with Brent crude prices falling from $109 per barrel in June 2014 to $37 per barrel in December 2015, mainly accounted for the lower inflation. In economies where official data on core inflation, or overall inflation excluding food and energy items, are available, there is some evidence that an economic slowdown also contributed to softer inflationary pressure.[6]

While inflation is low in the region as a whole, there is considerable divergence between subregions and economies, with commodity-dependence being an important driver. In economies with sizeable commodity exports, subdued commodity prices weakened their terms of trade and external account performance, which resulted in deep currency depreciations and higher inflation rates (see figure 1.10). In contrast, inflation in net commodity-importing economies continued its downward trend that started in mid-2014 and continued into 2015. Producer prices indeed decreased in most of these economies in 2015, ranging from about 2.5−5.5% in China, India, Pakistan, the Republic of Korea and Thailand to about 9% in Singapore and Taiwan Province of China. Without the rationalization of energy price subsidies that took place in many economies in the region, such as India and Indonesia, the pass-through from producer prices to consumer prices would have been stronger and would have resulted in even lower consumer inflation in 2015.

In economies with low inflation and/or weak domestic demand, the outcome has been easing of monetary policy. The Republic of Korea, Sri Lanka and Thailand lowered their policy interest rates by 50 basis points in 2015, while India reduced them by 125 basis points and Pakistan by 300 basis points. In all of these economies, the policy rates reached their multi-year low levels by end-2015. In the early months of 2016, Bangladesh and Indonesia also reduced their policy rate by 50 basis points each. However, monetary policy considerations should go beyond concerns of near-term economic growth and inflation, and be mindful of other issues, such as financial stability, exchange rate movements and capital flows. For instance, amid excessive growth of broad money, Sri

Figure 1.10 **Monthly inflation and policy interest rates in selected Asia-Pacific economies, 2013-2016**



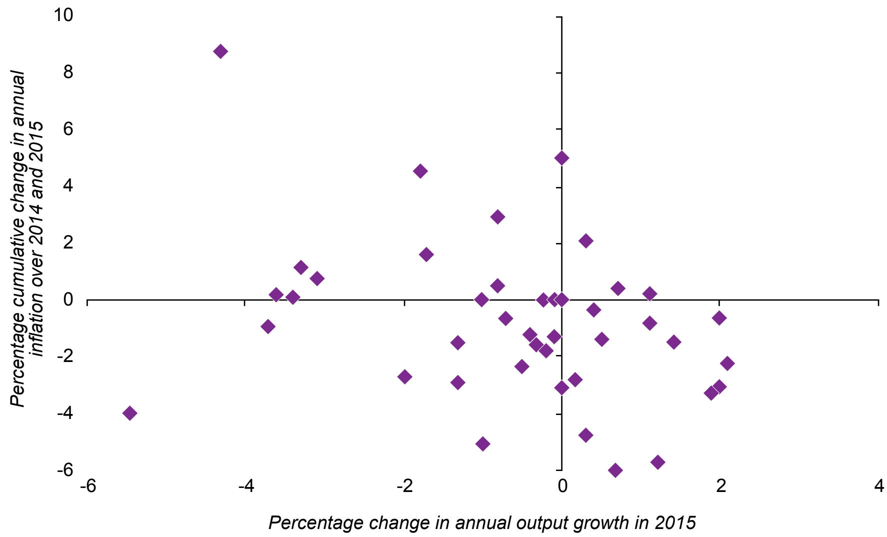
Source: ESCAP, based on data from CEIC Data. Available from www.ceicdata.com (accessed 31 March 2016).

Note: The inflation rates are calculated as unweighted, 3-month moving averages of consumer price indices in 20 net commodity-importing economies and 5 commodity-exporting economies. These unweighted average values helped to lessen both the downward bias caused by low inflation in China for the former group and the upward bias caused by high inflation in the Russian Federation for the latter group. The other four countries considered here as commodity exporters are Armenia, Azerbaijan, Kazakhstan and Mongolia.

Lanka reversed its eased monetary policy stance by raising the policy rate by 50 basis points in February 2016 after a reduction of a similar magnitude in April 2015.

An important point worth highlighting is that the low inflation, along with the easy monetary policy stance of the last few years, has not really lifted economic growth, as usually would tend to be the case. Figure 1.11

Figure 1.11 **Percentage change in annual output growth in 2015 against cumulative percentage change in annual inflation in 2014 and 2015 for selected Asia-Pacific economies**



Source: ESCAP, based on data from CEIC Data. Available from www.ceicdata.com (accessed 31 March 2016) and national estimates.

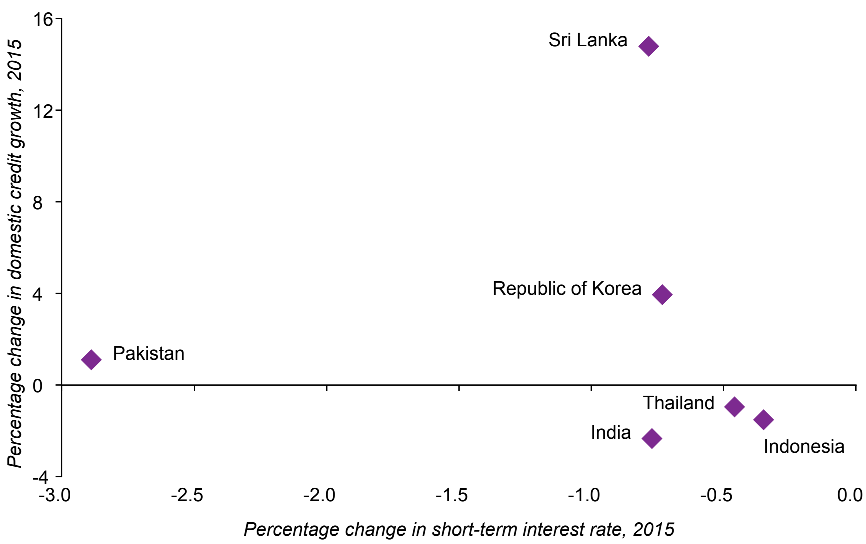
depicts a scatter plot between recent changes in annual output growth and inflation and shows that there is mixed evidence on the growth-inflation nexus. In particular, of 29 economies where inflation moderated over the period of 2014 and 2015, economic growth accelerated in 2015 relative to that of 2014 in only 13 economies (bottom-right quadrant).[7]

The disconnect between growth, inflation and monetary policy can be attributed to a combination of several interconnected factors. At the macro level, this period of low inflation has been clouded by uncertainty due to an unfavourable economic environment, such as concerns over an uneven economic rebound in advanced economies, growth deceleration in the region and heightened volatility in financial markets. These developments weighed on consumer sentiments and constrained private consumption, particularly amid rising household debt levels in some economies in the region. Moreover, despite lower inflation, it appears that real wage growth has slowed in many economies. This could be because subdued economic activity and low inflationary expectations limited nominal wage adjustments.[8]

Fixed investment has not responded to monetary policy easing as well. One reason is a limited pass-through from a lower policy rate to lower short-term interest rates in 2015, as observed in such economies as Kyrgyzstan, Nepal, the Russian Federation, Taiwan Province of China and Turkey. In several countries where short-term interest rates did decrease following monetary policy easing, the evidence on the link between borrowing costs and domestic credit growth is mixed (see figure 1.12). In India, Indonesia and Thailand, domestic credits expanded at a slower pace in 2015 relative to 2014 despite lower short-term interest rates. In India, investors remained cautious, as economic growth prospects are contingent upon progress being made in structural policy reforms. In Indonesia and Thailand, weak domestic demand held back investment decisions. Sluggish economic activity means that Thailand's industrial capacity utilization rate has declined steadily since mid-2013 and stood at only 63% at end-2015, resulting in new investment projects being postponed. Another factor that held back fixed investment growth despite lower nominal interest rates is the increase in real interest rates. In particular, inflation-adjusted lending rates in Hong Kong, China; Malaysia; the Philippines; Singapore; and Thailand increased by 0.7-2.6 percentage points in 2015 relative to the levels in 2014. All of these economies registered slower domestic credit growth in 2015.

At the micro level, the impact of lower commodity prices on income distribution is contributing to low growth in domestic consumption. Low inflation over the last few years is largely driven by decreases in fuel prices, which tend to disproportionally benefit higher-income groups due to the higher share of fuel in their consumption basket.[9] However, consumption by higher-income groups is typically less sensitive to price changes, so the impact of lower inflation

Figure 1.12 **Percentage change in interest rate and domestic credit growth, 2015**



Source: ESCAP, based on data from CEIC Data. Available from www.ceicdata.com (accessed 31 March 2016).

on additional spending tends to be small. Moreover, falling global oil prices in the past few years have coincided with lower international food prices, which are also reflected in much smaller food price increases in most economies in the region,[10] a situation that tends to reduce farm incomes and limit consumption among rural households.

In looking forward, consumer inflation in developing Asia-Pacific economies is projected to soften slightly more in the near term, to 3.7% in 2016 and 3.6% in 2017. The decrease is expected to be underpinned by lower inflation in the North and Central Asian subregion, especially in the Russian Federation. In other subregions, inflation is generally anticipated to edge up from a low base in 2015. Indeed, there are more countries where inflation is projected to rise in 2016 and 2017 than those with lower or stable inflation, including China and India.

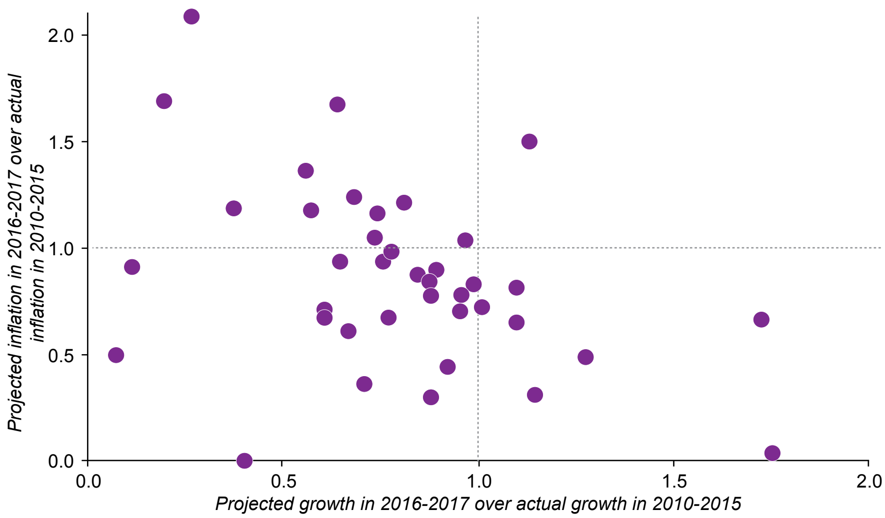
Considerations relating to financial stability and external account stability will have an influence on the conduct of monetary policy

A low-growth, low-inflation environment in the region, all things being equal, would generally suggest that there is further room for an easy monetary policy stance in the coming few years. Figure 1.13 shows that, of 48 Asia-Pacific economies, 22 of them are set to experience lower growth and inflation rates in 2016 and 2017 relative to their past trends recorded during the period 2010-2015 (bottom-left quadrant). This group of economies includes, among others, emerging economies, such as China; Hong Kong, China; Indonesia; the Republic of Korea; Singapore; and Turkey, as well as economies with smaller, less accessible financial markets, such as Armenia, Azerbaijan, Fiji, the Lao People's Democratic Republic, Maldives, Mongolia, Nepal and Solomon Islands. As far as monetary policy goals of promoting steady economic growth and maintaining price stability are concerned, monetary policy support can be deemed desirable in these economies given below-trend growth and inflation prospects.

Meanwhile, there are countries where projected growth also falls below past trends, but the use of an accommodative monetary policy stance may be constrained due to higher-than-trend inflation expected in the coming years (top-left quadrant). This group of countries is dominated by North and Central Asian economies, such as Georgia, Kazakhstan, the Russian Federation and Turkmenistan. Malaysia and Samoa also belong to this group but their average inflation in 2016 and 2017 is projected to remain modest, so there may still be room for some monetary policy support.

Nevertheless, in many economies with prospects for below-trend growth and inflation, considerations relating to financial stability will also have an influence on the conduct of monetary policy. In particular, a monetary policy stance that is kept too loose for too long could undermine domestic financial stability because firms and individuals tend to undertake riskier investment decisions when their balance sheets look stronger than

Figure 1.13 **Projected output growth and inflation in 2016 and 2017 relative to trends in the period 2010-2015 for selected Asia-Pacific economies**



Source: ESCAP, based on data from CEIC Data. Available from www.ceicdata.com (accessed 31 March 2016) and national estimates.

they would otherwise. The need to strike a balance between the role of monetary policy in supporting economic growth and ensuring financial stability is especially relevant in economies where household and/or corporate debt levels are already relatively high or rising rapidly, such as China, the Republic of Korea and Singapore,[11] as well as those with currently high loan default ratios, such as Armenia, Maldives and Mongolia.[12]

Similarly, monetary policy and related liquidity-generating developments in advanced economies also tend to have a bearing on the conduct of monetary policy in emerging economies. The key channel of influence is external account stability via sharp changes in capital flows and exchange rates, which in turn has implications for domestic financial stability in terms of changes in the balance sheets of corporates and banks. In this context, as interest rate increases in the United States move forward, the gap between interest rates in the United States and the region could narrow further and potentially result in greater capital outflows and currency depreciations. In such circumstances, it could become difficult for developing economies in the region to lower their interest rates further despite low inflation and weak economic growth. They may consider continuing with current levels of interest rates, provided a weaker exchange rate is accepted and does not undermine external account stability. These conditions are quite constrained in such economies as Turkey where the size of external debt and reliance on foreign funds have increased markedly since the global financial and economic crisis began in 2008.

While monetary policy support may be feasible in economies facing prospects for below-trend growth and inflation as well as concerns about low financial stability, the effectiveness of monetary policy could still remain limited in some cases. For example, the economies of Armenia, Azerbaijan, Maldives and Mongolia are characterized by a high degree of dollarization (Mwase and Kumah, 2015), which tends to weaken monetary policy effectiveness because the foreign currency component of broad money cannot be controlled directly by monetary authorities. Similarly in Fiji, the Lao People's Democratic Republic, Nepal and Solomon Islands, their less developed financial markets typically limit the monetary policy transmission mechanism.[13] Nonetheless, although eased monetary policy may not help to actively boost household consumption and business investment in such economies, such a policy should still indirectly support economic growth. For example, lower domestic interest rates help to reduce a Government's debt servicing costs; such savings could be used to finance fiscal support programmes or scale down planned fiscal consolidation. However, incorporating such fiscal considerations while deciding upon the monetary policy stance would require the existence of a credible and independent central bank along with transparent and established coordination mechanisms with the fiscal authority.

1.4. Fiscal policy requires balancing fiscal discipline and flexibility

Countercyclical fiscal policy potentially can play a supportive role for economic growth, provided fiscal sustainability is ensured

Given the gradually declining trend in economic growth in developing economies in the region, countercyclical fiscal policy, unlike monetary policy, potentially can play a more supportive role for growth. Indeed, the stance of fiscal policy in the region in 2015 was largely countercyclical and expansionary. China pushed ahead with large infrastructure projects and provided tax breaks and other relief measures for corporations.[14] India adjusted its fiscal consolidation path to allow for more capital expenditures.[15] Indonesia reallocated most of its savings from a fuel subsidy cut to infrastructure and social spending. The Republic of Korea and Thailand passed supplementary budgets aimed at stimulating domestic demand. However, the Russian Federation had to cut public spending as oil and gas revenues continued to decline, although it was able to draw on past windfall savings to mitigate some of the adverse impacts.[16]

For a number of least developed countries and small island developing States, the concern is not only cyclicality but also how to expand public goods and services in support of national development without risking fiscal sustainability or "overheating" the economy. Total government expenditures have grown rapidly in Myanmar, for instance, albeit from a low base. Fiji and a number of other Pacific island economies have also scaled up capital expenditures in recent years.

Whether fiscal policy is aimed at stabilizing the economy or supporting national development, an important consideration has to do with fiscal sustainability. By and large, most developing countries in the region have relatively low government debt as a percentage of GDP, which fell significantly during much of the 2000s due to the implementation of prudent policies as well as rapid economic growth. The declining trend was reversed in the wake of the global financial and economic crisis that began in 2008; after stabilizing somewhat in the years immediately following the crisis, government debt levels recently began to pick up again (see figure 1.14). On average for the region, the general government debt level is estimated to have increased to a still manageable 42% of GDP in 2015 compared with 36% in 2007.

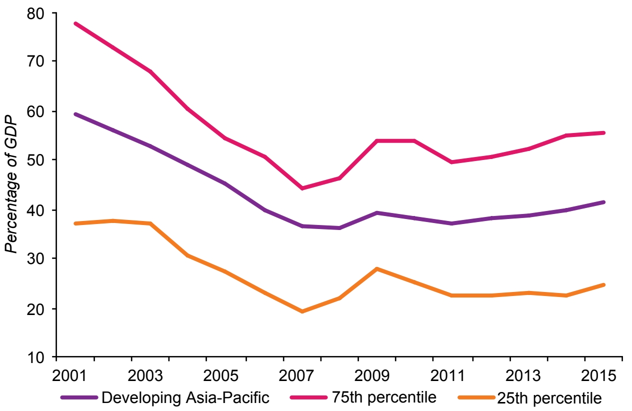
Finding the right balance between fiscal discipline and flexibility is important to support the development needs of the region

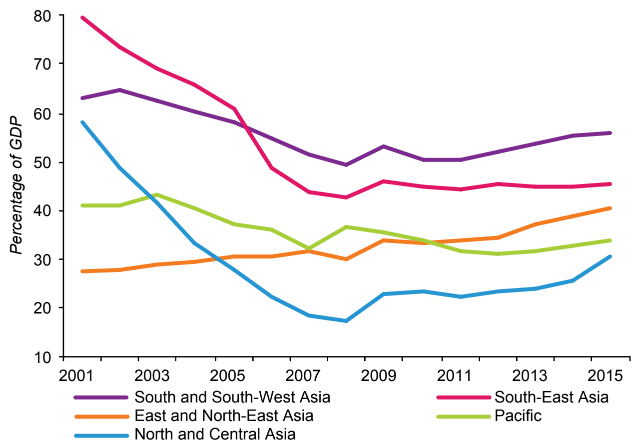
It should be recognized that there is no mechanical or universally accepted threshold for limiting public debt, a fact that has been confirmed by recent empirical studies (Pescatori, Sandri and Simon, 2014). Moreover, as fiscal austerity measures, informed by the notion of a unified threshold, prompted sharp output declines in Europe, the policy relevance of holding on to a particular threshold has been questioned. Ultimately, each country needs to assess the costs and benefits of higher public debt, for instance smaller margins to cope with contingent risks against faster achievement of education, health and other development goals.[17] If deemed necessary, consolidation could be done in a phased and comprehensive manner – for instance by establishing a medium-term framework for reprioritizing expenditures and broadening the tax base – rather than by making sudden cuts in capital expenditures, which could be self-defeating by eventually retarding growth. For instance, India's latest deficit reduction effort has been accompanied by fuel subsidy reform, which itself was well sequenced, and tax reform, which leaves more room for making capital expenditures.

Similarly, for countries which have fiscal rules, it is important to find the right balance between fiscal discipline and flexibility.[18] For instance, Indonesia's budget balance rule requires the general government budget deficit not to exceed 3% of GDP in any given year. Amid slower growth and revenue shortfalls, concerns have been raised that the Government's 2016 budget, which contains significant allocations for infrastructure, health and other priority areas, may need to be revised.[19] Some flexibility may be warranted, especially given Indonesia's relatively low public debt. For instance, a cyclically adjusted budget deficit rule or a fiscal rule can be considered in which public investment and other priority outlays are excluded from the perimeter of the rule. Redesigning the fiscal rule in such a manner would leave more space for countercyclical and development-oriented fiscal policies.[20] It should also be noted that such countries as China and the Republic of Korea do not have legally binding rules but only internal guidelines for preparing their budgets, which have been generally effective.

As had been argued in the year-end update of the Survey for 2015 (ESCAP, 2015d), an important consideration beyond stabilization is the potential impact of fiscal policy on the distribution of income and opportunities and on long-term economic growth. Spending on education, health and infrastructure are particularly important in this regard, and countries are trying to scale up such spending by phasing out inefficient and regressive expenses. For instance, India, Indonesia and Malaysia implemented fuel subsidy reforms, often accompanied by targeted

Figure 1.14 **General government gross debt in selected Asia-Pacific economies, 2001-2015**





Source: ESCAP, based on data from International Monetary Fund, *World Economic Outlook, October 2015: Adjusting to Lower Commodity Prices*. Available from www.imf.org/external/pubs/ft/weo/2015/02/pdf/text.pdf.

Note: The figure covers 39 developing economies in the region, but excludes Australia, Japan and New Zealand. Data for 2014 and 2015 are estimates.

mitigating measures, such as cash transfers for low-income households.[21] However, allocating the budget across competing priorities and necessary expenses is not a straightforward task. For instance, several Governments have significantly increased civil service pay and allowances, or plan to do so in the coming years, but this may "crowd out" other expenses. While the "optimum" allocation would ultimately depend on a country's circumstances and preferences, a comparison with regional peers and relevant variables, such as the child mortality rate for health spending, may shed some light.

Social expenditures, which are important for inclusive and equitable growth, are increasing, albeit from a low base. Indonesia allocated 5% of its 2016 national budget to health expenditure compared with 3% in 2014 (Negara, 2016). Many countries, including Indonesia, have committed themselves to achieving universal health coverage (Ly and Yarrow, 2014). The Philippines allocated more than a third of its 2016 national budget to social services, which covers housing, livelihood and community-driven projects. Pakistan is expanding its Benazir Income Support Programme to 5.3 million beneficiaries. Many countries in the region have similar conditional cash transfer programmes. Aside from increasing the size of the budget concerned, access and affordability for the poor should be enhanced. For instance, in Bangladesh in 2011 skilled birth attendants were present for 64% of births to women in the highest-income quintile but for only 12% of births to those in the lowest-income quintile (ESCAP, 2015b).

Public infrastructure spending is particularly important for long-term growth and requires better implementation capacities

For long-term growth, public infrastructure outlays are particularly important. Several Governments are scaling up capital expenditures, including through debt financing or the sale of certain State assets, as well the reallocation of expenditures and improved revenue collection. Indonesia also recently recapitalized several State-owned enterprises for infrastructure investment. Malaysia has successfully attracted private participation under its Economic Transformation Programme, which helped create a pipeline of bankable projects. India and Thailand are launching new infrastructure funds to attract long-term private financing from sovereign wealth funds and pension funds. However, aside from financing, it is important to improve project selection, as well as management and implementation capacities across the board.

Government expenses can be improved along economic classification and functional lines. A number of countries are increasing civil service pay and allowances. In Cambodia, minimum monthly salaries for civil servants are expected to rise to $250 by 2018, which is equivalent to $3,000 annually, compared with the annual per capita income of $1,100 in 2014. In Bangladesh, it was recommended in the 2015 review of public sector pay that base pay for all grades be approximately doubled and that significant changes be made in terms of allowances. Keeping in mind that developing the quality of the civil service requires wide-ranging reforms beyond pay, Governments should make an effort not to compromise critical social and infrastructure spending. In addition to such indicators as the cost of living, Governments can also compare the wage bill with the size of other expenses, such as the consumption of goods and services, subsidies and social benefits that are administered by employees (see figure 1.15).

In term of government financing of expenditures, while borrowing is an option especially in times of low financing costs,[22] there is a risk that interest payments may ultimately limit the Government's spending capacity. For instance, countries such as India, Pakistan and Sri Lanka spent an estimated equivalent of 4-5% of their GDP on interest payments in 2015 (see figure 1.16).[23] The composition of debt matters. In Pakistan, heavy reliance on short-term borrowing makes debt dynamics sensitive to interest rate changes. Limited access to concessional external financing has also pushed countries such as Viet Nam to rely more on domestic debt at higher interest rates and shorter maturities.

1.5. Growing household and corporate debt indicate increasing risks

Household and corporate debt has risen rather sharply in recent years in some economies, increasing the risks for the region

The risks for the region due to slowing growth as well as capital outflows have been heightened in some economies due to high levels of household and corporate debt, which have increased significantly in a number of countries in the past decade. Those levels are being driven by low interest rates, ample liquidity and increased access to cross-border loans and international capital markets. In the wake of the global financial and economic crisis that started in 2008, debt-driven consumption and investment played an important role in sustaining the region's high economic growth rate. Greater use of debt had

Figure 1.15

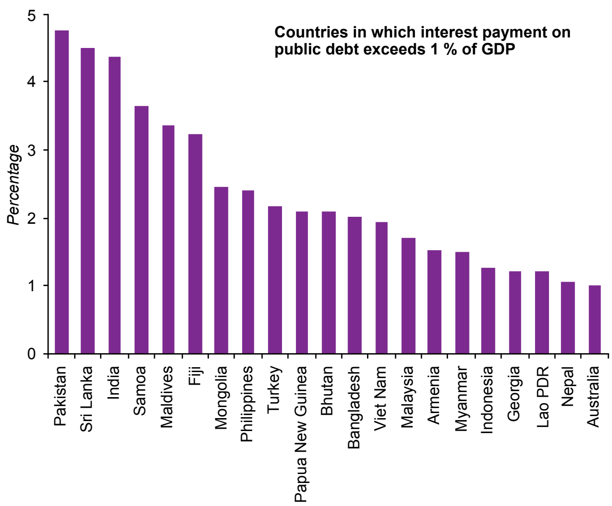
Government expenditures on employee compensation

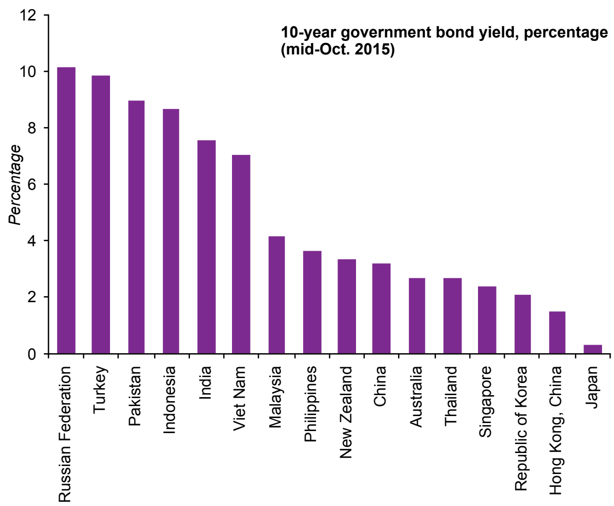
Source: ESCAP, based on data from International Monetary Fund, Government Finance Statistics.

Note: Data are for 2014 or latest available year. Selected non-compensation expenses consist of the use of goods and services, subsidies and social benefits; expenditures such as grants are excluded. LHS = left-hand side; RHS = right-hand side.

Figure 1.16

Government expenditures on debt servicing





Source: ESCAP, based on data from International Monetary Fund, *World Economic Outlook, October 2015: Adjusting to Lower Commodity Prices*, and Trading Economics. Available from www.tradingeconomics.com.

Note: The estimated interest payment for 2015 was calculated as the difference between estimated government overall balance and primary balance in 2015.

desirable aspects, reflecting the region's financial development. Events in the past year, however, have exposed the risks associated with higher debt – both in terms of financial stability and future growth prospects. In particular, the depreciation of the Chinese currency since August 2015 and the increase in interest rates in the United States since December 2015 have prompted large capital outflows from the region and a reassessment of the growth outlook and risks.

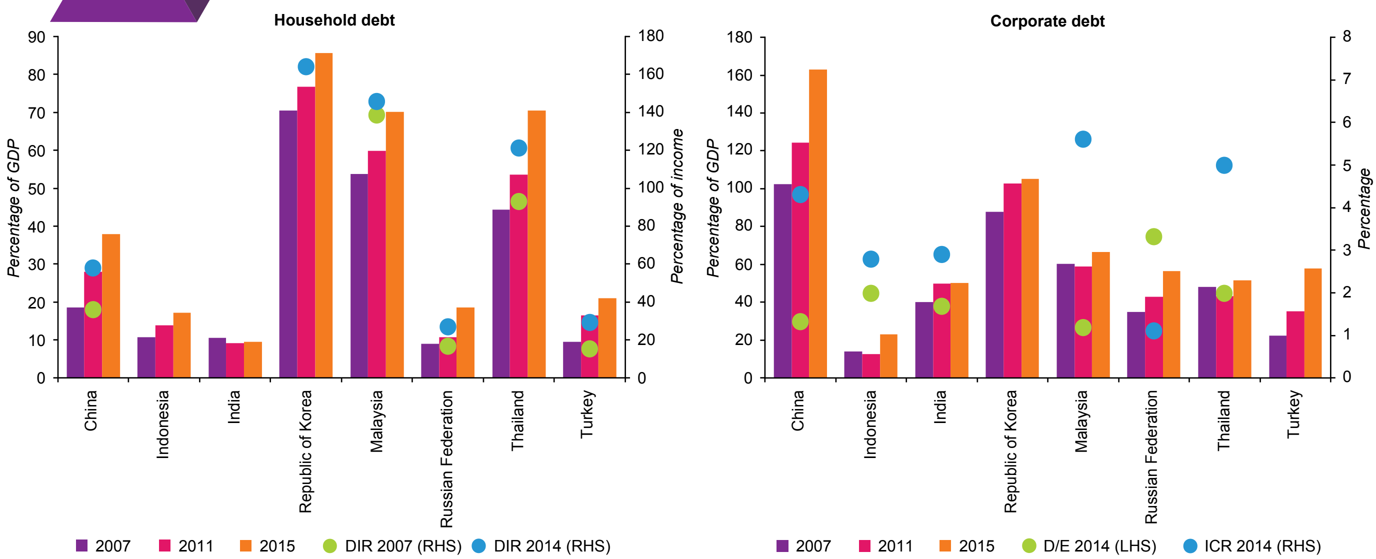
Compared with the situation at the time of the 1997 Asian financial crisis, the region's financial system is now stronger and backed by sizable official reserves. However, debt servicing capacities of the private sector may be more constrained at this time in view of the economic slowdown and subdued earnings. Debt exposure to highly cyclical or excess capacity sectors, such as real estate, construction, energy and heavy industries, will prove to be a challenge in the deleveraging stage. The confluence of shifts in the global financial and commodity cycles could also have negative implications for some countries.

The latest available data show that household debt is as high as 86% of GDP or 164% of disposable income in the Republic of Korea and also quite high in Malaysia and Thailand. Corporate debt is as high as 163% of GDP in China, although firm-level indicators of leverage and debt-servicing capacity suggest that firms in India, Indonesia and the Russian Federation may be more vulnerable to shocks (see figure 1.17). While private debt levels tend to rise with higher incomes, the rapid pace of increase in the past decade has raised concerns. Historically, episodes of rapid credit growth have almost always been followed by a banking crisis, as in the case of the 1997 Asian financial crisis. Since 2007, the private debt to GDP ratio (household and corporate debt combined) surged by some 80 percentage points in China and by 30-40 percentage points in Malaysia, the Republic of Korea, Thailand and Turkey, as the growth of debt far outpaced nominal growth of GDP. In other words, mortgage loans and consumer loans grew faster than household disposable income while corporate leverage increased.

Even if conditions are broadly manageable, pockets of risk still exist

Although debt may eventually boost incomes and assets if it is effectively invested, the immediate implication of higher and rapidly increasing debt is a rise in the private sector's debt service ratio, with a higher share of household incomes and corporate earnings going to debt servicing. If deemed unsustainable, this situation may encourage some deleveraging and act as a drag on domestic demand. Alternatively, debt

Figure 1.17 **Household and corporate debt in selected Asia-Pacific economies**



Source: ESCAP, based on credit to the non-financial sector data set, Bank for International Settlements; household accounts data set, OECD; Richards Dobbs and others, "Debt and (not much) deleveraging", McKinsey and Company; and Julian Chow, "Stress testing corporate balance sheets in emerging economies", International Monetary Fund Working Paper WP/15/216 (Washington, D.C., IMF, 2015).

Note: Household debt is shown as percentages of GDP (left axis) and disposable income (right axis); DIR = debt to income ratio. Corporate debt, excluding financial institutions, is expressed in terms of GDP. This is complemented by firm-level indicators from the Orbis database, as reported in Chow (2015) referenced above. D/E = debt to equity, or corporate leverage. ICR = interest coverage ratio, or corporate earnings before interest and taxes to interest. Debt to GDP ratios for the first quarter of 2007 and 2011 and second quarter of 2015 (latest available). LHS = left-hand side; RHS = right-hand side.

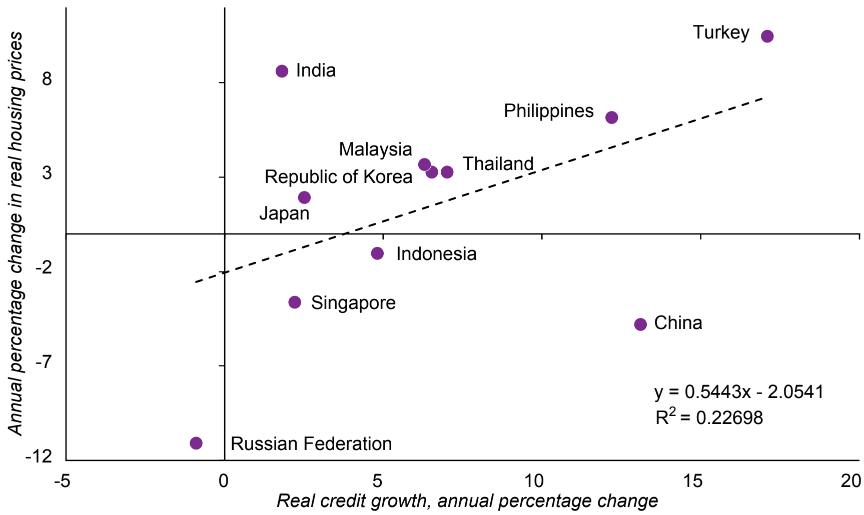
levels may increase further to sustain high levels of spending, in which case sustained economic growth would come at the cost of increased financial risks and a potentially sharper slowdown in the future.

There are two caveats to this growth-instability nexus. First, if debt accumulation is used productively and increases the region's capital stock, both growth and stability may be achieved. Nevertheless, history suggests that financial booms tend to go hand in hand with significant resource misallocations (BIS, 2015). Second, if countries manage to restructure debt efficiently, by lowering refinancing costs and lengthening maturities, a more gradual deleveraging with relatively low financial risks may be achieved. China, Malaysia and the Republic of Korea seem to be taking this path.[24] However, this strategy also could result in the encouragement of even more borrowing.

Debt sustainability would vary across households and corporates, so that pockets of risk could exist even if the overall picture looks manageable. In the case of household debt, a particular concern is the disproportionate amount of debt held by households with low capacity to service debt.[25] In Thailand, debt servicing as a share of income was 27% for all households but nearly 50% for the poorest income quintile in 2013 (Muthitacharoen, Nuntramas and Chotewattanakul, 2014). In the Republic of Korea, where the household debt-to-income ratio has surpassed 160%, much of the debt is owed by the self-employed in low-productivity service sectors (Bank of Korea, 2015). Another risk is that much of what is considered household assets as well as debt are tied to the real estate sector, making households vulnerable to fluctuations in the price of housing. House prices and credit have grown rapidly in a number of countries and exhibit a positive correlation (see figure 1.18). Even in China, India and Indonesia, where credit to households is relatively small, mortgage lending has been growing rapidly; in China, where the household debt-to-income ratio neared 60% in 2015, mortgage loans made up half of the credit extended to households.

Corporate debt concerns are not new to Asia, and the recent increase in corporate leverage (debt to equity) may seem rather insignificant compared with the deleveraging that followed the 1997 Asian financial crisis. There was also significant deleveraging in State industrial firms in China during the second half of the 1990s and early 2000s. Nevertheless, the renewed increase in leverage in the wake of the 2008 crisis raises several concerns. Firm-level data reveal that the most highly leveraged firms tend to have lower profitability and lower interest coverage ratios (earnings to interest) and to be less liquid (IMF, 2014). In India, a third of corporate debt is owed by companies with debt-to-equity ratios exceeding 300%, and many firms carry high interest burdens. In China, indebtedness of State-owned enterprises soared even as the return on assets fell, in contrast to foreign and private industrial firms which were cutting their leverage and boosting their profitability (Rutkowsky, 2015).

Figure 1.18 **Growth of housing prices and credit in selected Asia-Pacific economies, last 12 months**



Source: ESCAP, based on data from Global Housing Watch, International Monetary Fund.

Moreover, as suggested previously, leverage has grown in highly cyclical or excess capacity sectors, such as real estate, construction, energy and heavy industry. This combination – along with the high dollar exposure (as discussed below) – leaves the corporate sector highly vulnerable to shocks. A stress test of the resilience of the corporate sector to shocks, such as exchange rate depreciation, earnings decline and increases in borrowing costs, shows that debt at risk could spike significantly even from relatively low levels (Chow, 2015).

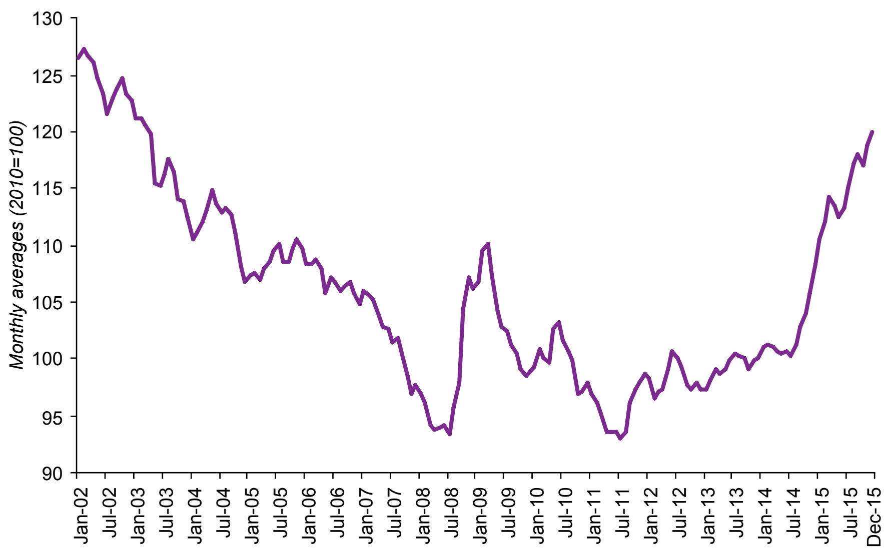
Risk exposure increases when the increase in dollar-denominated corporate debt is considered

In addition to the sharp increase in debt, a related concern is the exposure of corporates to external debt, in particular the share of debt denominated in United States dollars. This is because the United States federal fund rate has begun to rise, which will cause increases in dollar financing and refinancing costs (for maturing loans) over the next few years. At the same time, the more traditional risk of currency mismatch has resurfaced amid strengthening of the United States dollar. The nominal effective exchange rate of the dollar depreciated before the start of the crisis in 2008, but has been appreciating since 2011 and at a faster pace more recently (see figure 1.19). Currency-related risks are mitigated if there are natural hedges, such as export earnings, or hedging via derivatives. In this regard, there seems to be quite a variation across countries and sectors. For instance, the currency composition of assets and liabilities are less likely to be matched by property developers in China or energy and utility firms in India, which have been among the most active international debt issuers in recent years. Also, compared with corporates in the Republic of Korea (which are known to have access to liquid domestic or offshore markets that support financial hedging strategies for both currency and interest rate risk exposures), peers in China and Indonesia are less likely to be hedged as markets may not be deep enough to provide appropriate and cost-effective hedging (Chui, Fender and Sushko, 2014).

As of mid-2015, United States dollar debt held by non-bank borrowers, including non-bank financial institutions and government debt as well as non-financial corporate debt, in selected major Asia-Pacific developing economies stood at $2.1 trillion, two thirds of which amount was in dollar loans (domestic and cross-border) and a third in dollar bonds (including offshore), although the ratio varied across countries. While China stands out in absolute terms, its dollar debt as a share of annual exports and foreign currency reserves was on the lower end, that is, 52% and 35%, respectively (see figure 1.20). Turkey on the other hand had debt-to-exports and debt-to-reserves ratios as high as 127% and 200%, respectively.

In considering non-financial corporate debt only, the share of dollar debt is estimated in the range of 5-10% in China, India, Malaysia and the Republic of Korea

Figure 1.19 **Nominal effective exchange rate of the United States dollar, 2002-2015**



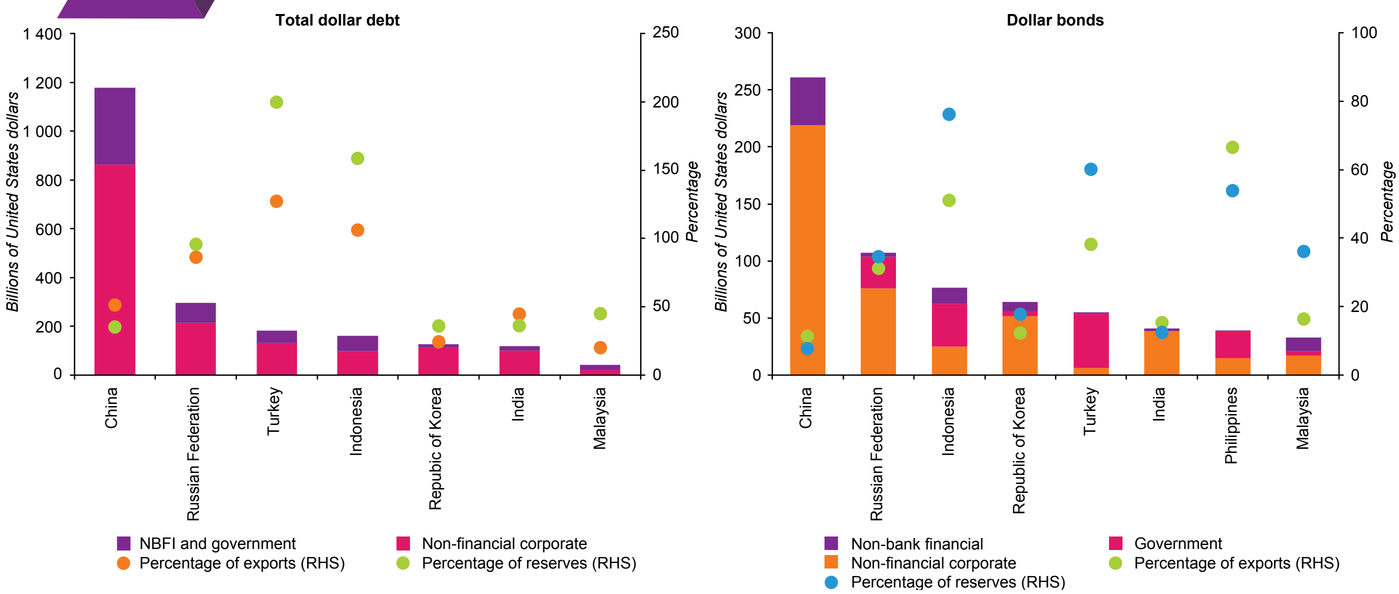
Source: Bank for International Settlements.

Note: Monthly averages of the value of the currency against a weighted average of several foreign currencies; data until December 2015.

compared with about 30-50% in Indonesia, the Russian Federation and Turkey (McCauley, McGuire and Sushko, 2015). Figure 1.20 also shows data for dollar bonds only; Indonesia, the Philippines and Turkey seem to have relatively large dollar exposures compared with their dollar earnings or reserves, although the share of the non-financial corporate sector is relatively smaller.

The implications of dollar debt, including spillovers into the domestic economy, would vary depending on how the dollar debt was used. Firms engaged in international trade borrow dollars to finance dollar-invoiced transactions. They also use dollar credit to fund holdings of inventory and fixed assets at home or to fund productive assets held by affiliates outside the home country.[26] However, the recent sharp increase in corporate debt seems to entail more than just trade finance and domestic and foreign investment, as there was an attempt to profit from interest rate differentials or currency movements (McCauley, McGuire and Sushko, 2015). In other words, firms seemed to have also borrowed dollars to accumulate financial assets, including those in the domestic currency, and thereby were able to engage in carry trade (see figure 1.21). Some dollars were deposited in domestic banks, which may explain how banks

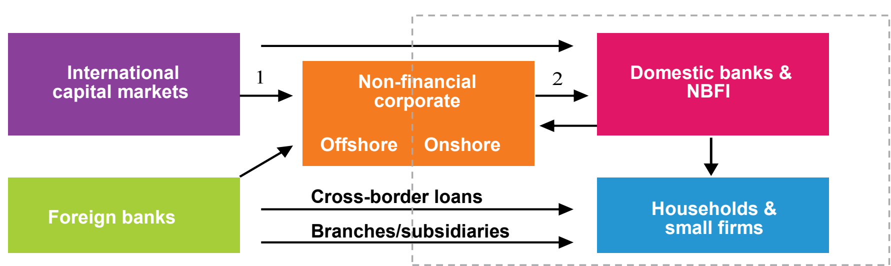
Figure 1.20 Dollar debt in selected Asia-Pacific economies, latest data



Source: ESCAP, based on data from Bank for International Settlements; Robert McCauley, Patrick McGuire and Vladyslav Sushko, "Global dollar credit: links to US monetary policy and leverage", Bank for International Settlements Working Papers No. 483 Basel, Switzerland, BIS, 2015); and CEIC Data.

Note: Data are on dollar debt for the second quarter of 2015, total exports in 2015 and foreign exchange reserves at end-2015. Total dollar debt includes dollar loans as well as dollar bonds. NBFI = non-bank financial institutions.

Figure 1.21 Channels of credit and carry trade



Source: ESCAP.

Note: Arrows indicate the direction of credit – bank loans and debt securities. The dotted line indicates a residence-based domestic economy used in GDP and balance of payments; it differentiates onshore and offshore borrowing. As an illustration of the carry trade, funds raised in international capital markets at a low interest rate (1) are not only used for investment but also deposited in domestic banks at higher interest rates (2). NBFI = non-bank financial institutions, also known as "shadow banks".

were able to increase lending to households and small firms while maintaining relatively stable loan-to-deposit ratios even in countries with relatively low domestic savings. Some of the accumulated cash also funded corporate holdings of higher-yielding domestic assets, such as wealth management products or investment fund shares (Chui, Fender and Sushko, 2014). In such cases, the unwinding of dollar debt may have large spillover effects on the domestic economy beyond the finances of the leveraged firms.

2. MACROECONOMIC POLICY SUGGESTIONS

This section presents some selected policy considerations keeping in view the key short-term and long-term macroeconomic challenges that the region must address to revive sustained and resilient economic growth. In the short term, it will be critical to take measures to mitigate the impact of high private debt in some economies to ensure that growth is not dampened by issues related to financial stability. In the long term, Governments will need to consider approaches to expand tax resources in order to fund productive fiscal policies which will support domestic growth drivers. Finally, Governments' active engagement in initiatives towards greater regional cooperation can boost intraregional trade, investment and financial flows and reduce dependence on extraregional growth drivers.

2.1. Financial sector measures to manage growing corporate and household debt

A comprehensive yet phased approach is needed to address the implications of sharply growing private debt

In order to ensure sustained growth and financial stability, Governments will need to introduce a host of comprehensive measures to address the issue of sharply growing private debt. Policy priorities should include better monitoring of household and corporate liabilities and assets, and effective use of macroprudential and capital flow management tools.[27] Policymakers could also increase the attention paid to banks' sectoral exposures in addition to overall capital adequacy, while accounting for contingent liabilities on the fiscal side. For countries such as China, improving credit allocation and restructuring State-owned enterprises are also critical for achieving debt sustainability. However, as had been argued in the year-end update to the Survey for 2015 (ESCAP, 2015d), policymakers should be aware that abrupt tightening measures may further constrain the private sector's debt servicing capacities and increase debt risks across the board. Thus, a phased yet comprehensive approach is recommended. At the same time, the region's process of financial development should be continued through greater cooperation and integration.

Monitoring of household and corporate finances should include both liabilities and assets, as the quality of assets may also affect the capacity for debt servicing

In terms of monitoring, data on household assets – both financial and real estate assets – could be improved, as the data are scarce compared with those on income and expenditures. Micro and macro-level analysis of household debt would help policymakers better assess the risks both for financial stability and future growth prospects. For instance, in Thailand the primary concern is that higher debt burdens will affect consumption, particularly for low-income households, although there are signs of asset price speculation by retail investors (Bank of Thailand, 2014). Monitoring vulnerable and systemically important firms, as well as banks and other sectors closely linked to them, is also crucial. Such expanded monitoring requires that the collection of data on corporate sector finances, including foreign currency exposure, be improved (IMF, 2015).

However, effective monitoring may be difficult given that companies are not subject to the sort of regulation that is applied to banks. The usual avenue would be to rely on greater public disclosure, either ex ante or ex post. Such requirements could be imposed by the Government or may be included in accounting standards or stock market listing requirements. Companies may fear an adverse response from investors and lenders stemming from the disclosure of significant exposure to foreign currencies and so be dissuaded from borrowing excessively. However, as disclosure through annual reports is infrequent and slow, a case may be made for requiring some form of more frequent disclosure, at least to the authorities, by large companies (Hawkins and Turner, 2000).

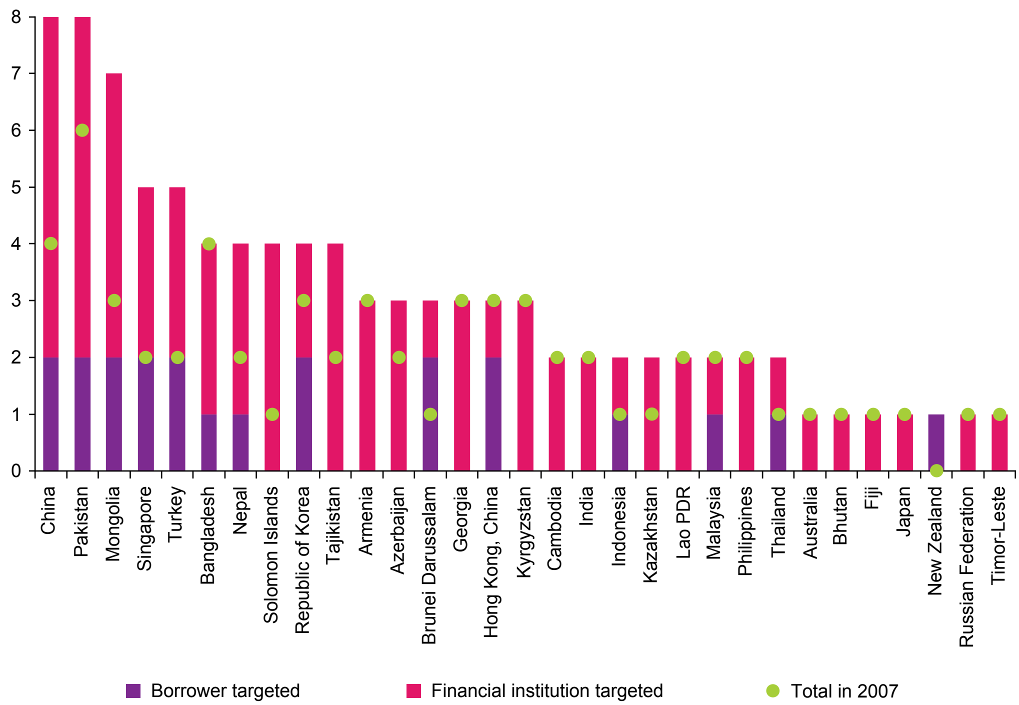
Use of macroprudential and capital flow management tools can be made more effective

Much of the financial stability enjoyed by Asian economies today can be attributed to the prudent measures put into place in the wake of the 1997 Asian financial crisis. However, given the renewed increase in debt, macroprudential measures have been increased in some countries either in terms of the number or the intensity of the measures (see figure 1.22). These actions include borrower-targeted measures, such as limits on loan-to-value ratios (which impose a minimum down payment) and debt-to-income ratios (which restrict unaffordable increases in debt), as well as lender-targeted measures, such as concentration limits (which limit the fraction of assets held by a limited number of borrowers) and limits on foreign currency loans.

Other measures may include sectoral capital requirements, which force lenders to hold extra capital against loans to a specific sector, thus discouraging heavy exposure to that sector. Also, higher risk weights can be imposed, for instance on mortgage loans with high loan-to-value ratios, as in the case of Malaysia. Stricter loan-to-value limits can be applied in order to differentiate speculators with multiple mortgage loans from first-time home buyers. If housing price booms are driven by increased demand from foreign cash inflows that bypass domestic credit intermediation, other tools, such as stamp duties, may be more effective, as in the case of Singapore. At the same time, however, given the low infrastructure stock and the rapid urbanization taking place in many countries, high housing prices may also reflect supply bottlenecks. In such cases, structural policies, including urban planning and expansion of government-subsidized housing, would be needed.

For corporate debt, direct prudential controls could also be considered. For instance, only companies rated above a certain grade, or which can demonstrate that they have either foreign currency income or adequate systems to manage the risk, would be allowed to borrow offshore. Foreign borrowings could be limited in size or a minimum maturity could be set. In India, foreign borrowing (other than trade credit) by companies is regulated by the authorities, which insist on a minimum maturity of five years for loans in excess of $20 million and do not allow put options to subvert this regulation (Hawkins and Turner, 2000).

Figure 1.22 **Number of macroprudential measures used in selected Asia-Pacific economies**



Source: ESCAP, based on data from Eugenio Cerutti, Stijn Claessens and Luc Laeven, "The use and effectiveness of macroprudential policies: new evidence", International Monetary Fund Working Paper No. WP/15/61 (Washington, D.C., IMF, 2015).

Note: The number of measures does not necessarily reflect intensity. Data for 2013 are based on the IMF survey on global macroprudential policy instruments conducted in 2013 and 2014. The macroprudential tools are divided into 12 categories, including 2 borrower-targeted instruments (loan-to-value ratio caps and debt-to-income ratios) and 10 financial institutions-targeted instruments (dynamic loan-loss provisioning, capital buffer requirements, leverage ratio, capital surcharges on systemically important financial institutions, limits on interbank exposure, concentration limits, limits on foreign currency loans, foreign exchange and/or countercyclical reserve requirements, limits on domestic currency loans, and levy or tax on financial institutions).

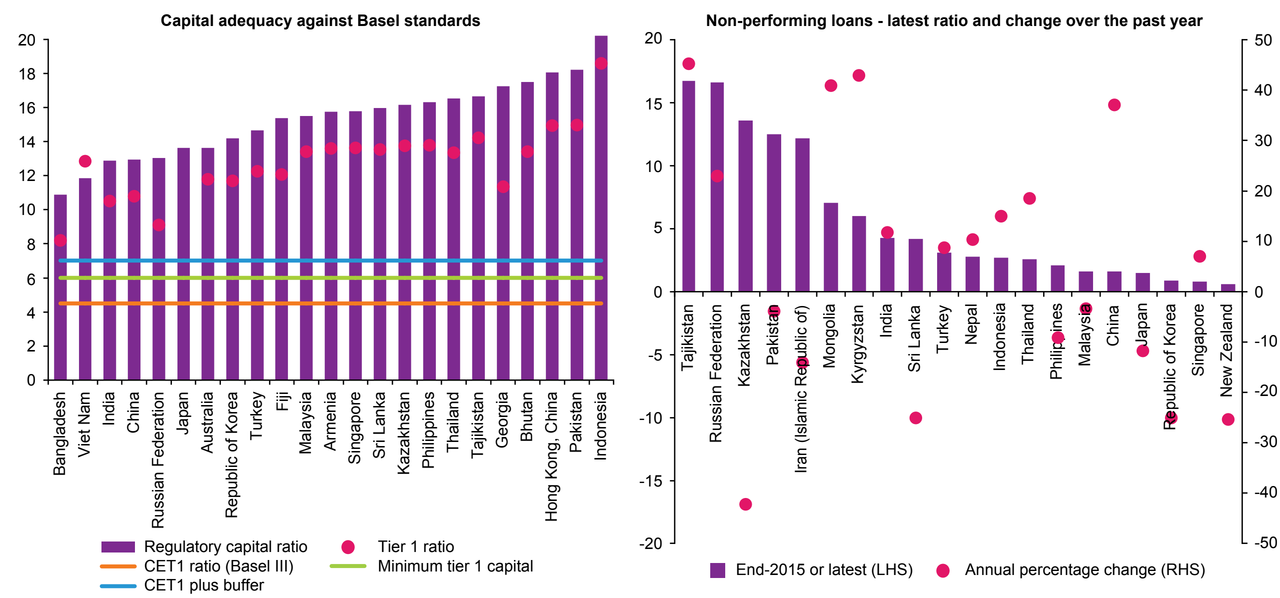
In some cases, however, macroprudential measures may be less effective without parallel capital flow management measures. For instance, in China direct cross-border loans by banks outside China to non-banks inside China increased rapidly after the Government restricted foreign banks' ability to bring dollars into the country (McCauley, McGuire and Sushko, 2015). This is consistent with the finding that the greater use of macroprudential policies is associated with more reliance on cross-border claims (Cerutti, Claessens and Laeven, 2015). In the Republic of Korea, restrictions on dollar loans encouraged a shift to dollar bonds; although this measure lengthened the maturity, the stock of debt continued to grow.

Better supervision of the banking sector and effective debt restructuring would be helpful

Although Asian banks are generally well capitalized (see figure 1.23), it is likely that mortgage delinquencies and corporate defaults will rise as financing costs rise and income and earnings remain subdued in some cases. In fact, although non-performing loan ratios remain relatively low in most countries where private debt has increased, there are some early signs of deterioration in asset quality. For instance, China's non-performing loan ratio increased by nearly 40% over the past year, albeit from a low base. To mitigate vulnerabilities affecting the financial sector that arise from conditions of non-financial sectors, bank supervision could be strengthened with respect to the quality of loans (bank assets) and exposure to foreign exchange and interest rate shocks. Doing so would entail the use of risk-weighted assets, which would give due attention to credit risks. At the same time, sectoral exposures could be re-examined and appropriate concentrate limits put into place, for instance with respect to the real estate sector. Stress tests could also be introduced to ensure that banks have not only sufficient capital levels to absorb losses but also governance structures and risk management processes that promote banking stability.[27]

Effective debt restructuring could help lower the financing/refinancing costs and lengthen maturity. For instance, this could happen through a regulation of the shadow banking sector, which has grown rapidly in the past decade. In China, one reason that banks have been issuing loans so quickly – faster than overall credit growth – is that they are replacing "shadowier forms of financing" (Economist, 2015). This

Figure 1.23 **Banking sector capital adequacy and asset quality in selected Asia-Pacific economies, latest data**



Source: ESCAP, based on financial soundness indicators, International Monetary Fund and CEIC Data. Available from www.ceicdata.com (accessed 31 March 2016).

Note: Capital adequacy data for the third quarter of 2015 or latest available, and non-performing loan data for end-2015 or latest available. For the capital thresholds, see Basel Committee on Banking Supervision, *Basel III: A Global Regulatory Framework for More Resilient Banks and Banking Systems* (Basel, Switzerland, 2010 and 2011). Available from www.bis.org/publ/bcbs189.pdf. CET1 = common equity tier 1 ratio, which excludes any preferred shares or non-controlling interests but includes the sum of equity capital and disclosed reserves, and sometimes non-redeemable, non-preferred stock. LHS = left-hand side; RHS = right-hand side.

step would also help enhance financial transparency, which is critical for minimizing uncertainties and preventing contagion across the board. Improving the credit history information of household and firms – for instance through credit registers – could also help lenders become better informed about the current debt of potential borrowers. At the same time, efforts to enhance financial access for households and small firms should be accompanied by financial education and training to inform borrowers of potential risks. While credit helps smooth consumption against income fluctuations, this aspect also means that households can become less concerned about negative income shocks so that, rather than saving for a rainy day, they just borrow more (Dynan and Kohn, 2007).

Improving credit allocation and restructuring State-owned enterprises are also critical for sustainability of private debt

For countries such as China, improving credit allocation and restructuring State-owned enterprises are also critical for sustainability of private debt. As noted previously, in China indebtedness of State-owned enterprises soared even as return on assets fell in contrast to foreign and private industrial firms which were cutting their leverage and boosting their profitability (Rutkowsky, 2015). Policymakers have taken some steps to encourage banks to lend to smaller and more efficient private firms, including by liberalizing deposit rates to encourage greater competition. There is also ongoing deliberation on privatization of State-owned enterprises, including innovative pilot schemes in which such enterprises transfer part of their equity stakes to a social security fund, with the aim of raising efficiency in the State sector (as the funds would influence these enterprises' governance structure and operations) while strengthening pension financing. It should be noted, too, that in China, "corporate debt" includes not only that incurred by State-owned enterprises but also off-budget borrowing by local governments. In this regard, the recent sizeable bond-swap programme for local governments has helped reduce the cost of debt servicing.

2.2. Enhancing tax revenues through base-broadening

Raising adequate revenues is critical for ensuring fiscal sustainability

As fiscal policy assumes a growing role in stabilizing the economy through countercyclical measures and supporting long-term national development priorities, it is important to ensure fiscal sustainability through the raising of adequate revenues as well as through effective debt management. In particular, improving tax policy and administration is critical to financing government expenditures in an efficient and fair manner.

As highlighted in the Survey for 2014 (ESCAP, 2014a), many countries in the region seem to have room to increase tax revenues. Countries at the lower end of tax-to-GDP ratios tend to have economic structures that are less conducive to raising taxes. For instance, countries in South Asia rely more on agriculture and services than their peers in East Asia that are manufacturing-heavy. Low openness to international trade and low urbanization rates can also make it more costly for Governments to raise taxes.

Nevertheless, even after accounting for these differences, the tax base seems to be unusually narrow in some countries. In Pakistan, the number of active personal income tax filers is fewer than 1 million, significantly below the 5.7 million people reportedly earning above the income tax threshold.[24] The number of registered taxpayers is higher than the number of tax filers, but still very low compared with the total population (see figure 1.24). Similarly, the number of active corporate income tax filers is less than 1% of the number of commercial and industrial electricity users.

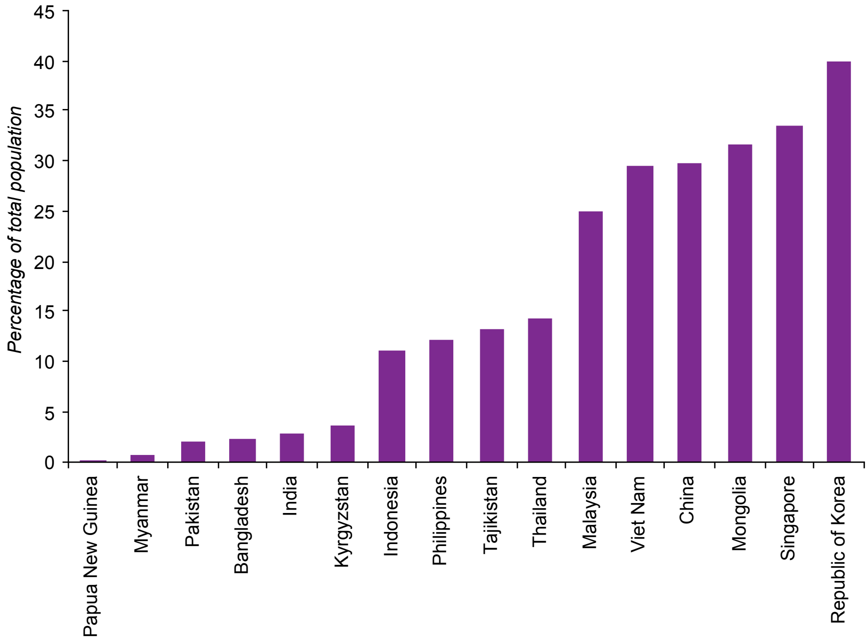
Identification and registration of taxpayers and removing redundant exemptions are critical steps in broadening the tax base

The identification and registration of taxpayers is a critical first step in collecting taxes. Some tax administrations operate registration systems that issue unique taxpayer identification numbers, while others use a citizen or business identification number that is used generally across Government. For instance, in Pakistan the Government has recently issued notices to potential taxpayers and is integrating the national tax number system (covering less than 2% of the population) with the computerized national identity card database (covering about 80%). Expanding the tax net requires more than just registration, however. Tax compliance should be enhanced through withholding taxes and third-party information reporting as well as audits. At the same time, effective taxpayer services, including those delivered through online platforms, can minimize compliance costs for individuals and businesses and promote voluntary compliance.

A major factor behind narrow tax bases are wide-ranging and potentially redundant exemptions. For instance,

Figure 1.24

Registered taxpayers for individual income in selected Asia-Pacific economies



Source: ESCAP, based on national sources, and Satoru Araki and Iris Claus, *A Comparative Analysis of Tax Administration in Asia and the Pacific* (Mandaluyong City, Philippines, Asian Development Bank, 2014).

Note: Data are for 2013 or latest available year.

agricultural income receives special tax treatment in several South Asian countries, without a proper distinction being made between poor and wealthy farmers. In addition to the legally lost revenues, this situation creates opportunities for tax evasion, as taxpayers can abuse the legislation by declaring business income as agricultural income in order to avoid taxation (Reva, 2015). Tax holidays are also widely used in Bangladesh, Pakistan and Sri Lanka for the manufacturing and services sectors. Again, loose tax incentives can create opportunities for tax avoidance and evasion as investors funnel profits from an existing profitable company through the tax holiday company. Similar problems arise with regard to indirect taxes in view of the long list of items eligible for exemptions or reduced rates. While these are often justified on claims of enhancing tax progressivity, there is actually very little assessment on the redistributive impact of such tax concessions.

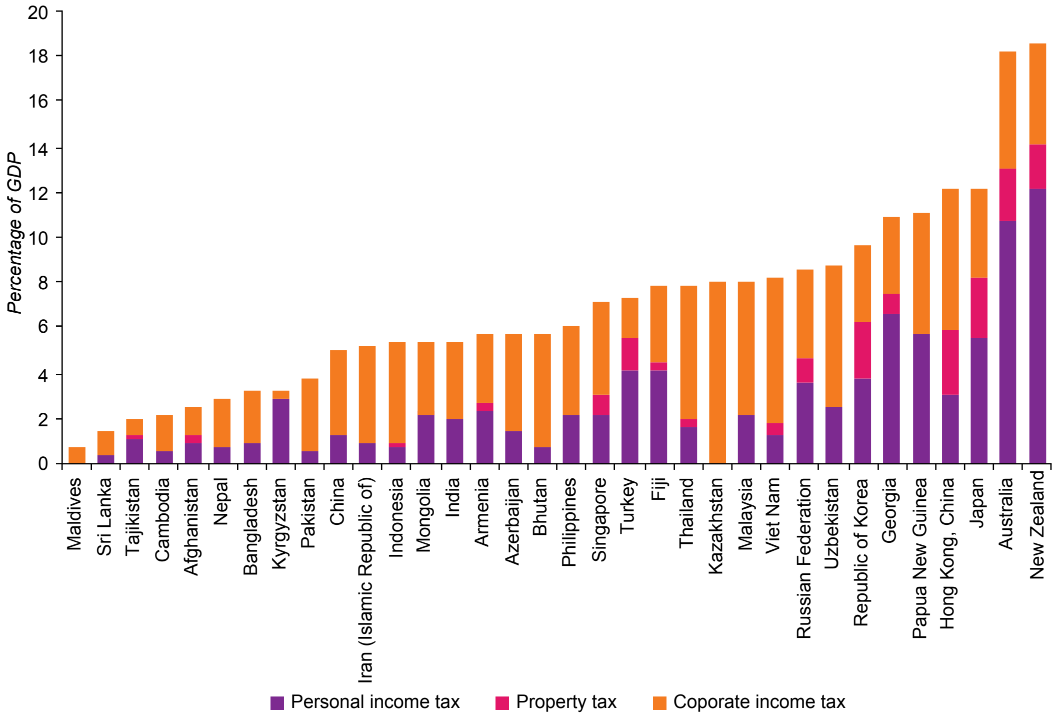
As a first step in addressing this challenge, Governments could publish tax expenditures to encourage proper cost-benefit analysis of tax exemptions and incentives.[30] According to an open budget survey undertaken in 2015, Governments of countries in the region that publish at least some tax expenditures number only 14.[31] Estimated foregone revenues ranged from 1.5% of GDP in the Philippines in 2011 to nearly 5% in India in 2013, although coverage and methodology tended to vary across countries.[32] At the same time, Governments could estimate and report the impact of at least key tax expenditures, that is, whether they are achieving their intended policy goals and if so, how effectively, when compared with direct government spending. The design of tax expenditures could be improved, for instance by making certain provisions time-bound. Improving tax legislation is also critical for minimizing the room for confusion and inconsistent implementation.

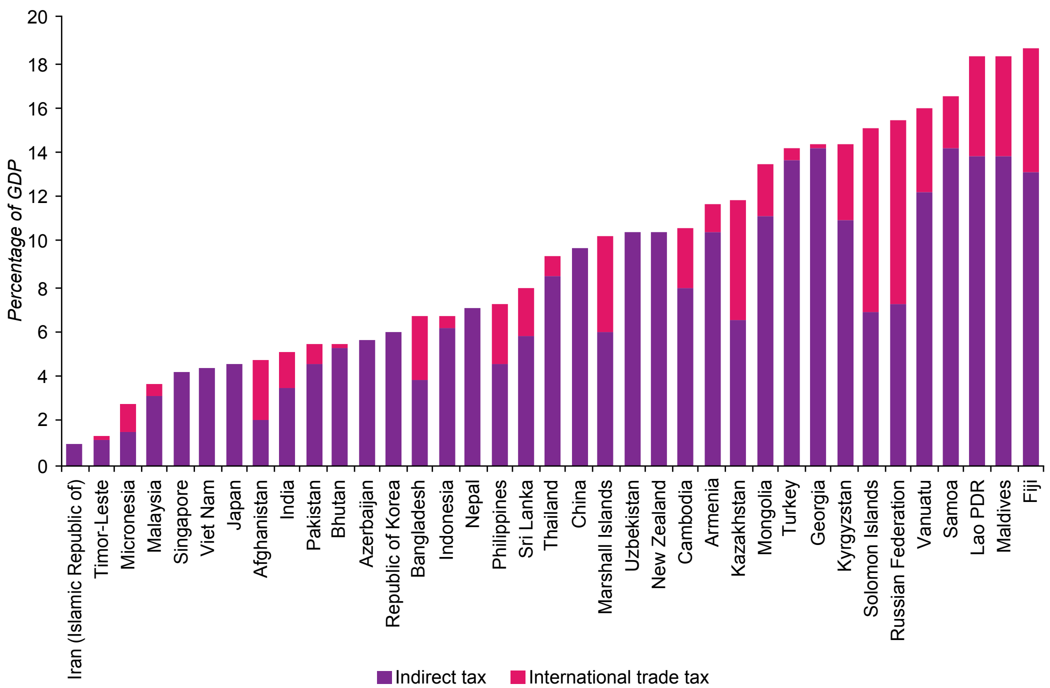
Enhancing tax progressivity, and avoiding undue distortions can support efforts to raise revenue

In addition to strengthening revenues through base-broadening, an important objective of taxation has to do with tax progressivity. In this regard, increasing the revenue share of income taxes is important (Atkinson, Piketty and Saez, 2011). Personal income taxes in particular are considered to be potentially more progressive, given that there is less room to shift the tax burden than is the case with corporate income taxes.[33] However, personal income taxes currently play a disproportionately small role, contributing less than 2% of GDP, in more than half the countries in the region (see figure 1.25). In addition to income taxes, taxation of assets could enhance tax progressivity.

Figure 1.25

Direct and indirect tax revenues in selected Asia-Pacific economies





Source: ESCAP, based on International Monetary Fund, Government Finance Statistics, World Revenue Longitudinal Data and CEIC Data. Available from www.ceicdata.com (accessed 31 March 2016).

Note: Data are for 2014 or latest available year. Indirect tax includes general goods and services tax, such as sale tax and value-added tax (VAT) and excise tax on specific items. For Viet Nam, only VAT revenues are shown. Data on international trade tax revenues were not available for a number of countries.

Since 2014, China has launched a pilot property tax scheme in Shanghai and Chongqing, and that scheme is expected to be expanded nationwide. Countries such as Viet Nam and more recently Thailand have introduced inheritance and gift taxes.

Another aspect of recent tax reforms concerns economic efficiency, or the question of how to raise adequate revenues without unduly distorting economic activities. Many countries have moved to value-added taxes (VAT) to avoid the cascading effect of regular business and sales taxes. In 2016, China is extending VAT to cover the remaining four industries – finance, construction, property and consumer services – and the complete transition is expected to result in total tax savings of $150 billion for enterprises.[35] Such reforms have been more difficult in India, where two types of VAT are charged: one at the federal level and the other at the state level. There is tax cascading on industrial goods as no input credit is available for the central VAT. The separate implementation of the service tax also results in arbitrary under- or overtaxation of products.[36] India is now working on a unified, nationwide goods and services tax which may boost economic growth by as much as 1.5% of GDP in the medium term (Chadha and others, 2009).

Pursuing comprehensive regional tax coordination can reduce revenue loss from increasing complexity and tax competition

Finally, given the fact that the world is becoming more interlinked, the tax implications of dealing with international investors are increasingly becoming more challenging for national tax administrations. Similarly, in the absence of comprehensive tax coordination among countries in the region, the risk of cross-country competition through tax incentives is increasing. Keeping in view these and other related considerations discussed above, the region's economies could significantly benefit by setting up a forum for regional cooperation and coordination in tax matters. Such a forum could help serve in fulfilling five key objectives: (a) supporting tax revenue enhancement efforts of Asia-Pacific countries; (b) strengthening and rationalizing municipal financing to support the region's continuing urbanization; (c) promoting tax policies that directly support inclusive growth and sustainable development; (d) facilitating exchange of information and coordination to address harmful tax competition; and (e) providing an open platform for developing countries to discuss and coordinate their positions on new international tax standards and practices.

2.3. Regional cooperation and integration to foster domestic demand

Weak global economic growth has given impetus to unlock new sources of aggregate demand through regional cooperation and integration

The ongoing weakness and prolonged uncertainty about recovery of global economic growth has given impetus to regional economies to unlock new sources of aggregate demand in order to sustain their growth dynamism. By expanding regional demand and stimulating domestic consumption, regional economies could in aggregate increase their overall prospects of productive investment activities. Regional economic cooperation and integration is particularly promising in the areas of capital markets, intraregional trade, infrastructure development, ICT connectivity and energy connectivity.

The development of capital markets is crucial for the provision of long-term financing for investment in the region. Currently, there are substantial differences in stock market capitalization across the region, with such capitalization ranging from 144% of GDP in Malaysia to 0.3% of GDP in Armenia. Countries need to move towards harmonization of legal and regulatory frameworks to attract investors and to increase the liquidity and efficient functioning of domestic capital markets. The eventual objective would be the adoption of common financial transaction standards and the establishment of region-wide financial infrastructure that could better support cross-border financial transactions, especially for long-term investment projects. These standards should be based on international frameworks, such as those of the International Organization of Securities Commissions and the Committee on Payments and Market Infrastructures. An Asia-Pacific capital market development forum of regional policymakers would be a useful next step, which would facilitate deliberations on the way forward for harmonization and the linking of capital markets in the region.

There is also scope for further strengthening of regional trade integration to support the rapid growth of intraregional trade that has occurred in recent years. Regional policies could be undertaken to accelerate the growth of regional value chains as a key vehicle of trade, especially by linking to countries with special needs and propagating vertical specialization. Furthermore, building on developments since the ninth WTO Ministerial Conference held in Bali, Indonesia, in December 2013 and the tenth WTO Ministerial Conference held in Nairobi in 2015, cooperative trade policies could be undertaken to further enhance trade facilitation measures and thus reduce trade costs.

Increasing intraregional trade requires initiatives to improve regional infrastructure and ICT and energy connectivity

The steady rise of intraregional trade in the region cannot fully achieve its potential without improved regional infrastructure development and overall strengthening of regional connectivity. Better regional surface transport networks and multimodal transport networks connected through dry ports are key elements of this strategy. In this context, the Asian Infrastructure Investment Bank, led by China, with authorized capital of $100 billion and initial subscribed capital of about $50 billion, can play an important role in providing financing for infrastructure development. This source of new financing could especially help connect the least developed countries with the emerging economies in the region. Similarly, the “Silk Road Fund” announced by China in 2014 would also support megaprojects of the “one belt one road” initiative, with investment in various infrastructure projects as its centrepiece. A similar initiative of the BRICS countries to set up the “New Development Bank” is also expected, with an initial funding of $100 billion, to provide financing and expertise required for the development of infrastructure in the region.

In the area of regional ICT connectivity, countries can move towards establishing the “Asia-Pacific Information Superhighway”, which could connect each country’s backbone networks and integrate them into a cohesive land- and sea-based fibre infrastructure. Doing so would reduce the cost of business and especially increase opportunities for and the participation of small and medium-sized enterprises, which are most sensitive to business costs, in regional production networks. The ESCAP secretariat has been requested by its member States to support this initiative by establishing an open-ended working group to develop principles and norms as well as a master plan covering both the policy and technical aspects of the so-called superhighway (ESCAP, 2015b). Over recent years, cooperation through such initiatives as the Greater Mekong Subregion information superhighway, the South Asian subregional economic cooperation information superhighway and the Trans-Eurasian information superhighway has already offered a promising start in enabling countries to reap the benefits of the digital revolution.

Given the enormous number of gaps in energy connectivity, regional cooperation to develop an Asian energy highway can play an important role in bridging the divide and enhancing energy security. The Asian energy highway is an initiative supported by ESCAP to establish an intergovernmental dialogue on common infrastructure and harmonized energy policies. The establishment of such a highway in the region would further integrate market mechanisms that enable power to be moved more efficiently and sustainably, and thus improve private sector investment opportunities, especially in landlocked developing countries. The next steps in the development of the energy highway should be for further integration of the concept into national energy plans through appropriate institutional arrangements and financial planning.

Increasing South-South assistance in sharing of knowledge, financing and other resources will be important to increase convergence in levels of sustainable development

Enhancing South-South assistance, one of the pillars of the regional cooperation and integration mechanisms, can play an important role in narrowing intercountry divergence in development outcomes, thus supporting the region’s economic prospects. Inequalities in incomes and opportunities can be reduced by fostering convergence in levels of sustainable development through the sharing of knowledge, financing and other forms of resources. Over recent years, China, India, Singapore, Thailand and Turkey, among other countries, have used the vehicle of South-South cooperation, amounting to more than $20 billion in assistance, to provide other developing countries in the region with support to improve their capabilities to sustain economic growth and sustainable development in such areas as infrastructure development, social programmes and climate change-related support.

The bottom line is that the region’s potential to support an aggregate demand-centric economic recovery is considerable and can be utilized through cooperation and integration, especially in the areas of capital markets, intraregional trade, infrastructure development, and ICT and energy connectivity. ESCAP has played and will continue to play an important role in promoting these objectives.

3. POLICY CHALLENGES TO IMPROVE THE QUALITY OF GROWTH

Apart from ensuring sustained and robust economic growth by resolving macroeconomic challenges, policymakers will need to undertake measures to improve the quality of this growth. To do so, they will need to address some key social and environmental challenges that have increasingly come to the fore, as will be highlighted in this section. First, they will have to consider the issue of inclusivity in the current growth model in the region, as can be seen in terms of less than satisfactory creation of decent jobs; the fact that the number of poor has not declined as fast as previously in recent years; and that the benefits of economic growth have increasingly been enjoyed by more well-off members of society than the poor. Second, a major phenomenon that has accompanied economic growth in the region is the rise of the middle class, which has posed numerous economic as well as social challenges, such as pressure on Governments to provide a range of public services, over and above the provision of basic needs. Third, the region has experienced rapid urbanization in recent years, which is leading to myriad societal and environmental issues and represents a microcosm of complex challenges faced by Governments to improve the quality of economic growth.

3.1. Slower growth having impacts on employment prospects, poverty and inequality

The slowdown in economic growth is adversely affecting the prospects for employment and its quality

Even as economic growth plateaus in Asia and the Pacific, it is not clear whether it has been sufficiently inclusive. A key area of concern is the quantity and quality of jobs created. Employment growth in 2015 was merely 1.1% (or 21.3 million jobs) for the region as a whole.[37] In East Asia, job growth was notably weak at 0.3% (or 2.9 million jobs), weighed down by both the decelerating economy in China and the country's ageing population. By contrast, in South Asia employment creation accelerated from 1.7% in 2014 to 2.1% in 2015 mainly as a result of strong labour force trends in India. Job growth reached 1.5% (or 4.5 million jobs) in South-East Asia and 1.4% (or 256,000 jobs) in the Pacific island economies.

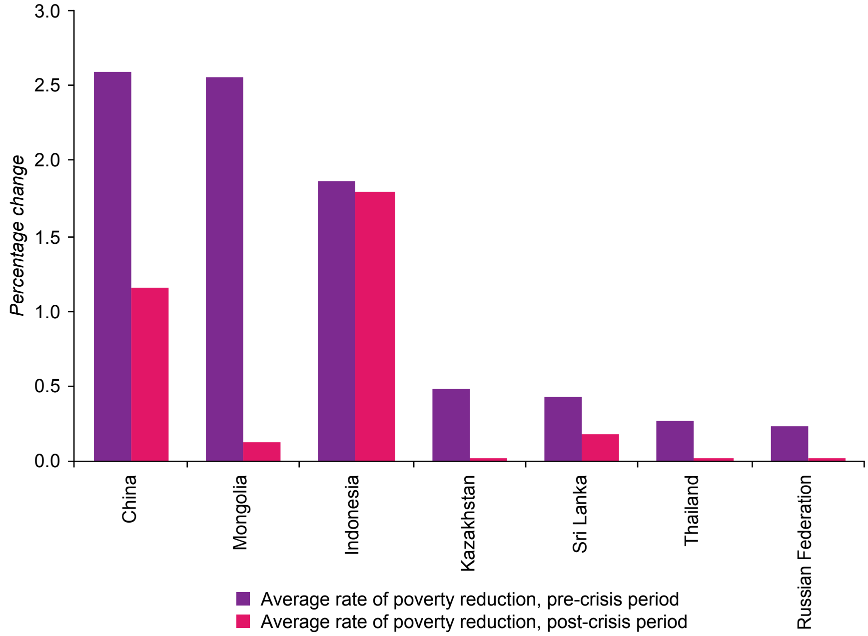
A key factor shaping weak employment rates in the region is lower labour force participation, partly resulting from more young people staying longer in school before entering the job market. Despite this positive part of the explanation, young people who do seek work face considerable challenges, such as taking up a job that is poorly remunerated or one that underutilizes their potential. The Asia-Pacific youth unemployment rate in 2015 was 11.5% and was higher for young women (11.7%) than young men (11.4%). Youth unemployment is notably high in the Pacific island economies and in South-East Asia (13.1%). Overall, young people in the labour force are 3.8 times more likely to be unemployed than their adult counterparts in the region. By subregion, the ratio is even higher in South-East Asia (5.4 times) and South Asia (4 times). In the region as a whole, the share of young workers from poor households (defined as earning less than the $1.90 extreme poverty line) was 14.2% in 2015 compared with 9.8% for adult workers. The working youth poverty rate was particularly high in South Asia (21.6%).

While job growth in Asia and the Pacific was muted in 2015, mixed progress was recorded in enhancing the quality of employment. Vulnerable employment as an own-account or contributing family worker in the developing Asia-Pacific region is still widespread and typically involves informal work arrangements without legal or social protection. The vulnerable employment rate was 55.4% (or 1 billion workers) in 2015, down slightly from 55.7% in 2014. Women are more likely than men to be in vulnerable jobs. For example, the vulnerable employment rate was 79.5% for women and 71.7% for men in South Asia. Likewise, in South-East Asia the rates were 60.1% and 52.8% for women and men, respectively.

The benefits of economic expansion have accrued relatively less to the poor in recent years as is evident from rising income inequality

Economic slowdown and challenges facing employment are contributing to concerns about the extent of poverty reduction in the region.[38] Inclusive growth requires not only robust economic growth but ensuring that economic expansion reaches the poorer sections of the population. Available data indicate that some major developing economies in the region, accounting for a major proportion of the population in Asia and the Pacific, have undergone a decelerating trend in the rate of poverty reduction in the post-crisis period until 2013 as compared with the recent pre-crisis period (see figure 1.26). These economies include China, Indonesia and the Russian Federation, among others. It is worth highlighting that economic growth can reduce poverty only to a certain extent, and that some forms of poverty cannot be reduced through economic growth alone, particularly when poverty is heavily linked to social exclusion.

Figure 1.26 **Average rate of reduction of the poverty headcount ratio at $1.90 a day in selected Asia-Pacific economies, pre-crisis and post-crisis periods**



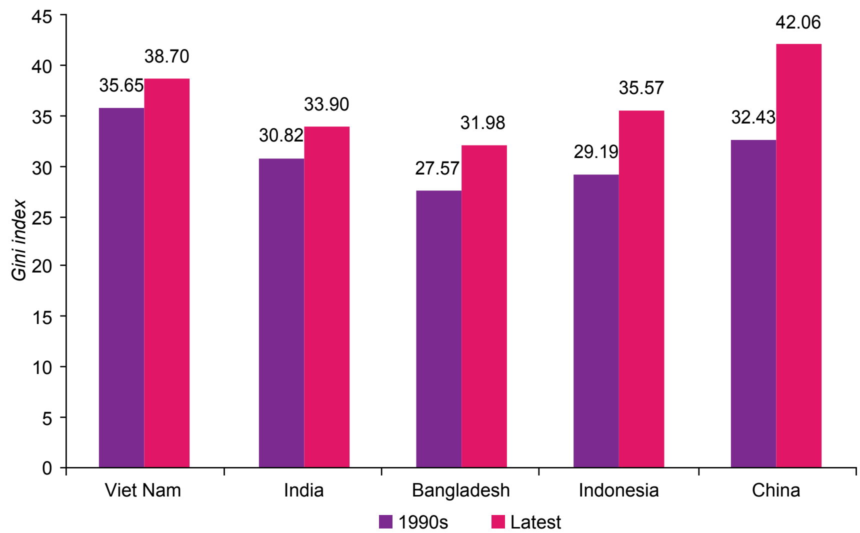
Source: ESCAP, based on the World Bank's World Development Indicators for various years.

Note: The ranges for China are 1999-2008 and 2008-2010; Indonesia 1999-2008 and 2008-2010; Kazakhstan 1996-2008 and 2008-2013; Mongolia 1998-2007 and 2010-2012; Russian Federation 2000-2008 and 2008-2012; Sri Lanka 1995-2006 and 2009-2012; Thailand 2000-2008 and 2008-2012.

The 2030 Agenda for Sustainable Development provides a framework that emphasizes giving focus to reducing all forms of inequalities; thus, it can help in addressing broader concerns related to poverty.

While it is to be expected that the rate of poverty reduction will slow along with slowing economic growth, the benefits of economic expansion have also accrued proportionately less to the poor in recent years, as is evident from the rise in income inequality. This situation can be observed in the Gini inequality indices for five major developing economies, which account for the vast majority of the population in the region (see figure 1.27). Inequality for all these economies has

Figure 1.27 **Gini coefficients of inequality in selected Asia-Pacific economies, 1990s and latest**



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

Note: Gini index of 0 represents perfect equality, while an index of 100 implies perfect inequality. With regard to 1990s data, the year 1990 was used for China and Indonesia; 1991 for Bangladesh; 1992 for Viet Nam; and 1993 for India. As for the latest data, 2009 was used for India; 2010 for Bangladesh, China and Indonesia; and 2012 for Viet Nam.

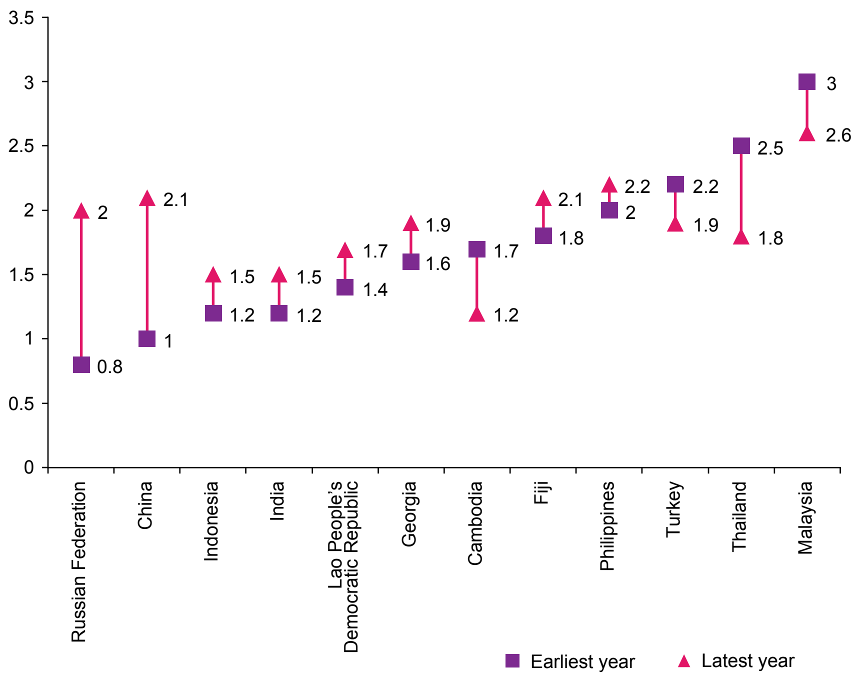
risen when comparing the latest post-crisis reading with the value in the 1990s. ESCAP calculations show that, had inequality not increased, approximately an additional 200 million people could have been lifted out of poverty in the three most populous countries of the region alone – China, India and Indonesia.

Further evidence regarding the pressing problem of rising inequality can be seen by considering the Palma ratio, which is the ratio of the income share of the richest 10% of the population's share of gross national income divided by the share of the poorest 40%. In some countries, the richest 10% hold twice as much in income as the lowest 40% (see figure 1.28). For instance, the Palma ratio increased from 1.0 to 2.1 in China and from 0.8 to 2.0 in the Russian Federation. In countries where inequality fell, such as Malaysia, the ratio remained high.

There are cases where income inequality persisted or even increased in spite of a reduction in poverty. For instance, between 1993 and 2012, India managed to halve the percentage of people living in absolute poverty. Yet, overall income inequality increased, with the income share of the richest 10% rising to 30% in 2013 from 26% in 1994, and the share of each of the lower four quintiles decreasing slightly (World Development Indicators, various years). Another example is Mongolia, where relative income shares as a whole changed little, although absolute poverty was almost eradicated. However, the highest income quintile, and among them particularly the richest 10%, gained the most, while the share of other income deciles decreased slightly (World Development Indicators, various years).

An important characteristic of recent growth performance in a number of major developing economies in the region has been increases in asset prices, primarily real estate and equity values. The income accruing from these asset market increases has gone primarily to the more well-off sections of society that are able to invest in such assets. For example, for China between 2002 and 2010, 97% of the increase in inequality had been due to changes in the values of financial and housing assets (Kotarski, 2015). As a result of such increases in asset values, the number of ultra-high net worth individuals, those with a net worth of more than $50 million, in major developing economies in the region, such as China, India,

Figure 1.28 **Palma index in selected Asia-Pacific economies, 1980s-1990s and latest**



Source: United Nations, Economic and Social Commission for Asia and the Pacific, *Time for Equality. The Role of Social Protection in Reducing Inequalities in Asia and the Pacific* (ST/ESCAP/2735). Available from www.unescap.org/sites/default/files/SDD%20Time%20for%20Equality%20report_final.pdf.

Note: Data for earliest available year refer to 1981 for China and Thailand; 1983 for India; 1984 for Indonesia and Malaysia; 1985 for the Philippines; 1987 for Turkey; 1988 for the Russian Federation; 1992 for the Lao People's Democratic Republic; 1994 for Cambodia; and 2002 for Fiji. Data for latest available year refer to 2008 for Fiji; 2009 for Malaysia; 2010 for China and Indonesia; 2011 for India; and 2012 for Cambodia, the Lao People's Democratic Republic, the Philippines, the Russian Federation, Thailand and Turkey.

Indonesia and the Republic of Korea, has increased considerably between mid-2014 and mid-2015 (Credit Suisse Research Institute, 2015). The increase in asset values has been amplified by easy money policies of advanced economies, which attracted portfolio flows into the region in order to obtain higher returns.

Apart from the direct impact of decelerating growth, an important driver of the slowing rate of poverty reduction and rising inequality in the post-crisis period is the underlying nature of the growth model itself, which essentially favours unfettered consumption-led, debt-fuelled increases in economic output. There is nothing inherently wrong with consumption-led economic expansion. The problem emerges when a large segment of the population, especially the lower-income groups, increasingly and excessively rely on debt rather than wages to support increases in consumption. This may be due to the outpacing of wage growth by productivity increases that many developing economies in the region have seen in recent years, and that has led to a shift in the balance between shares of labour and that of capital in national income, resulting in unequal distribution of incomes in favour of capital (ILO, 2015a).

Thus, a fundamental reason driving lower poverty reduction and rising inequality is that of slow wage growth in recent years. This has been seen clearly at the global level, where much of the recent increase in inequality in many countries has been driven by changes in wages and wage inequality (ILO, 2014). Ensuring consistent increases in wages is important for reducing poverty and inequality, as the poor are more often employed in wage-earning sectors as compared with those who are better off, who rely more on non-wage income sources. A productivity-driven wage-led approach to economic growth is therefore preferable, as it has a higher chance of addressing issues of poverty and inequality, in addition to supporting sustained increases in economic growth.

Slow progress in reducing poverty as well as the growth of income inequality have further underscored the pressing need for greater social protection in the region. Key aspects of a social protection floor include universal access to affordable health care; free primary and secondary education; unemployment benefits for wage earners and income-support measures for those in need; contributory and social pensions; and full access to social benefits for persons with disabilities, including disability allowances, services and support. Apart from the need to ensure inclusive and sustainable development, greater social protection will also support regional economies in boosting the role of domestic demand in growth by reducing precautionary savings for emergencies, especially by the poor.

Reducing inequalities of outcomes will critically require addressing inequalities of opportunity

Furthermore, reducing inequalities of outcomes will critically require addressing inequalities of opportunity. These inequalities refer to unequal access to chances required to sustain and improve livelihoods and lead meaningful lives. Unequal access to health care and education are key examples of inequality of opportunity. Many countries in the region lagged in achieving targets on health under the Millennium Development Goals. Close to 80% of the region's population still does not have access to affordable health care. Also, despite strong progress in improving overall access to education, about 18 million children of primary school age in the region do not attend school.

Policies to tackle inequality must also give due recognition to the fact that characteristics that identify the social group to which an individual belongs have a substantial influence on well-being and economic outcomes. These characteristics include gender, age, ethnicity, disability and migration status. In the Asia-Pacific region, women, youth, older persons, persons with disabilities and international migrants are particularly affected. Horizontal inequalities created due to these characteristics are buttressed by a lack of voice and power in these social groups. Such horizontal inequalities constitute a large component of overall inequalities within countries. Beyond individual and group exclusion, these types of inequalities can hinder economic growth and national stability by weakening bonds in society and creating disengagement and dissent.

3.2. Rising middle class creates challenges but also offers opportunities

The rise in the middle class in recent decades has created numerous socioeconomic challenges, and yet this phenomenon can strengthen domestic demand

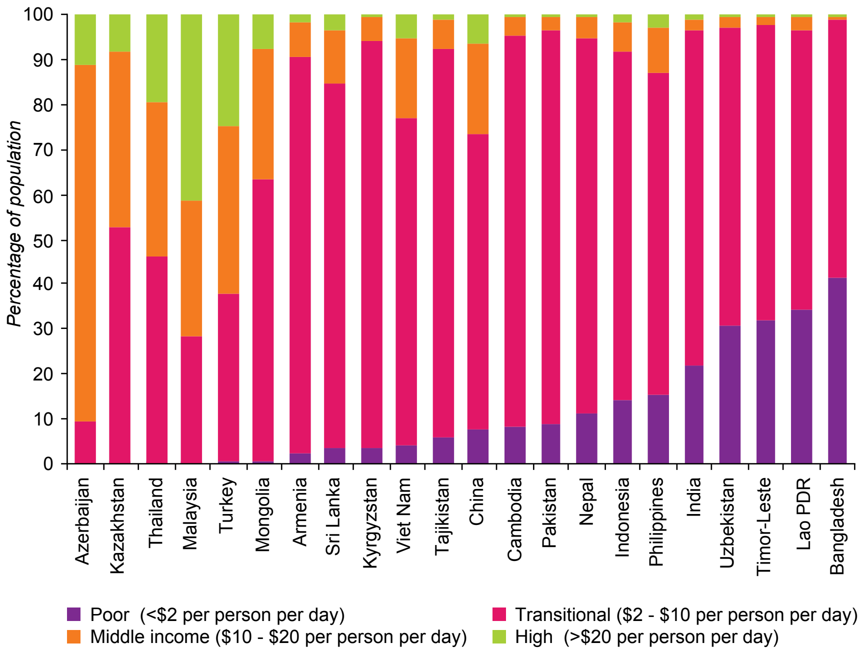
Despite the slowdown in recent years, the rapid economic growth that had been recorded in the previous few decades has resulted in a noticeable increase in the size of the "middle class" in many countries in the Asia-Pacific region. This phenomenon has created numerous socioeconomic challenges but also several opportunities. For instance, a rising middle class, with higher disposable income, tends to demand public services that go beyond basic needs, such as access to better-quality education and health care, and water and recreational services along with reliable energy and ICT infrastructure. This situation puts pressure on Governments to provide such services and, if they are adequately met, can create further development potential through improved social services. Moreover, this new group offers the prospect of an increasing pool of domestic demand to be tapped by economies, which would thus reduce their dependence on the struggling external sector.

Generally, the definition of “middle class” in the context of a developing economy varies from the definition used in developed countries, where it is not based exclusively on income but also entails a certain value system. However, to follow the definition of other international organizations and for the purposes of comparative analysis, people with incomes of between $2 and $10 a day are described as forming the transitional class; those with incomes between $10 and $20 a day are defined as belonging to the middle-income class, while those living on at least $20 a day are considered as members of the high-income class.

An important point worth highlighting is that, in societies with high-income inequality, where the income shares of the top 10% or even top 1% have risen sharply, the group earning just above $2 a day is still at the relative bottom of income distribution. This group is very vulnerable to falling back into poverty due to shocks, such as a persistent decline in economic growth and employment prospects, disease in the family or loss of the main breadwinner and natural calamities. Thus, this group is considered as a “transitional class” and requires consistent support to build their resilience rather than fitting the traditional definition of “middle class”. This risk is particularly high in countries with limited systems of social protection that would strengthen resilience to such shocks.

In 2012, only about 10% of the population in developing countries in the Asia-Pacific region lived in absolute poverty, defined at that time as living on less than $2 person per day. In the same year, more than 1.6 billion additional people compared with the situation in 1993 had incomes ranging from $2 to $20 a day as a result of rapid economic growth and increased development efforts. Consequently, in 18 countries in the Asia-Pacific region, more than half their populations were in the transitional – and therefore vulnerable – class, earning between $2 and $10 a day (see figure 1.29); they accounted for more than 2.5 billion people. In seven countries, namely Armenia,

Figure 1.29 **Percentage income distribution in selected Asia-Pacific economies, 2013**



Source: ESCAP calculations based on data from World Bank PovCal database. Available from http://iresearch.worldbank.org/PovcalNet/index.htm?1.

Cambodia, Kyrgyzstan, Nepal, Pakistan, Sri Lanka and Tajikistan, more than 80% of their populations formed part of the transitional class, which indicates the scale of the multifaceted challenges faced by these economies. Nevertheless, this situation also means that now only a minority of the population of these countries is living in absolute poverty and that these countries can increasingly count on domestic demand as a source of economic expansion in their growth strategies.

The role of the middle class is particularly important in stimulating domestic demand. Apart from their greater purchasing power, the middle-class income group is more resilient to shocks than the transitional class. In several countries in the region, a relatively large proportion of their populations now form part of this group. Azerbaijan is the country with the strongest middle-income class – about 80% of the population earns between \$10 and \$20 a day. In Turkey and Thailand, the middle-income class represents 37% and 34% of the population, respectively, with 46% and 38% of the population still belonging to the transitional category. In China, the share of the transitional class has increased from about 40% in 1993 to 65% in 2012, while the share of the middle-income class, which was less than 1% in 1993, increased to 20.6% in 2012 (World Bank, 2016a).

Among the many implications of this situation, the increased purchasing power of the growing middle class has led to an overall increase in energy and food consumption per capita along with changing food habits. As a result of such changing habits, however, obesity and other factors that pose health risks have led to a higher incidence of non-communicable diseases. Taxing unhealthful foods, such as sugar-sweetened beverages, is one example of policies that can be introduced to address obesity and non-communicable disease. There is a need to promote more healthful and sustainable lifestyles beyond nutrition, such as promoting physical exercise, which includes creation of green spaces that are accessible to all, including persons with disabilities and older persons, as well as creating incentives to walk instead of using private cars or motorcycles.

Provision of adequate social protection should go hand in hand with responding to the demand for government services that go beyond basic needs

As indicated above, when people emerge from poverty, they create demands for government services beyond basic needs. For example, with rising income levels people demand affordable and high-quality health care beyond basic health services. As in many countries in the Asia-Pacific region, health-care services still have to be funded by households' out-of-pocket expenditure; even with their increased income, the middle class still cannot afford health-care services beyond those that meet very basic needs. As a result, in Cambodia and Pakistan for example, infant mortality remains at a high level, although it drops significantly in the higher income quintiles of those countries. Some reports contain a description of the difference in access to skilled birth attendance according to income (see ESCAP, 2015b).

Similarly, rising income levels also lead to increased demand for better-quality education and not just more years of schooling. For instance, as income levels increase demand for early childhood education tends to increase as well. Many countries do not provide early childhood education as a public service; it is mostly provided by the private sector or civil society. People are also likely to demand adequate and sufficient recreational activities, including green spaces, which are also required to promote healthful lifestyles. The rise in such demands increase pressure on Governments to provide adequate access to social services in both rural and urban areas by enhancing the provision and affordability of such services. Currently, considerable inequalities exist in access to social services between income groups and between rural and urban areas (ESCAP, 2015b).

Thus, as with the poor, the emerging middle class, especially the transitional class, needs a level of social protection to reduce the risk of the people concerned falling back into poverty and to increase the resilience of such people to shocks. Given the rapid pace of population ageing in some subregions in Asia and the Pacific, increasing the coverage of pension systems is also becoming progressively more important. Without a comprehensive system of income security for older persons, large numbers of people risk falling back into poverty when they become old, posing a risk for countries' recent success in reducing poverty.

Overall coverage with social insurance tends to increase by income group, with the highest income quintile being covered significantly more by contributory pensions than other income quintiles. For example, in Viet Nam, 19% of people in the highest income quintile are covered by contributory pensions, but only 8.2% and 10.9% of those in the third and fourth income quintiles, respectively, are covered this way. The reason is that many people in the lower income quintiles are employed in the informal sector, which is difficult to cover through contributory pensions. To address this issue, several countries, such as China, Thailand and Viet Nam, have introduced a voluntary contributory pension scheme to cover people in the informal sector. However, effective participation in voluntary pension schemes remains low among workers in that sector, largely because the unstable income of such workers makes it difficult for them to contribute to such schemes regularly. The situation is different in countries in North and Central Asia, including Mongolia, where coverage of contributory pensions is relatively equal across income quintiles, as they inherited pension schemes from times that were characterized by a strong role for the Government.

With the rise of the middle class in some countries, more people than previously are able to contribute regularly to social insurance schemes, such as unemployment insurance, contributory pensions or health insurance. This situation has also helped develop a market for private health insurance beyond basic coverage. Contributory pensions are a means to raise domestic savings and to contribute to consumption-smoothing throughout the lifecycle. A few countries in the region already have a well-developed system of contributory pensions, primarily countries in East and North-East Asia as well as North and Central Asia, while other countries are currently in the process of reforming the system and expanding coverage, such as China. However, in most low-income and lower-middle-income countries, coverage of contributory pensions remains low. In many countries, existing pension schemes cover only the public sector, leaving the majority of the population uncovered.

3.3. The phenomenon of urbanization

While the overall impact of urbanization on economic growth has been positive, growing strains have emerged with regard to urban infrastructure and resource consumption

A particular feature of the rise of the middle class as well as the wider economic growth process in the region is the phenomenon of rapid urbanization, which has been associated with a shift from agriculture in rural areas to manufacturing and services in urban areas. This process has led to a large movement of the poor to cities as well as a rapid increase in the size of the middle class in cities. While the overall impact on economic growth has been positive, the emergent strains on urban infrastructure and resource consumption require specific government policies to deal with the changing dynamics. One part of the approach to tackle these issues is to redirect urbanization to emerging smaller cities. Another part of the solution is to take action within existing cities to reorient consumption patterns and develop necessary infrastructure. An important aspect of undertaking such proactive policies will be tackling the issue of insufficient local government funding.

As home to 4.3 billion people in 2014, the Asia-Pacific region accounts for 60% of the world's population. Of these people, more than 2.1 billion live in urban areas; they represent approximately 45% of the region's total population and 55% of the global total urban population. The share of urban dwellers in the region has been rising over the last 25 years as a result of natural population growth, rural-to-urban migration and the reclassification of rural areas into urban areas. An estimated 120,000 people in the region migrate to cities every day (ESCAP, 2014b). As a result, all subregions in Asia and the Pacific are experiencing urban growth at higher rates than overall population growth. By 2018, more than half the regional population will live in urban agglomerations. In just over 30 years from this milestone, no less than two thirds of the population in the region will be urban, or about 3.2 billion people. To put this figure into perspective, that number is equivalent to what was the entire population of the Asia-Pacific region as recently as 1990. In the last 15 years alone, 630 million people were added to the populations of Asian and Pacific cities − a number greater than the current urban population of Europe.

Of the 28 megacities in the world, 17 are now in the Asia-Pacific region. The great scale of the region's urbanization, however, goes well beyond megacities. The majority of the urban population live in rapidly growing small and medium-sized towns, where the region's urban transformation is actually unfolding (ESCAP, 2014b). Indeed more than half (54.4%) the region's urban residents live in smaller cities with populations of fewer than 500,000 people. The important point to note is that secondary and smaller cities and towns do not have the resource base of many larger cities, and the urban poor have less access to basic service provisions, adequate livelihoods and decent transportation options.

The economic contribution of cities to GDP is significant, in view of their large contributions to national wealth. Indeed, the region's largest and most globalized cities have economies larger than many countries in the region. In the case of China, cities contribute 74% of national GDP, while representing only 43% of the population (Dobbs and others, 2011).

The city of Tokyo generated almost $1.9 trillion of GDP in 2010, which was the largest amount in the region, followed by Moscow and Sydney (Foreign Policy, 2012). Cities in the region are now the pre-eminent localities of economic growth and wealth creation. Millions of people in urban areas have been lifted out of poverty, forming an expanding urban middle class of almost 2 billion people (ADB, 2010).

Despite the positive contribution of cities to economic growth, not all urban dwellers have benefited from this transformation, and inequalities are increasing. In many cities, the majority of the urban population continues to rely on the informal sector for employment, housing and access to land, infrastructure, services and transport. It is notable that employment in the informal sector of large economies, such as India, Indonesia, Pakistan and the Philippines, continues to account for from one half to two thirds of total employment despite years of strong economic growth. Unless and until the urban poor are formally recognized, they will remain deprived of the rights of urban citizenship, secure land tenure and access to basic services, including access to clean water and sanitation, and health care, among other services. This problem is prominent in low-income economies in the region, where nearly two thirds of urban dwellers live in slums, a figure which is increasing (UN-Habitat, 2012).

Further concentration of economic development in a few large cities could lead to greater imbalance across urban areas. At the same time, many second- and third-tier cities continue to lag behind megacities, reinforcing the urban challenges within these agglomerations and exacerbating imbalanced economic growth. Therefore, in much of the region there is a need for more balanced urbanization, including having greater attention paid to regional and secondary cities and enhanced rural-urban linkages to realize a sustainable, inclusive and resilient urban future. A focus on emerging smaller cities would provide policy opportunities to reshape and rebalance the region's urban future.

Urbanization has been largely unplanned, causing persistent and emerging sustainability challenges

The real problem is that urbanization has been largely unplanned and poorly integrated, with resource use along with high exposure to disaster risks leading to persistent and emerging sustainability challenges. Concerns about sustainability have often been secondary to that of economic growth. This pattern of exploitation is now being felt in terms of declining liveability in many cities, decreasing access to green and open spaces and deteriorating viability of natural systems. For instance, in many Asia-Pacific countries, while there has been progress in terms of the availability of a safe water supply and improved sanitation for urban dwellers,[39] the issues of equal distribution and the quality of water still remain. Furthermore, lack of sufficient access of those living in informal settlements or slums to safe water and sanitation has resulted in widespread urban health disparities between various population groups.

Furthermore, many cities face a crisis over waste, a situation which has created health hazards, incurred rising costs and complicated poverty reduction efforts. Pressures related to affluence − managing changing consumption and production patterns of the growing middle class, air pollution and congestion related to increasing vehicle use and the emergence of e-waste − further aggravate urban challenges. Moreover, gradual erosion of ecological buffers and increasing exposure of critical infrastructure in parts of the region contribute to the risk that cities face, while many rapidly expanding cities are located in major multi-hazard "hotspots" that are vulnerable to cyclones, floods, earthquakes and landslides (see box 1.3).

An integrated and multidisciplinary approach to planning along with effective governance is required to address issues related to urban sustainability

It is not possible to address such sustainability issues in isolation. Therefore, water-energy-food and land nexus-based solutions and risk-sensitive development are essential for achieving sustainable development and must underpin future strategies. The need for greater resource efficiency to support future urban development is critical given the expanding resource footprint of cities, which are transcending ecosystem and administrative boundaries. Importantly, building the resilience of cities to natural disasters is necessary in view of the high and increasing risk of urban disasters, a situation that demands greater coordination across the stakeholders and institutions concerned. The need for integrated planning requires a multidisciplinary approach as well as effective and dynamic governance.

Moreover, it is necessary to nurture sustainable cities in the region by investing in social support structures and social protection systems, and by creating greater opportunities for all. It is no coincidence that such countries as Japan and the Republic of Korea, which

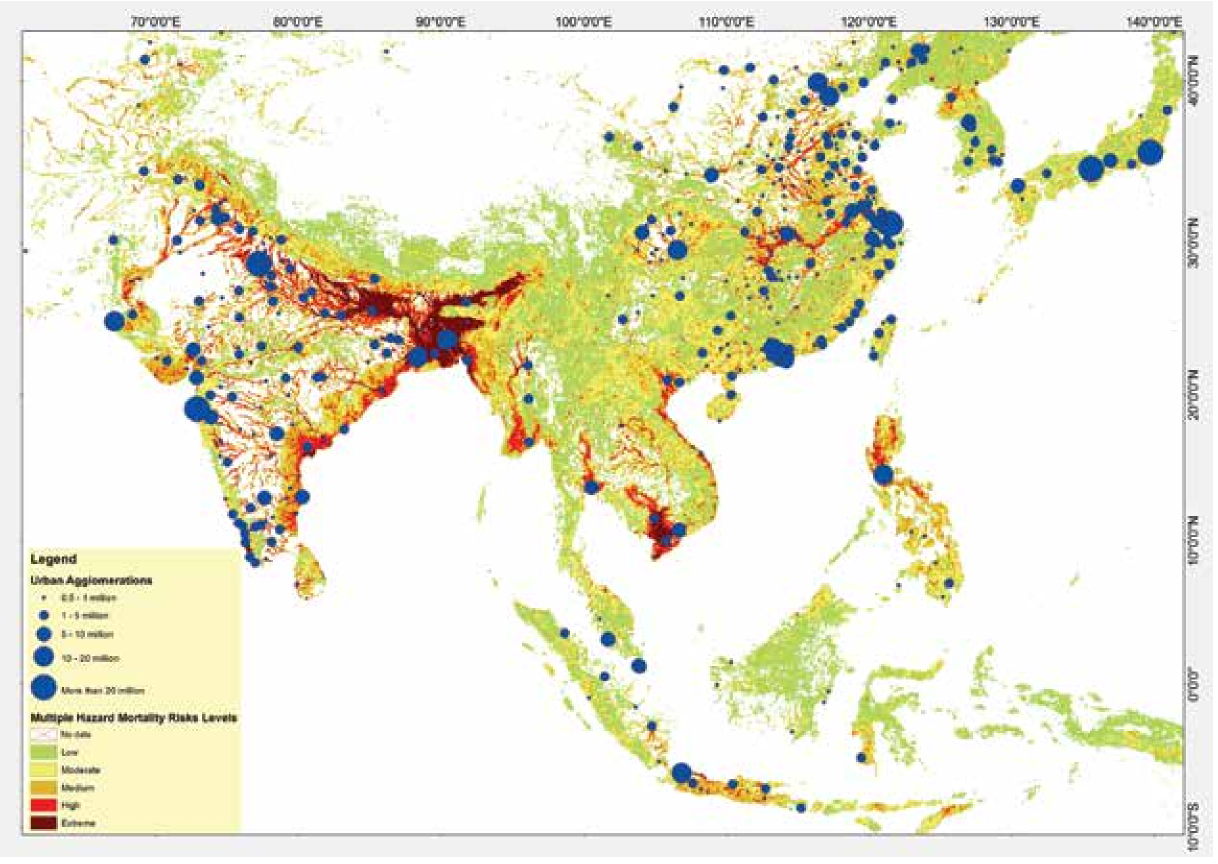
Box 1.3

Urgent need to address increasing urban disaster risk in Asia-Pacific region

Building resilience to disasters and reducing disaster risk are among the regional priorities for sustainable development in Asia and the Pacific.

There are clear reasons for giving these aspects priority. In 2015 alone, more than 16,000 lives were lost as a result of natural disasters in the region; they accounted for 70% of the global total of such deaths.[a] Many of the disasters were urban ones. Urban flooding was frequent, including the Jakarta flood in February that year, the floods in the Japanese city of Joso in September and Chennai, India, in December, which resulted in more than 500 deaths.[b] Massive disaster impacts resulted from the 2015 Nepal earthquake that killed nearly 9,000 people and caused economic damage and losses valued at more than $7 billion, which were most concentrated in the capital, Kathmandu.[c]

Asia-Pacific cities exposed to multiple hazards



Source: United Nations, Economic and Social Commission for Asia and the Pacific, *Asia-Pacific Disaster Report 2015: Disasters without Borders – regional resilience for sustainable development* (Sales No. E.15.II.F.13), figure I-20.

Disclaimer: The boundaries and names shown and the designations used on this map do not imply official endorsement or acceptance by the United Nations.

Rapid economic growth and rising populations in cities have led to major changes in land use in the region. In particular, ecological buffers that provide protection against natural disasters have been eroded, thus raising the urban disaster risk level. Critical infrastructure, such as roads, water and sanitation systems and the electric grid, in many cities is old and not disaster resilient. Thus, it is necessary to implement risk-sensitive urban planning, enforce proper building codes, retrofit critical infrastructure and invest in urban infrastructure.

In addition to these aspects, many of the rapidly expanding cities in Asia and the Pacific are located in ”disaster hotspots” where there is high risk from cyclones, earthquakes, floods and landslides, as seen in the figure above. Climate change and projected sea level rise pose further challenges, especially to

Box 1.3 *(continued)*

coastal cities where more than half the region's urban population currently live. Today, in the region, about 742 million people living in cities are at "extreme" or "high" disaster risk. By 2030, this number could reach 980 million.[d]

Building urban resilience requires a paradigm shift in urban development and management. Without such a shift, it would be difficult to protect the hard-earned development gains in the Asia-Pacific region.

[a] EM-DAT, International Disaster Database of the Centre for Research on the Epidemiology of Disasters. Available from www.emdat.be. Accessed 23 February 2016.
[b] Arun Janardhanan, "Now Chennai struggles to lay its dead to rest", *Indian Express*, 10 December 2015, Available from http://indianexpress.com/article/india/india-news-india/now-chennai-struggles-to-lay-its-dead-to-rest (accessed 27 January 2016).
[c] Government of Nepal, National Planning Commission, *Nepal Earthquake 2015: Post Disaster Needs Assessment*, Volume A, Key Findings (Kathmandu, 2015).
[d] United Nations, Economic and Social Commission for Asia and the Pacific, *Asia-Pacific Disaster Report 2015: Disasters without Borders – regional resilience for sustainable development* (Sales No. E.15.II.F.13).

have invested strongly in education, health care and social protection, have created more equal, dynamic, creative and ultimately more successful urban centres (UN-Habitat and ESCAP, 2015). Change requires new vision and partnerships, spanning national and local governments, as well as the private sector and civil society, all of which need to join efforts to promote economic and social cohesion. Promoting diversification and structural changes, with strong local governance, is the best way to transform urban economies.

A key challenge in this regard is that the region's governance frameworks appear ineffective and insufficient to address the patterns and magnitude of urban growth. Many of the region's cities are managed using outdated legal and regulatory frameworks and institutional arrangements. Renewal of urban planning and governance requires countries to break away from competitive and fragmented systems − among various levels of government and between governmental and non-governmental actors − towards more collaborative strategic approaches (UN-Habitat and ESCAP, 2015).

It is essential, while strengthening planning and policy frameworks, to also open up new partnerships to revitalize cities and organize urban growth more coherently. Effective policies for spatial management, land-use planning, infrastructure investment, poverty reduction and environmental protection require accurate, relevant and real-time data on urban trends and conditions. However, urban data collection and reporting have not kept up with the needs of most cities. Where this capacity does exist – specifically in the case of globally connected cities – data are rarely clustered in a way that is constructive for policy use. This "data deficit" is undermining informed decision-making and the planning of urban development, including responding to complex social and economic change. What is needed is nothing less than an "urban data revolution" for the region.

Enhancing local government finances will be essential to develop the requisite urban infrastructure

Current revenue sources at the local government level are also woefully insufficient to meet the long-term financing needs of urban infrastructure. Many urban centres are unable to raise funding from capital markets to enhance capital investments. Property taxes tend to be the most lucrative source of local revenue, but evidence from the region shows that property tax usually accounts for only about 20% of local government revenues. Collection of fees for basic economic and social services is also low, while wastage and theft of electricity and water in particular have begun to weaken the financial viability of significant numbers of energy and water boards, resulting in sizeable circular debt within jurisdictions. As a result, many small and medium-sized towns across all countries in the region continue to depend on the transfer of funds from higher levels of government for capital expenditure as well as revenue expenditure. Often, these funds are not assured, a situation which leads to chronic shortages of services and skilled staff in addition to complicating budget planning processes.

Local governments must maximize their existing revenue sources and manage their assets more effectively. Mumbai in India and Istanbul in Turkey offer good examples of cities that raise revenue through consolidation of land and assets as well as auctions in private markets. Cities in the future, however, will clearly need to access additional sources of external financing either individually or through "pooling" with other local governments. In attempting to meet future needs, cities will require greater access to capital markets, but the ability to do so will also demand better oversight and more transparent systems of financial management.

3.4. Labour market policies for growth with employment and adequate wages

There is room to improve labour market approaches to ensure that economic growth translates into productive and better-quality jobs

In order to promote inclusive growth, a key focus of the Sustainable Development Goals, Governments of countries in the region will need to examine and reconsider existing labour market approaches and formulate appropriate policies to ensure that economic growth translates into productive and better-quality jobs. Policy interventions may also be required to ensure that such job creation leads to commensurate increases in real wages. Two groups that require particular attention from policymakers are youth and vulnerable workers, the populations of which are high in the region.

A major area of policy focus should be in the education sector. Beyond primary schooling, developing the future workforce in many low- and middle-income countries involves the ability of people to gain greater access to secondary education, as well as to technical and vocational education and training. Middle- and high-income economies are also facing challenges related to the disconnect between tertiary education and the needs of employers. In addition to improving access to higher education, it will be even more important in the future to improve the quality of education and make it relevant to fast-changing labour markets. Various measures could help reform education systems and strengthen learning outcomes. Some useful initiatives undertaken by countries include establishing a teacher licensing system, extending pre-service and in-service training, recognizing outstanding performance of teachers and improving teachers' compensation, establishing a benchmark system for quality standards, and reorienting learning practices towards the information and knowledge economy.

A responsive system for technical and vocational education and training (TVET) is also critical for workforce development and would help fill gaps in skills and competencies not provided by higher education. However, TVET currently accounts for a small share of school enrolment in many regional countries. TVET institutions in many countries face challenges related to the relevance of curricula, poor-quality instruction and infrastructure and the absence of certification frameworks that meet the standards of employers. Also, gender stereotyping hinders young women from choosing some vocational tracks. A focus on improving TVET quality and relevance through stronger linkages to the demands of industry is paramount, as is expanding access for poor and rural populations, integrating core skills, developing tools for improving the recognition of continuous and prior learning, and enhancing the availability of reliable labour market information and vocational guidance. For instance, the Lao People's Democratic Republic is developing a labour market information system and a TVET education management information system that will enhance assessment of skills demand and strengthen employment services for TVET students and job seekers (ILO, 2016).

Active labour market policies can be another set of effective interventions that could help workers better integrate into fast-changing labour market conditions. Such policies can include enhancing the functioning of public employment services, providing career counselling, offering additional training and improving the quality of labour market information. An example is the National Employment Agency of Cambodia, with technical assistance from ILO; it is furnishing career advice, job search assistance and labour market information to young job seekers and raising awareness among young people of the resources and programmes available to them. Regarding the provision of career counselling, some countries have taken useful measures to target in particular vulnerable sections of youth. For example, Singapore's Development Framework for Youth Workers targets at-risk youth, provides them with career coaching and develops their so-called soft skills (ILO, 2015b).

Improving the link between productivity and wages is critical

Another important policy area is improving the link between productivity and wages. Low and slow growth in productivity is an issue in much of the region, an issue which is covered in chapter 3 in more detail along with some suggestions to improve the situation. However, while higher growth in labour productivity is a precondition for sustainable wage growth, it does not guarantee parallel wage growth. The correlation between labour productivity and wages is far from perfect, with wages having lagged productivity growth in many regional economies in recent years. For example, in ASEAN economies real wages have lagged productivity gains since 2005. Moreover, the gap has been even more pronounced in specific sectors, such as manufacturing in Thailand where real wages remained flat between 2001 and 2011 (ILO and ADB, 2014).

Effective collective bargaining can be one of the tools for rebalancing the gains from economic growth through facilitating fair wage increases in line with productivity. Currently, most regional economies have some way to go to strengthen their systems for collective negotiations between employers and workers. The pay-offs from building stronger institutions have been demonstrated in the advanced global economies where collective bargaining has facilitated economic restructuring – helping enterprises to cope with unexpected events and to strengthen training and skill formation.

Collective bargaining can also standardize employment conditions across enterprises and reduce the potential for a downward spiral of wage competition between enterprises. This risk can be addressed through negotiations between union federations and employers' organizations that set minimum conditions for an entire sector (multi-employer bargaining) and to a lesser extent through agreements between individual companies and company-level trade unions (single-employer bargaining). Among developing countries in the region, the Republic of Korea and Singapore have the highest proportion of workers covered by collective bargaining; most other regional economies have far lower coverage (ILO, 2015c).

In the absence of effective collective bargaining, minimum wage policies are another important tool in setting fair wages in the region. The core objective of such policies should be to protect workers who lack collective bargaining power, often low-skilled workers. However, such policies often lead to controversy and sometimes even conflict. Governments therefore need to strengthen minimum wage-setting institutions and base decisions on sound evidence and communication with trade unions and employers. Several countries have taken steps in this direction. For instance, Malaysia and Viet Nam have both set up new, tripartite bodies to review minimum wages. In India, the Government announced a much-needed review of the Minimum Wages Act 1948. Another important concern is that, even though minimum wage systems may be in place in numerous economies in the region, the rates are not adjusted regularly. For example, in Thailand sizeable adjustments in 2012/13 followed a long period of stagnation (ILO and ADB, 2014).

4. CONCLUSIONS

The economic outlook for developing Asia-Pacific economies is broadly stable but is clouded by uncertainty. There is the possibility of further deceleration in growth due to a confluence of macroeconomic risks, which continue to buffet the region. These risks are interconnected and thus quite complicated to manage. Even if the risks to growth do not materialize, broader development concerns remain that may impede progress towards achieving the Sustainable Development Goals in the region. Such developments indicate that even the moderate growth seen in the region is falling short in terms of adequately benefiting those sections of society that need it the most − the poor.

To ensure effective implementation of the Sustainable Development Goals, the region will need to strive both for higher economic growth and better-quality growth. Since external demand is likely to remain weak in the near term, countries will have to focus on boosting domestic demand. Ensuring the quality of growth will require internalizing various aspects of inclusiveness and sustainability in policymaking. The key tool available to Governments to achieve these aims is fiscal policy, with fiscal space being available in many economies. Spending on education, health and infrastructure is particularly important in this regard. Regional cooperation initiatives also afford valuable support for domestic initiatives to spur higher growth and achievement of the Sustainable Development Goals, especially for poorer economies with lower domestic capabilities.

Importantly, in broad terms, the growth model currently being pursued by countries in the region is underpinned by debt accumulation rather than productivity-driven increases in real wages. Increasing real wages through the boosting of productivity will be critical to ensure long-term growth in incomes that will eliminate poverty and ensure a better future for all citizens. Chapter 3 contains analyses in greater depth of the issue of increasing productivity and affords a set of recommendations for the consideration of policymakers concerning the way forward.

Endnotes

[1] Total merchandise exports by Asia-Pacific economies include exports from China. If exports from China are excluded, the share would rise to 19%. See United Nations, Economic and Social Commission for Asia and the Pacific, *Asia-Pacific Trade and Investment Report 2015: Supporting Participation in Value Chains* (Sales No. E.15.II.F.15). Available from www.unescap.org/resources/asia-pacific-trade-and-investment-report-2015-supporting-participation-value-chains.

[2] Oil prices fell in mid-January 2016 to their lowest levels since 2003, having declined by 35% in 2015, with only a moderate increase having been observed since. Similarly, agricultural prices, as measured by the FAO Food Price index, declined by 19% in 2015, marking the fourth consecutive year of low prices. The widely followed S&P GCSI Industrial Metals index also declined by 24% in 2015.

[3] The global emerging markets grouping consists of Argentina, Brazil, Bulgaria, Chile, China, Colombia, the Czech Republic, Ecuador, Egypt, Hungary, India, Indonesia, Lebanon, Malaysia, Mexico, Morocco, Nigeria, Peru, the Philippines, Poland, the Republic of Korea, Romania, the Russian Federation, Saudi Arabia, South Africa, Thailand, Turkey, Ukraine, United Arab Emirates and Venezuela.

[4] The “one belt one road” initiative is aimed at building jointly a “silk road economic belt” and a “twenty-first century maritime silk road”, strongly advocated by China. The implications and benefits of these measures are being discussed among the associated countries and the Asia-Pacific region as a whole. Some claim the initiative could potentially create investment opportunities for China in terms of infrastructure and also lead to a potential increase in bilateral trade.

[5] Inflation was slightly lower at 4.1% in 2009, but that was driven largely by a high base of 8.3% inflation recorded in 2009 amid the global food and fuel price surges.

[6] These economies include the Philippines, Singapore and Thailand. On the other hand, core inflation in the Republic of Korea increased in 2014 and 2015 in line with a rebound in household consumption, while overall inflation exhibited a downward trend.

[7] Changes in inflation are measured as the sum over the two-year period of 2014 and 2015 because the positive effect of lower inflation on consumption and overall economic growth tends to occur with some lags.

[8] In Hong Kong, China; Indonesia; the Republic of Korea; and Thailand, the average growth of inflation-adjusted monthly earnings was either lower or negative during 2014 and 2015 when compared with the preceding two years.

[9] For example, in Taiwan Province of China the overall price level decreased by 0.3% in 2015, while prices of transport items fell by 5.7%. Consumer inflation faced by the population in the lowest income quintile increased by 0.1%, while this figure dropped by 0.4% for those in the highest income quintile.

[10] Between June 2014 and January 2016, the World Bank’s overall food price index fell by 23.1%, while the price of fertilizer, the main agricultural input, dropped by only 10.6%. In the region, food inflation moderated in 2015 in many economies where the agricultural sector remains sizeable, such as Bangladesh, Cambodia, China, India, Pakistan, the Philippines, Thailand and Viet Nam.

[11] In the Republic of Korea, household debt stood at 87% of GDP at end-2014. In China and Singapore, the ratio was lower at about 40% and 61% of GDP, respectively, but this has increased by at least 20 percentage points since the global financial and economic crisis began in 2008.

[12] The share of non-performing loans in total loans amounted to 15.3% in Maldives in the third quarter of 2015, while this share was 7-8% in Armenia and Mongolia at end-2015.

[13] Estimates on the transmission lag in small or low-income countries are often not available. For example, in Nepal, while the central bank reported that the credit channel is the strong channel of monetary policy, there is no information on the transmission lag. For further information, see State Bank of Pakistan, *Monetary Policy Frameworks in the SAARC Region*. Available from www.sbp.org.pk/mpd/MPF-SAARC-Region.pdf.

[14] For instance, in the second half of 2015, the Government of China approved two railway projects with a total value of nearly $11 billion, lowered the income threshold for firms eligible for reduced corporate income tax rates and slashed in half the 10% purchase tax on vehicles with small engines. See United Nations, *Economic and Social Commission for Asia and the Pacific, Economic and Social Survey of Asia and the Pacific 2015: Year-End Update* (ST/ESCAP/2743).

[15] The target year for reducing the budget deficit to 3% of GDP was postponed a year to 2018 rather than the earlier planned target of 2017. This helped offset the slowdown in private investment, as government capital expenditures were 30% higher in the period April-December 2015 compared with the previous year.

[16] While it has been reported that all government ministries except the defence ministry were directed to cut their budgets by 10%, actual reductions were lower as the Government decided to draw on its reserve fund.

[17] For estimated financing requirements to achieve different development goals, see United Nations, Economic and Social Commission for Asia and the Pacific, *Economic and Social Survey of Asia and the Pacific 2013* (Sales No. E.13.II.F.2), chap. 4.

[18] Fiscal rules are permanent constraints on fiscal policy, expressed in terms of a summary indicator of fiscal performance, which could be budget balance or public debt, usually as a percentage of GDP, or level or growth of government expenditures. Countries in the region that have implemented fiscal rules are Armenia, Australia, Georgia, India, Indonesia, Japan, Malaysia, Maldives, Mongolia, New Zealand, Pakistan, the Russian Federation, Singapore and Sri Lanka.

[19] Increased spending, combined with revenue shortfalls, widened the budget deficit to 2.8% of GDP in 2015, above the 1.9% target.

[20] For a broader discussion on rethinking macroeconomic policies, see United Nations, Economic and Social Commission for Asia and the Pacific, *Economic and Social Survey of Asia and the Pacific 2013* (Sales No. E.13.II.F.2), chap. 3.

[21] India deregulated the prices of petrol and diesel fuel in 2010 and late 2014, respectively, and raised the excise duty on fuel in 2015. Indonesia raised fuel prices in mid-2013; it eliminated petrol subsidies and capped diesel subsidies in 2015. Malaysia liberalized premium petrol prices in 2010 and shifted to a “managed float” (in which prices are set monthly to reflect global oil prices) on regular unleaded petrol and diesel in late 2014.

[22] For instance, Indonesia raised $3.5 billion through international bonds on 1 December 2015, ahead of the United States interest rate hike. Fiji also recently issued $200 million in bonds to roll over a maturing bond at a lower interest rate than the original bond.

[23] The estimated interest payment for 2015 is calculated as the difference between estimated government overall balance and primary balance in 2015, as contained in International Monetary Fund, *World Economic Outlook, October 2015: Adjusting to Lower Commodity Prices*. Available from www.imf.org/external/pubs/ft/weo/2015/02/pdf/text.pdf.

[24] For instance, China has obliged local governments to provide better data on their debts and has forced banks to bring more of their shadow loans onto their balance sheets, providing a clearer picture of liabilities. China has also used both monetary easing and a giant bond-swap programme to reduce the cost of servicing debts. As a result, the weighted interest rate on existing liabilities declined from roughly 6% to 4.5% in 2015.

[25] This point should not be overemphasized, however. As a whole, the bulk of household debt is held by the rich (either in the form of income or assets). For instance, in the Republic of Korea 46% of total debt is held by the richest quintile, whereas for the poorest quintile the figure is only 4.2%.

[26] While outbound FDI has increased in recent years, domestic investment has been somewhat subdued. However, in assessing how much of the funds raised are invested, possible future investments should also be considered, as firms may have front-loaded funding on the back of low United States dollar yields but may have delayed making investments due to domestic and global uncertainties.

[27] Macroprudential measures are designed to limit systemic financial risks, whereas capital flow management measures are aimed at addressing the negative effects of large and volatile capital flows. The latter tends to, but does not always, discriminate on the basis of residency. Given that systemic risks may arise from capital flows, there are overlaps between the two measures.

[28] Many of these issues are highlighted in Basel Committee on Banking Supervision, *Core Principles for Effective Banking Supervision* (Basel, Switzerland, Bank for International Settlements, 2012). However, implementation can vary substantially across countries.

[29] To put things into perspective, there are 15.6 million broadband Internet subscribers and more than 40 million individual bank accounts in Pakistan. See International Monetary Fund Country Report 16/ 2 on Pakistan. Available from www.imf.org/external/pubs/ft/scr/2016/cr1602.pdf.

[30] Tax expenditures are defined by the International Public Sector Accounting Standards Board (IPSAS) as “preferential provisions of the tax law that provide certain taxpayers with concessions that are not available to others” (IPSAS 23, Revenue from non-exchange transactions (taxes and transfers) 2006, Cl. 7, p. 5). They can apply to any type of tax, such as corporate or personal income tax, consumption taxes, customs duties and land taxes.

[31] See http://survey.internationalbudget.org/#download. In response to the survey question, “Does the Executive’s Budget Proposal or any supporting budget documentation present information on tax expenditures for at least the budget year?” the following countries in the region responded positively: Georgia; India; Indonesia; Malaysia;

New Zealand; Pakistan; Papua New Guinea; the Philippines; the Republic of Korea; the Russian Federation; Sri Lanka; Tajikistan; Thailand; and Turkey.

[32] The coverage of tax expenditure reporting varies across countries and affects estimates of foregone revenues.

[33] For instance, the tax burden could be shifted by the owners of capital to employees or consumers.

[34] Viet Nam's inheritance and gift tax of 10% is charged on the value of assets inherited or received as a gift exceeding in value 10 million Vietnamese dong on each occasion such income arises. Assets include securities, capital holdings, real estate and other assets subject to ownership. Thailand's inheritance tax, which came into effect in February 2016, is 5% for ascendants or descendants and 10% for others; it is levied on assets worth more than 10 million baht.

[35] Estimates by the China International Capital Corp., Ltd. See Xinhua, "Chinese premier presses VAT reform to boost economic vitality", 25 January 2016. Available from http://news.xinhuanet.com/english/2016-01/25/c_135044216.htm.

[36] For instance, software upgrades can be supplied as part of a contract for maintenance services, in which case a different tax rate would be applied. See Satya Poddar and Ehtisham Ahmad, "GST reforms and intergovernmental considerations in India", Government of India, Ministry of Finance, Department of Economic Affairs Working Paper No.1/2009-DEA (New Delhi, 2009).

[37] All regional and subregional employment estimates are based on International Labour Organization (ILO), *World Employment and Social Outlook: Trends 2016* (Geneva, ILO, 2016) and ILO, *Key Indicators of the Labour Market*, 9th ed. (Geneva, 2015). The regional and subregional groupings used by ILO differ somewhat from ESCAP definitions; however, the percentage of the population covered by both groupings is similar due to the inclusion of all major developing economies in both sets of definitions.

[38] Poverty reduction is defined in terms of a decrease in the poverty headcount ratio, defined as the percentage of the population living on less than $1.90 a day at 2011 international prices.

[39] In 2012, 97% of the urban population in the region had access to a safe water supply; the figure had been 94% in 1990. However, access to improved sanitation for people living in urban areas in the region has been much slower in achievement − at 75% . See United Nations, Economic and Social Commission for Asia and the Pacific, *Statistical Yearbook for Asia and the Pacific 2014* (ST/ESCAP/2704).