

MAINTAINING GROWTH MOMENTUM AMID UNCERTAINTIES AND INTERNAL CHALLENGES

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In 2014, the average growth rate of the developing economies of Asia and the Pacific is forecast to rise to 5.8%. This represents a modest increase of 0.2 percentage points over that of 2013. Although the developing Asia-Pacific economies continue to anchor the global economic recovery, both external and internal factors are holding back their faster growth. Besides slow recovery in advanced economies, capital outflows due to the reversal of monetary policy in the United States of America pose difficulties for a number of economies. Growth in some large developing economies in the region is also challenged by infrastructure shortages, large budget deficits, inflationary pressure and rising inequality.

Growth and macroeconomic stability in the region continue to be affected by growth prospects and policies of the developed world. While growth strengthened in major developed economies in 2013, it still remains weak and continues to have an impact on exports from the region. Concerns about the reduction in quantitative easing by the United States Federal Reserve (or the bond-buying programme) referred to as “tapering” caused significant volatility in currency and asset markets first in September 2013 and then again in January 2014.

The constrained domestic growth prospects of the region have underlined the importance of productive countercyclical government spending

Domestic challenges also had an impact on some of the region’s major economies in 2013. Infrastructure shortages have led to significant gaps in productive capacity. These gaps have contributed to inflationary pressures and rising balance-of-payments deficits. Asset prices have been driven up in emerging economies in recent years by surges in capital inflows following quantitative easing in the developed world. On the other hand, some of those economies experienced rapid outflows of large amounts of capital at the first sign of a possible reversal of United States monetary policy. These events point to the vulnerability of these emerging economies’ domestic financial sectors. Rising inequality has contributed sharply to growing household debt in a number of economies. This has increased the vulnerability of their populations to economic shocks, as well as contributed to current account imbalances.

The constrained domestic growth prospects of the region have underlined the importance of productive countercyclical government spending to support inclusive growth and sustainable development. Indeed, achieving inclusive and sustainable development will be the centre-piece of concerns of the entire international community as the development agenda is mapped out. A critical challenge within the region and globally will be locating the funding

for the necessary development programmes. A number of countries in the region, especially in South and South-West Asia, do not currently have enough fiscal space for such additional spending. Policies to increase domestic resource mobilization, in particular fiscal space, as discussed in chapter 3, will therefore be critical.

There is also a need to deepen regional economic cooperation and integration and utilize new and innovative mechanisms to finance development. A significant step in this regard has been recent renewed interest among the member States in the creation of a regional financing agency for infrastructure. In October 2013, the President of China, Mr. Xi Jinping, proposed an Asian infrastructure investment bank to promote connectivity and economic integration.¹ ESCAP has been proposing such a bank for a number of years to effectively deploy the region’s large foreign exchange reserves to meet its huge investment needs. This issue, among others, was considered at the Ministerial Conference on Regional Economic Cooperation and Integration in Asia and the Pacific, convened by ESCAP in December 2013. It was proposed that working groups of experts would be formed to design and present proposals to Governments in the region on a new financial architecture and other key development challenges.

The following sections consider the challenges facing the region in greater detail and then offer a number of policy recommendations. The first of these begins with a discussion of growth prospects in developed countries and the potential for spillover of developed countries’ policies to affect growth and capital flows in the region. Growth and inflation prospects in the region, including in some major regional economies, are then discussed. That section is followed by the outlook for regional trade developments – both external and intraregional. Prospects for foreign capital flows, including foreign direct investment (FDI), remittances and tourism are discussed next. Then the discussion is shifted to major socio-economic challenges in the region, which include the problem of job creation and its quality and

the persistent problem of inequality. Subsequently, the first set of policy recommendations outlines the potential for productive government spending to directly support growth in the short term while helping to reduce the domestic challenges affecting growth in the long term. The second set of policy recommendations addresses youth unemployment, a particularly important part of the jobs challenge. The last set of policy recommendations outlines policies to manage the risks from volatility in capital flows to the region.

remains a concern for the region. The United States saw annual growth dip to 1.9% in 2013 from 2.8% in the previous year (see figure 1.1). The eurozone experienced less annual growth contraction in 2013 of 0.4% as compared with 0.6% in the previous year. Significantly, the eurozone emerged from recession in the second quarter of 2013, although growth remained weak. Japan's annual growth increased in 2013 to 1.5% from 1.4% in the previous year. Japan's economy recorded strong growth in the first part of 2013 following the early rounds of stimulus by the new administration. However, growth was less rapid in later months.

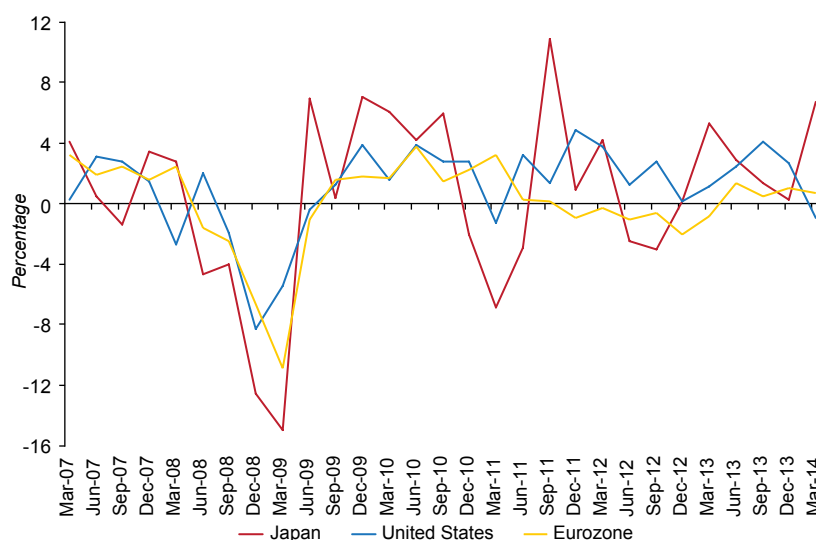
GROWTH RECOVERY UNDER PRESSURE

Slow growth and policies of developed economies having an impact on the region

Growth in the region was affected by low growth in the developed economies in 2013. Given the importance of these economies in terms of trade and investment linkages, their continued slow recovery

Consensus projections for global growth indicate a moderate increase in growth for the developed economies in 2014. In this regard, the G20 economic officials in February 2014 announced the intention of the grouping to raise its collective GDP by 2% above the current trajectory over five years. They proposed to do so by enacting coordinated policies in a number of key areas: investment, employment, trade and macroeconomic fundamentals.²

Figure 1.1. Real GDP growth of major developed economies, quarter-on-quarter, 2007-2014



Sources: ESCAP, based on seasonally adjusted data from the United States Department of Commerce, *National Income and Product Accounts Gross Domestic Product, First Quarter 2014 (second estimate)* (Washington, D.C., Bureau of Economic Analysis, 2014); Japan, Cabinet Office, *Gross Domestic Product: First Quarter 2014 (First Preliminary)* (Tokyo, Economic and Social Research Institute, 2014); and European Commission, "Spring 2014 forecast: Growth becoming broader-based" (Brussels, 2014). Available from http://europa.eu/rapid/press-release_IP-14-513_en.htm.

Note: GDP growth rates are based on annualized data.

It will be challenging to significantly increase growth in the major developed economies in the near term. For the United States, a strong self-sustaining recovery has historically depended on consumer spending. However, with joblessness remaining high, a surge in consumer demand is unlikely to occur. The situation is exacerbated by a rise in inequality, with the well-off having benefited disproportionately from recent growth.³ As the well-off are unlikely to consume as great a proportion of their increased income as those on lower incomes, the increase in effective demand is likely to be less than would have been the case had there been no increase in inequality.

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The eurozone is also subject to challenges in 2014. The unemployment rate is still high in many eurozone countries and is contributing to the lack of self-sustaining consumption-led growth. While eurozone financial markets were reasonably calm in 2013, there remains the risk of macroeconomic instability resulting from any renewed loss of confidence by investors in the progress of debt resolution. Furthermore, with inflation in the eurozone running at a worryingly low 0.5% as of May 2014, there is uncertainty regarding the possible risk of deflation. The prospect of deflation will increase if the referral of the Federal Constitutional Court of Germany to the Court of Justice of the European Union in February 2014 concerning the constitutionality of the European Central Bank's outright monetary transactions scheme results in the Bank being unable to pursue expansionary monetary policy.

Within the Asian and Pacific region, the growth outlook for Japan will depend on the impact of the ongoing reform programme. The economy recorded an upturn in its growth with a set of economic stimulus policies which came into effect in 2013. The first so-called "arrow" of the policies was monetary stimulus through a programme of bond-buying by

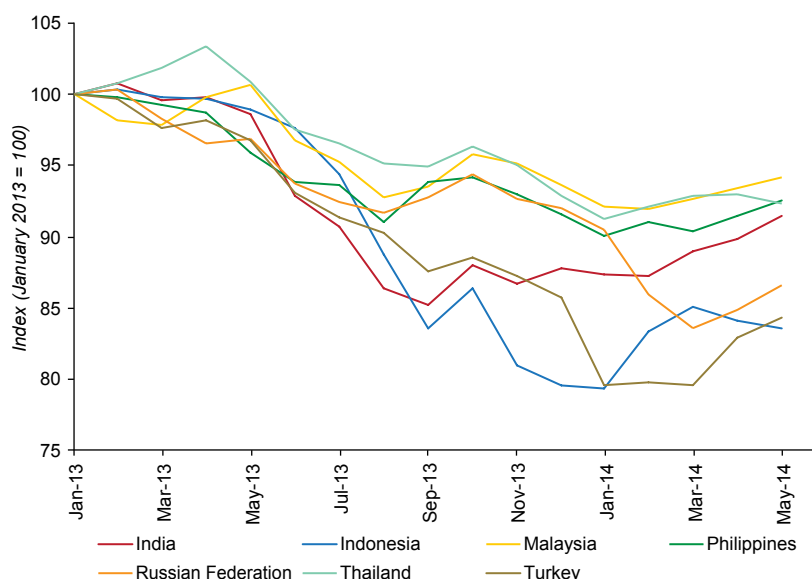
the Bank of Japan, with the objective of achieving an inflation rate of 2%. As a proportion of GDP, this has been the world's largest-ever quantitative easing programme. The injection of money into the domestic financial system led to a boost in asset prices, and thus household wealth and consumer expenditure. Monetary expansion also caused an exchange rate depreciation that significantly boosted exports. The second "arrow" of policies was a large fiscal stimulus package of 10.3 trillion yen (\$116 billion) for infrastructure projects and stimulating private investment. The third "arrow", to be presented to the legislature for approval in mid-2014, is a growth strategy comprising a range of policies to change the country's economic structure. An accompanying reform during this phase was an increase in consumption tax from 5% to 8% effective from 1 April 2014. In 1997, when Japan last increased the consumption tax, that measure slowed consumption demand considerably and aborted the country's nascent recovery. It is possible that there will be a dip in growth for the second quarter of 2014 (April-June) following the tax rise, a dip similar to the one that occurred in 1997. However, more important will be the extent of an expected rebound in the third quarter of 2014; it is too early to judge whether other government policies will continue to cushion or offset the impact of the consumption tax hike.

Apart from slow growth in developed economies, policies in the developed world also had significant impacts on the region through spillovers from the tapering of quantitative easing by the United States. In January 2014 there was a bout of capital outflows from the asset markets of the region. The greatest falls in equity markets were in Turkey (7.7%) and in India (4.4%). This followed a more widespread exit of funds in the third quarter of 2013 in expectation that tapering would start in September 2013. In the equity markets, the greatest decline was seen in Turkey (25%) during the period June-August 2013, followed by Indonesia and Thailand (nearly 20%). In August 2013 alone, stock market capitalization in seven economies in the region declined by \$323 billion as compared with the previous month.

Capital outflows from the region are partly a pre-emptive move by investors in preparation for the normalization of monetary policy by the United States. Tapering represents the first step in normalization. During tapering, monetary policy is still accommodative although less so every month, as the amount of extra liquidity provided by the Federal Reserve is reduced from \$85 billion by \$10 billion monthly. The next stage in normalization will be an increase in interest rates from zero, which will represent the actual tightening of United States monetary policy. There is uncertainty regarding when the interest rate rise will come, though it is believed according to the forward guidance of the Federal Reserve to be most likely sometime in 2015. As interest rates rise in the United States, capital is expected to flow back to that economy from the region. The repatriation of capital to the United States would lead to falls in asset prices in the region. Investors seek to pre-empt the falls in the value of their assets in the region by exiting the markets as early as possible when there are changes in expectations regarding the timing of monetary policy normalization.

Monetary authorities in the region have managed the impact on exchange rates of capital outflows through a combination of approaches – allowing for depreciation, using foreign exchange reserves and raising interest rates. Turkey allowed its currency to fall, vis-à-vis the United States dollar, by 7% in January 2014. In the period June-August 2013, the largest depreciations occurred in Indonesia (10%), followed by India, Malaysia, Turkey, the Philippines and Thailand (see figure 1.2). To prevent excessive depreciation, countries managed the extent of currency falls by spending some of their foreign exchange reserves. Indonesia, Malaysia and India recorded the largest declines in their foreign exchange reserves (see figure 1.3), having used between \$10.9 billion and \$6.9 billion over the period June-August 2013. Another measure used by some countries to manage depreciation was to raise interest rates and thus increase the attractiveness of their currencies. Interest rates were also raised to manage the inflationary impact of depreciation on domestic prices. In January 2014, Turkey sharply raised its overnight lending rate from 7.75% to 12% while India increased its repo rate by 25 basis points to

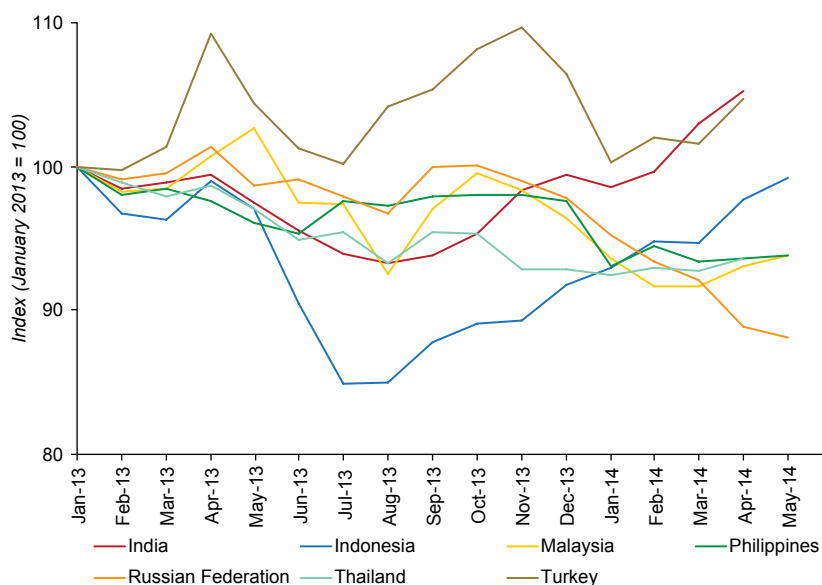
Figure 1.2. Exchange rate indices in selected developing Asia-Pacific economies, 2013-2014



Source: ESCAP, based on data from CEIC Data. Available from www.ceicdata.com (accessed 15 June 2014).

Notes: These indices are calculated vis-à-vis the United States dollar. Lower value signifies depreciation against the United States dollar.

Figure 1.3. Foreign reserve indices in selected developing Asia-Pacific economies, 2013-2014



Source: ESCAP, based on data from CEIC Data. Available from www.ceicdata.com (accessed 15 June 2014).

8%. During the earlier period of capital outflows, Indonesia increased its reference rate between May and November 2013 from 5.8% to 7.5%.

The degree to which capital has exited economies has been related to perceived weaknesses in their macroeconomic fundamentals, as well as to the size of their financial markets. Investors most penalized those economies, such as India and Indonesia, which were perceived as having relatively weak or deteriorating macroeconomic fundamentals. One key weakness for these economies was excessive dependence on foreign short-term portfolio capital to fund balance of payments deficits. Another key weakness of these economies was high inflation which required tight monetary policy. This in turn dampened growth prospects. Apart from the influence of particular weaknesses of economies on the decisions of investors, the degree of capital outflow has been observed to be related to the size and liquidity of their capital markets.⁴ Generally, countries with large and open financial markets experience greater outflows, as compared with less developed economies having relatively closed financial markets. This is because investors are able to rebalance their portfolios more easily and conveniently in the case

of more liquid and open financial markets. This is not to say that economies should be wary of more open financial markets but that they should ensure sufficient policy space to engage in countercyclical measures to thwart the negative impacts of capital outflows and put in place macroprudential measures for managing capital flows.

Further possible financial market turbulence triggered by the normalization of monetary policy in the United States may lead to significant, though differentiated, impacts on countries in the region. ESCAP analysis suggests that, under a worst-case scenario, the effects of such financial market turbulence could cut annual GDP growth by up to 0.7-0.9 percentage points in the most-affected economies — India, Malaysia, the Russian Federation, Thailand and Turkey (see box 1.1). Among the components of growth, fixed investment is most affected due to rising borrowing costs. The adverse impact on GDP growth would be larger than these first-round estimates for economies where monetary policy tightening was deemed necessary to stem capital flight. For example, annual growth in the Russian Federation could slow by as much as 1.3 percentage points in such a case, and in Thailand by 1.1 percentage points.

Box 1.1. How would financial market turbulence due to monetary policy normalization in the United States affect growth performance in Asia and the Pacific?

An attempt is made here to assess the impact of possible financial market turbulence, triggered by the normalization of monetary policy in the United States, on economic growth in selected developing Asia-Pacific economies. The first stage of normalization is the tapering of quantitative easing; this process started in January 2014. In the next stage, interest rates will be increased from zero. There is uncertainty regarding when the interest rate rise will occur, though it is believed most likely to be sometime in 2015. A mismatch between market expectations on the timing, pace and magnitude of the normalization and actual policy announcement, or even speculation about the timing of the announcement, could lead to financial market turbulence, as was evident in many economies in the region in mid-2013. Using a macroeconomic simulation exercise, two possible scenarios of market turbulence are analysed below.

Under the “high-case scenario”, the magnitude of financial sector shocks, in terms of lower share prices and currency depreciation, is assumed to mimic what was observed during the months from May to August 2013, the period when the markets believed that the tapering would commence in September. It is further assumed that, as global financial liquidity tightens, bank lending falls and confidence weakens. There is also a generalized increase in risk aversion against emerging economies. Such a combination of shocks is set for a time period of one quarter after the policy announcement or speculation about the announcement. This scenario is also feasible when the normalization is as expected but policy responses by affected economies are viewed as too slow or ineffective.

Under the “low-case scenario”, communication on a change in policy direction is largely clear so the market is assumed mostly to have factored in the normalization decision. Market reactions and perceived risks are thus assumed to be more modest than in the high-case scenario. This scenario also accounts for a situation where the pace and/or the magnitude of the normalization are milder than market expectations.

It is assumed that turbulence resulting from the normalization decision will constrain output growth in emerging Asia-Pacific economies through at least two channels. First, corporate borrowing rates would rise amid tighter financial liquidity and heightened systemic risk premiums.^a The second channel would be the effect of deteriorating market confidence and increased economic uncertainty on consumer spending and fixed investment.

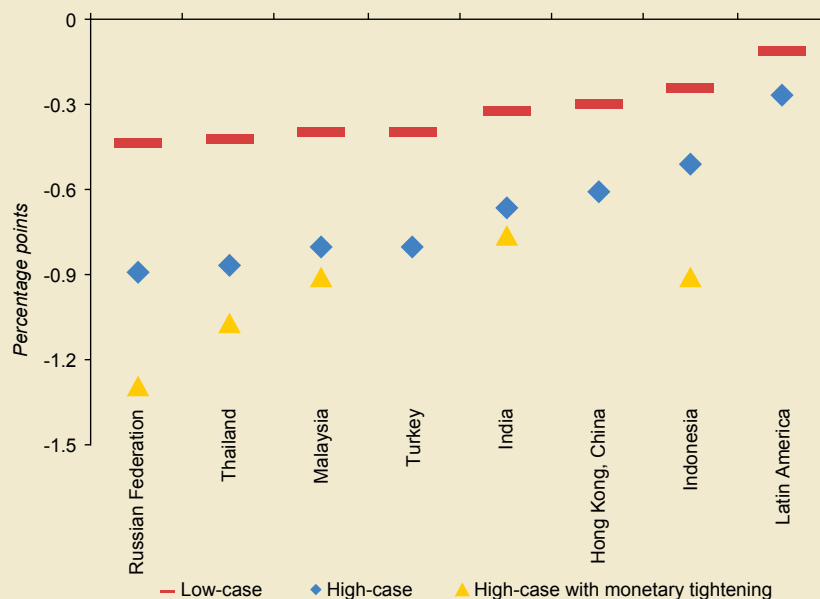
The figure below depicts the differences between estimated GDP growth rates under the two scenarios and baseline growth rates, as projected by the Global Economic Model of Oxford Economics.^b Under the high-case scenario, financial sector disruptions relating to the normalization decision could cut annual GDP growth by up to 0.7-0.9 percentage points in India, Malaysia, the Russian Federation, Thailand and Turkey. The impact would be sizeable, especially for economies where near-term economic growth is projected to be below potential, such as in the Russian Federation and Thailand, due to political factors. The simulation also suggests that the estimated output growth effect on emerging Asia-Pacific economies would be larger than for a group of major economies in Latin America, which ranges for the latter between 0.1 and 0.3 percentage points across the two scenarios.

The negative impact on output growth in economies occurs under these scenarios despite an increase in exports due to weaker currencies. This is because the export effect is outweighed by the negative impact on domestic demand components of GDP. Among the components of domestic demand, the greatest impact is on fixed investment due to higher borrowing costs. Indonesia, Malaysia, the Russian Federation and Thailand are likely to experience the greatest declines in fixed investment growth. Under the high-case scenario, annual fixed investment growth in these economies would be close to 3 percentage points lower than the baseline. Industrial output growth would decelerate and job losses would be higher than in the other economies considered

Box 1.1. (continued)

here. Together with rising joblessness and borrowing costs, higher inflation amid currency depreciation also would put pressure on household spending. Annual private consumption growth in all economies here is estimated to be 0.7-2 percentage points lower under the high-case scenario relative to the baseline.

Figure A. Differences between estimated GDP growth rates under simulation scenarios and baseline GDP growth rates



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

Notes: "Latin America" refers to the GDP-weighted average of the estimated impact in Brazil, Chile and Mexico. These three economies alone account for more than 60% of total output in Latin America.

If monetary policy also needs some tightening in response to capital flight, the growth deceleration for economies would be even more notable. Sharp tightening was necessary, for example, by Turkey in January 2014 when the overnight lending rate had to be raised by 425 basis points. To restore financial market stability, an economy may have to raise its short-term interest rate level to match that in other emerging economies perceived as being at risk of capital outflow. The figure above shows, for example, that if the Russian Federation were to increase its interest rate to the level of Turkey, a country with a comparable sovereign credit rating and considered recently at risk of capital outflow, monetary policy tightening would cut annual GDP growth by another 0.4 percentage points, increasing the total impact to 1.3 percentage points. This additional impact would also be large in Indonesia but less so in India as its current interest rate is already relatively high.^c Overall, financial market turbulence that requires monetary tightening could cut annual output growth in selected Asia-Pacific economies by 0.8-1.3 percentage points.

^a Long-term government bond yields in the region jumped in mid-2013 and stayed high towards the end of the year. During this period, there was widespread speculation about normalization although no change in United States monetary policy direction was announced. The yields between April and December 2013 increased by up to 480 basis points in Turkey, 300 basis points in Indonesia and about 100 basis points for most other emerging economies in the region.

^b The 10 economies included in this analysis are those that: (a) have attracted sizeable short-term capital inflows in the recent years; (b) faced falling equity prices and/or currency depreciation to a sizeable extent over May-August 2013 relative to January-April 2013; and (c) recorded sharp rebounds in September 2013 when the tapering did not materialize as had been feared. China is not included here as it did not meet these criteria. However, the liberalization of China's exchange rate and capital account that is not accompanied by appropriate macroprudential measures would also raise the country's exposure to global financial volatility.

^c In the cases of Malaysia and Thailand, their sovereign credit ratings are more favourable than that of Turkey, so the interest rate hike is assumed to match that of South Africa, which has a more comparable credit rating.

Apart from the short-term impact of volatile portfolio capital outflows, the long-term impact of normalization of monetary policy by the United States will be higher external borrowing rates for the region. Long-term interest rates for the United States dollar are expected to rise, which would lead to higher external borrowing costs for economies in the region. Foreign lending to the region has been spurred in recent years by the high liquidity flowing from the developed world (see box 1.2). Foreign lending has been in the form of direct lending by foreign banks to domestic banks and through the purchase by foreigners of domestic corporate and government bonds. The result has been the ability of economies in the region with open financial markets to borrow at historically low interest rates.

Higher external borrowing rates will have a direct impact on sovereign and corporate borrowing of regional economies from abroad. Rising rates will also have an impact on foreign borrowing by local banks for on-lending domestically, which may then in turn have to increase their domestic interest rates. Higher domestic interest rates are likely to have an impact on local business growth generally and especially for small and medium-sized enterprises (SMEs) as they are more dependent on bank lending. These multiple impacts may have a significant impact on overall GDP growth and employment generation in affected economies. If interest rates also need to be raised to prevent excessive capital outflow, there would be further negative impacts on growth and jobs.

Box 1.2. Potential and challenges for Asia-Pacific bond markets^a

With the low interest rates prevailing in advanced economies, the search for yield has led to significant liquidity flows from the developed world to the Asian region. This has had a notable impact on bond markets, particularly on corporate bonds. Thus, while the dominant source of financing remains bank-intermediated credit for companies, corporate bond issuance has accelerated. In 2013, in China it reached \$97.4 billion compared with \$23.6 billion in 2010. During the same timespan, corporate bond issuance increased almost five-fold in India, reaching \$16.8 billion, and it increased to \$15.8 billion in Singapore from \$3.9 billion in 2010. In fact, between 2008 and 2012, annual issuance of corporate bonds in 10 economies in the region increased from \$100 billion to \$512 billion, before declining somewhat to \$480 billion in 2013.^b

Despite these increases, corporate bond markets remain relatively small and underdeveloped in the region compared with those of advanced countries. In 2013, corporate bond market capitalization was less than 20% of GDP in China, Indonesia, the Philippines, Thailand and Viet Nam. In India, it was less than 12% of GDP in 2012. Corporate bond market capitalization exceeded 50% of GDP only in Hong Kong, China; Malaysia; the Republic of Korea; and Singapore.

One consequence of underdeveloped bond markets is that the risks of supplying long-term capital are overly concentrated in the banking sector in the region. This is particularly so as tighter capital requirements under the Third Basel Accord (Basel III), such as higher capital reserve ratios, are likely to reduce the availability of bank financing. Countries need to enhance their capability to supply long-term capital for financing economic development and to ensure financial stability to safely intermediate external flows. Local currency bond markets and regional bond markets must therefore be developed further as they are important instruments for longer-term finance for corporations and for long-term investors, including pension funds and insurance companies.

Local currency bond markets lessen the risk of currency mismatch and maturity mismatch, thereby mitigating against risks associated with the sudden stop of capital inflows. In this regard, it seems that economies in the region have learned from the currency and maturity mismatches that triggered the Asian financial crisis in 1997, as local currency bonds accounted for more than 80% of corporate bonds during 2009 and 2013, compared with less than 30% in Latin America. Yet, in some economies, bonds denominated in foreign currencies continue to carry an important weight, notably in Indonesia, where during this period

Box 1.2. (continued)

more than 80% of corporate bonds were denominated in foreign currencies. Moreover, since 2010 the importance of issuance of foreign-currency denominated bonds has been on the rise. This may be an indication that firms are taking advantage of lower dollar interest rates in recent years. However, greater foreign investor participation in domestic bond markets and more reliance on foreign currency issuance exposes economies to an additional source of capital outflow pressures. It does so by making local markets more sensitive to bond market developments in developed economies, and thereby vulnerable to external shocks.

Notwithstanding the increase in primary issuance of bonds, corporate bond market development is being impeded by low demand and low trading volumes in secondary markets. In part, this may be due to the fact that bond markets are not sufficiently integrated in the region or into the global economy. This hinders an efficient allocation of resources and robs markets of enforcement discipline and insurance mechanisms that exist in more closely integrated markets. Different and heterogeneous legal and regulatory frameworks impede the development of cross-border bond markets that would allow for greater circulation of the region's high savings.

The development and integration of government bond markets is a further critical element of corporate bond market development, particularly as government bonds provide important benchmark yield curves. Several initiatives to create regional government bond markets have taken place in the past, including the Asian Bond Markets Initiative and the Asian Bond Fund 1 and Asian Bond Fund 2.^c Yet, further progress currently remains limited.

Developing bond markets can provide an important source of financing for the region to address its development challenges. Despite having the highest savings rate in the world, most of the region's surplus savings are invested abroad. The region would benefit from greater efforts to develop, strengthen and integrate regional bond markets. This would enable a shift from bank-centric systems towards deep, liquid, efficient and robust financial and capital markets at the national and regional levels that could better mobilize resources from within and outside the region.

^a This box draws upon Levinger and Li (2014) and Turner (2014).

^b These economies comprise China; Hong Kong, China; India; Indonesia; the Republic of Korea; Malaysia; the Philippines; Singapore; Taiwan Province of China; Thailand; and Viet Nam.

^c For instance, to strengthen the Association of Southeast Asian Nations (ASEAN), China, Japan and the Republic of Korea (collectively known as ASEAN+3) launched the ASEAN+3 Asian Bond Market Initiative (ABMI) in 2002. In that same year, the Executives' Meeting of East Asia-Pacific (EMEAP) central banks group launched the \$1 billion Asian Bond Fund 1 (ABF 1); ABF 2, which invested in local currency bonds issued by sovereign and quasi-sovereign issuers in the same member economies as those in ABF 1, was launched in 2005.

Region's growth and inflation prospects

The economic growth rate in the region in 2013 increased slightly to 5.6% from 5.3% in 2012. The developing Asia-Pacific economies, having recovered strongly in 2010 with an average growth rate of more than 8%, have seen their annual growth rate dip below 6% starting in 2012. Apart from external pressure on growth in the region because of the slow recovery of the developed economies, growth in Asia and the Pacific in 2013 also suffered due to low growth in some major regional economies

as a result of domestic challenges. For a number of reasons, China, India and Indonesia, which have large domestic markets, experienced relatively low growth in 2013 compared with their strong performance earlier in the decade (see table 1.1). Growth in China remained unchanged at 7.7% in 2013 as compared with the previous year, but was significantly down from the levels recorded in 2011 and earlier. India saw some increase in growth to 4.7% in 2013 from 4.5% in 2012, but it was substantially down from the level in 2011 and even more so compared with 2010. Indonesia

Table 1.1. Selected economies of the ESCAP region: rates of economic growth and inflation, 2010-2014

(Percentage)											
	Real GDP growth						Inflation ^a				
	Average pre-crisis growth 2005-2007	2010	2011	2012	2013	2014 ^b	2010	2011	2012	2013	2014 ^b
East and North-East Asia^c	6.7	7.2	4.0	4.0	4.2	4.1	1.3	2.5	1.4	1.5	2.9
East and North-East Asia (excluding Japan)^c	10.9	9.5	8.0	6.4	6.6	6.6	3.2	5.1	2.6	2.4	3.0
China	12.7	10.4	9.3	7.7	7.7	7.5	3.3	5.4	2.6	2.6	3.1
Democratic People's Republic of Korea	..	..	..	..	..	..	..	..	..	..	..
Hong Kong, China	6.8	7.0	4.8	1.5	2.9	3.5	2.4	5.3	4.1	4.3	4.6
Japan	2.1	4.7	-0.5	1.4	1.5	1.4	-0.7	-0.3	0.0	0.4	2.8
Macao, China	16.5	26.4	21.3	9.1	11.9	11.3	2.8	5.8	6.1	5.5	6.0
Mongolia	8.7	6.5	17.4	12.4	11.7	10.0	10.1	9.2	14.3	10.5	12.0
Republic of Korea	4.8	6.3	3.7	2.3	3.0	4.0	2.9	4.0	2.2	1.3	2.1
North and Central Asia^c	8.2	4.4	4.7	3.8	2.1	1.3	7.0	8.6	5.1	6.7	5.5
North and Central Asia (excluding Russian Federation)^c	13.0	6.7	6.7	5.5	6.5	6.1	7.4	9.4	5.3	6.0	8.2
Armenia	13.6	2.2	4.7	7.2	3.5	4.5	8.2	7.8	2.6	5.8	5.0
Azerbaijan	28.6	5.0	0.1	2.2	5.8	5.0	5.7	8.1	1.1	2.4	4.0
Georgia	10.4	6.3	7.2	6.2	3.2	5.0	7.1	8.5	-0.9	-0.5	4.0
Kazakhstan	9.8	7.0	7.5	5.0	6.0	5.4	7.1	8.3	5.1	5.8	9.3
Kyrgyzstan	3.8	-0.5	6.0	-0.9	10.5	6.5	8.0	16.9	2.8	6.6	7.2
Russian Federation	7.4	4.0	4.3	3.5	1.3	0.5	6.9	8.4	5.1	6.8	5.0
Tajikistan	7.2	6.5	7.4	7.5	7.5	6.0	6.5	12.5	5.8	5.1	7.2
Turkmenistan	12.0	9.2	14.7	11.1	10.1	10.4	10.0	12.0	8.5	9.0	11.0
Uzbekistan	7.9	8.5	8.3	8.2	8.0	8.1	9.4	12.8	13.2	12.1	11.0
Pacific^{c, d}	3.4	2.5	2.4	3.5	2.4	2.9	2.8	3.4	1.7	2.3	2.7
Pacific island developing economies^c	3.2	5.2	7.6	5.3	4.0	4.9	4.6	6.4	2.6	3.7	4.9
Cook Islands	1.2	-3.0	1.0	4.4	3.2	2.2	-0.3	2.2	3.0	1.9	2.5
Fiji	-0.1	3.0	2.7	1.7	3.6	3.8	3.7	7.3	3.4	2.9	3.0
Kiribati	2.1	-0.5	3.3	2.5	2.0	3.0	-3.9	1.5	-3.0	2.0	2.5
Marshall Islands	2.0	5.8	0.6	3.2	0.8	3.0	1.8	5.4	4.3	1.6	1.5
Micronesia (Federated States of)	0.2	2.5	2.1	0.4	0.6	0.5	3.9	4.6	5.8	2.2	2.0
Nauru	-11.8	0.0	3.8	4.9	4.5	10.0	-0.6	-3.5	-0.5	1.4	5.0
Palau	3.4	-1.1	6.9	4.8	-1.0	3.0	1.1	2.6	5.4	3.0	2.5
Papua New Guinea	4.5	7.1	11.1	8.0	5.1	6.2	6.0	6.9	1.6	4.7	6.5
Samoa	3.7	0.5	1.4	2.7	-0.5	2.0	0.0	3.1	6.2	-0.2	2.0
Solomon Islands	6.4	7.9	10.6	4.8	3.2	3.7	1.0	7.4	5.9	5.6	5.5
Tonga	-1.3	3.3	2.9	0.8	1.6	2.0	5.1	3.8	2.5	0.8	2.0
Tuvalu	2.7	-1.4	-0.6	0.2	1.1	2.0	-1.9	0.5	1.4	2.0	2.5
Vanuatu	6.3	1.6	1.2	1.8	3.2	3.5	2.8	0.9	1.4	1.4	2.5
Developed countries (Australia and New Zealand)^c	3.4	2.5	2.3	3.5	2.4	2.9	2.7	3.4	1.7	2.2	2.7
Australia	3.4	2.6	2.5	3.6	2.4	2.8	2.8	3.3	1.8	2.4	2.8
New Zealand	2.8	1.8	1.2	2.9	2.4	3.3	2.3	4.0	1.1	1.1	2.0
South and South-West Asia^{c, d}	8.1	7.8	6.6	2.9	3.9	4.7	9.9	9.5	11.9	11.3	9.3
Afghanistan	10.2	8.4	6.5	14.0	3.6	3.2	2.2	11.8	6.4	7.4	6.1
Bangladesh	6.3	6.1	6.7	6.2	6.0	6.1	7.3	8.8	10.6	7.7	7.0
Bhutan	10.6	11.7	8.6	4.6	6.9	7.1	6.1	8.3	13.5	8.7	7.6
India	9.5	8.4	6.7	4.5	4.7	5.5	10.4	8.4	10.2	9.5	8.0
Iran (Islamic Republic of)	6.1	5.9	3.0	-5.8	-1.7	1.5	12.4	21.5	30.5	35.2	23.0
Maldives	7.2	7.1	6.5	1.3	3.7	4.5	6.1	11.3	10.9	4.0	5.0
Nepal	3.2	4.0	3.8	4.5	3.6	4.5	9.6	9.6	8.3	9.9	9.8
Pakistan	7.2	2.6	3.6	3.8	3.7	4.1	10.1	13.7	11.0	7.4	8.0
Sri Lanka	6.9	8.0	8.2	6.3	7.3	7.6	6.2	6.7	7.5	6.9	6.0
Turkey	6.7	9.0	8.6	2.2	4.0	4.0	8.6	6.5	8.9	7.5	7.6
South-East Asia^c	6.1	8.1	4.6	5.5	4.9	4.6	4.0	5.5	3.9	3.9	4.0
Brunei Darussalam	1.7	2.6	2.2	0.9	-1.8	1.2	0.4	2.0	0.5	0.4	0.5
Cambodia	11.4	6.0	7.1	7.3	7.6	7.2	4.0	5.5	2.9	2.9	3.4
Indonesia	5.8	6.2	6.5	6.2	5.8	5.4	5.1	5.4	4.3	6.4	5.5
Lao People's Democratic Republic	7.7	7.9	8.3	8.3	8.2	7.5	6.0	7.6	4.3	6.4	6.0
Malaysia	5.9	7.4	5.1	5.6	4.7	5.0	1.7	3.2	1.7	2.1	3.0
Myanmar	12.9	5.3	5.9	7.3	7.5	7.8	8.2	2.8	2.9	5.8	6.6
Philippines	5.8	7.6	3.6	6.8	7.2	6.7	3.9	4.6	3.2	2.9	4.3
Singapore	7.8	14.8	5.2	1.9	3.9	3.5	2.8	5.2	4.6	2.4	2.5
Thailand	4.9	7.8	0.1	6.5	2.9	2.2	3.3	3.8	3.0	2.2	2.4
Timor-Leste	5.0	9.5	12.0	8.3	8.1	8.0	6.9	13.5	10.9	10.6	9.5
Viet Nam	8.4	6.4	6.2	5.2	5.4	5.7	9.2	18.7	9.1	6.6	6.2
Memorandum items:											
Developing ESCAP economies	9.5	8.8	7.2	5.3	5.6	5.8	5.1	6.3	5.3	5.0	4.8
Least developed countries^e	6.0	5.5	6.0	5.6	5.5	5.6	6.5	7.8	8.6	6.8	6.3
Landlocked developing countries	11.7	6.2	6.4	5.3	6.2	5.8	7.2	8.9	5.7	6.3	8.1
Small island developing States	3.7	5.7	7.7	5.1	4.2	5.0	4.8	7.3	3.9	4.1	5.1
Developed ESCAP economies	2.3	4.3	0.0	1.7	1.6	1.6	-0.1	0.3	0.3	0.7	2.8
Total ESCAP	6.8	6.9	4.4	3.9	3.9	4.0	3.3	4.3	3.4	3.6	4.1

Sources: ESCAP based on national sources; United Nations, Department of Economic and Social Affairs (2014). *World Economic Situation and Prospects 2014*, Sales No. E.14.II.C.2. Available from www.un.org/en/development/desa/policy/wesp/wesp_current/wesp2014.pdf; IMF, International Financial Statistics database. Available from <http://elibrary-data.imf.org>; ADB, *Asian Development Outlook 2014* (Manila, 2014); 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, June 2014.

^a Changes in the consumer price index.

^b Forecasts (as of 15 June 2014).

^c GDP figures at market prices in United States dollars in 2010 (at 2005 prices) are used as weights to calculate the regional and subregional aggregates.

^d The estimates and forecasts for countries relate to fiscal years defined as follows: 2013 refers to fiscal year spanning 1 April 2013 to 31 March 2014 in India; from 21 March 2013 to 20 March 2014 in Afghanistan and the Islamic Republic of Iran; from 1 July 2012 to 30 June 2013 in Bangladesh, Bhutan and Pakistan; and from 16 July 2012 to 15 July 2013 in Nepal.

^e Samoa is excluded from the calculation for 2014 due to its graduation from the least developed country category.

experienced a decline in growth to 5.8% in 2013 from 6.2% in 2012.

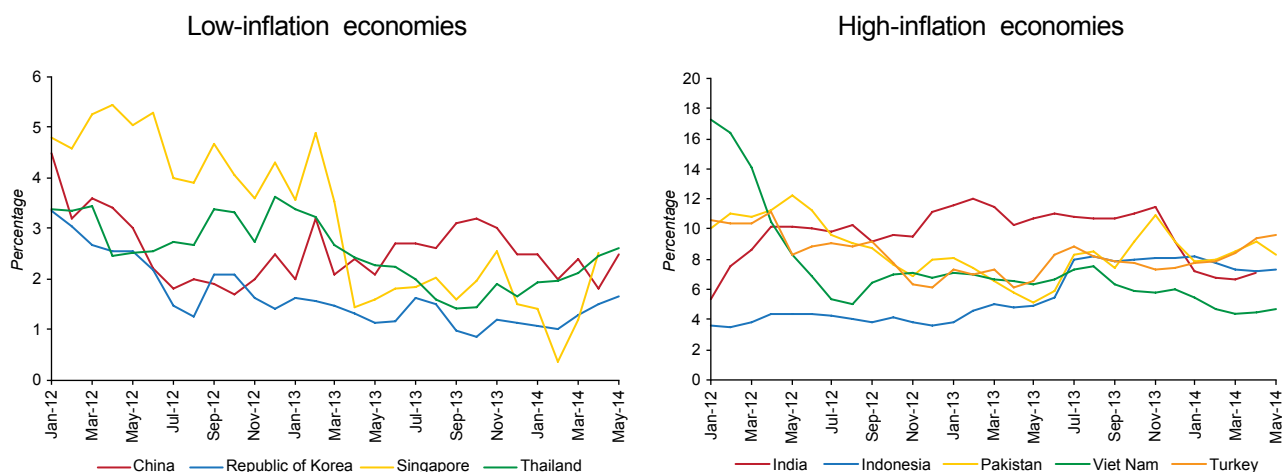
As expected for a large region, subregional growth experiences in 2013 differ. For example, subdued global commodity demand contributed to reduced growth of 2.1% in North and Central Asia and of 4% in Pacific island developing economies. Growth also slowed to 4.9% in South-East Asia, affected by weaker domestic demand in larger economies. East and North-East Asia recorded a rebound to 4.2% with the export of goods reviving recently. Growth in South and South-West Asia also picked up to 3.9% on robust private consumption. In 2014, Pacific island developing countries and South and South-West Asia are forecast to post stronger growth, while other subregions are forecast to have relatively stable or lower growth as compared with the previous year.

Inflation differed substantially across the region in 2013. Inflation in exporting economies, such as those in South-East Asia and East and North-East Asia, declined or remained stable in 2013 due to constrained global demand (see figure 1.4). Despite relatively robust domestic demand in many of these economies, overall slack owing to low export growth kept prices in check. Low inflation allowed for an accommodative monetary policy in most of these countries, with policy interest rates lower or more

stable in 2013 than in the previous year (see figure 1.5). On the other hand, for a number of economies where the export sector does not play as large a role, such as India, Indonesia and Pakistan, inflation remained high in 2013. Consequently, monetary policy was tightened for most of these economies during 2013. The inflation outlook in 2014 is generally moderate and headline inflation in the region is projected to be 4.8% in 2014, down from 5% in 2013 (see table 1.1). However, some major economies, such as India and Indonesia, will continue to face significant price pressures.

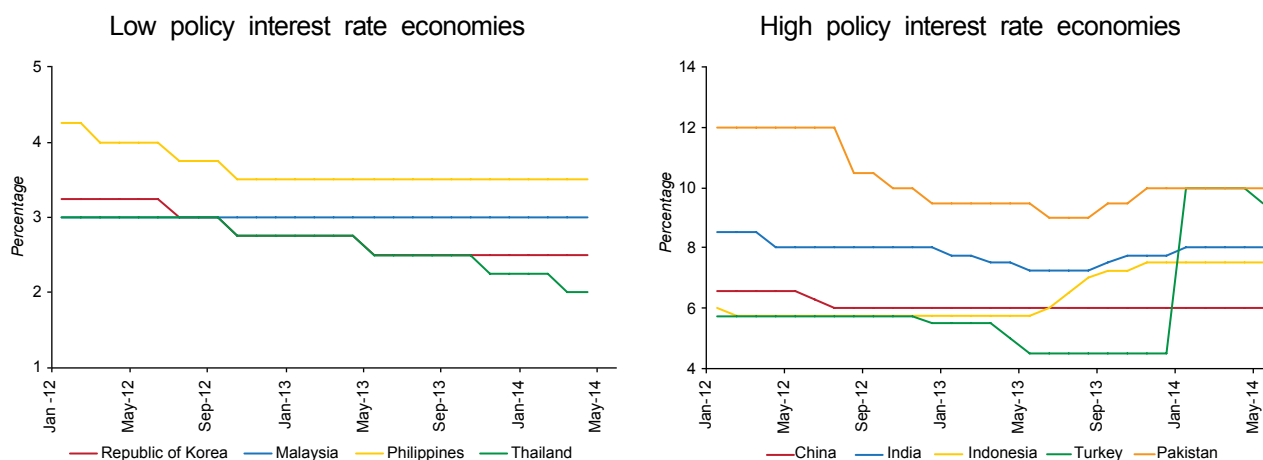
One positive factor for inflation in the region is that most commodity prices are likely to remain flat or decline over the next 12 months due to slow global recovery and the winding back of quantitative easing by the United States Federal Reserve. However, this prospect may change due to geopolitical factors and supply shocks in major producing countries. Moreover, major measures to curb financial speculation in commodity markets that had been agreed at the G20 Summit on Financial Markets and the World Economy, which was held in Cannes, France, in November 2011, still remain unimplemented. Besides the demand-supply fundamentals, high global liquidity has played an important role in supporting the persistently high prices of oil and globally traded food commodities

Figure 1.4. Consumer price inflation in selected developing Asia-Pacific economies, 2012-2014



Source: ESCAP, based on data from CEIC Data. Available from www.ceicdata.com (accessed 15 June 2014).

Figure 1.5. Policy interest rates in selected developing Asia-Pacific economies, 2012-2014



Source: ESCAP, based on data from CEIC Data. Available from www.ceicdata.com (accessed 15 June 2014).

Notes: The policy rates for each country include the nominal short-term one-year lending rate for China; Reserve Bank of India repo rate for India; Bank of Indonesia month end reference rate for Indonesia; Bank of Korea base rate for the Republic of Korea; overnight policy rate for Malaysia; reverse repo rate for Pakistan; reverse repurchase rate for the Philippines; the one-day bilateral repurchase rate for Thailand; and the one-week repo rate for Turkey.

and their volatility. This affected the region badly, especially during the high food and fuel price episodes during the period 2008-2010.

Prospects in the region's major developing economies

While detailed discussions of subregions and countries are presented in chapter 2, this subsection highlights developments and prospects in major developing economies of the region. The economy of China is projected to grow by 7.5% in 2014, lower than the rates recorded in 2012-2013. A substantial portion of the growth moderation in China has resulted from the Government's active attempts to alter the structure of growth away from investment and exports towards domestic consumption. The comprehensive and far-reaching reform programme is also taking measures to address growing inequality, property market overheating and shadow banking. These efforts have slowed growth in the short term, but it is hoped that growth would be more sustained and inclusive in the long run (see box 1.3). Although growth is projected to decline, inflation is forecast to increase from 2.6% in 2013 to 3.1% in 2014, mainly due to liberalization of administrative prices.

The key areas of reform in China include:

- Further adjusting the role of the Government to be a market facilitator and regulator through significant reduction in direct market interventions and substantive strengthening of regulatory capacities;
- Deepening fiscal reforms to improve fiscal accountability and sustainability, and rebalancing fiscal revenues and expenditures between the central and the local governments;
- Completing market infrastructure and the rule of law to promote fair competition and improve the business environment;
- Instituting orderly liberalization of interest rates and opening of the finance sector and other key service sectors to private and foreign investment;
- Improving governance and accountability of State-owned enterprises;
- Strengthening social security networks and promoting equal access to public services;
- Assigning greater land property rights to farmers;
- Exploring innovative social administration mechanisms, including collaborative interaction between government and civil society organizations;

Box 1.3. Understanding China's economic transformation programme

The new master plan announced in late 2013 to “comprehensively deepen reforms” is a response to a number of socio-economic challenges in China – the unsustainable investment-driven growth model, increasing economic inequality and the pressing problem of environmental deterioration.

China has recognized that a holistic and well-coordinated reform plan is required to deal with interlinked and mutually reinforcing challenges. The investment-centric growth model, for instance, leads to income distribution favouring capital over labour. The increasing concentration of wealth in the richest group decreases overall propensity to consume, thus putting downward pressure on effective demand and reinforcing the reliance on investment and exports. Many cross-cutting issues contribute to these challenges. In particular, the broad GDP-oriented government interventions in the past not only fuelled excessive investment but also sometimes suppressed income equality and environment-related concerns. Policymakers have realized that reforms in isolated areas were not sufficient to deal with the interconnected challenges.

The successful shifting to a more balanced and healthier development trajectory is being based on four critical transformations. The first is the transformation in economic structure from industry, especially from capital, resource, energy and pollution-intensive heavy industry, to the modern service sectors. This transformation is planned to enhance job creation, decrease reliance on heavy industrial investments and provide multiple environmental benefits. The pledged reforms to remove market-entry barriers, cut red tape and lower the tax burden on service sectors will contribute to this transformation. Financial reform will play a key role in fostering an advanced and dynamic financial sector as the backbone of modern services. These far-reaching reforms will first be experimented in individual cities or SEZs, including the China (Shanghai) Pilot Free Trade Zone.

The second transformation is urbanization and the corresponding reforms in the social welfare regime. China's urbanization rate is growing by 1 percentage point annually. The unprecedented rural-to-urban migration has the potential to create the largest middle class in the world and significantly boost domestic consumption demand, especially demand for services. To realize these benefits, the Government plans to provide more equal access to economic opportunities, as well as to public services.

Third, there is to be a transformation of government planning at all levels, from GDP-centric thinking to a balanced development philosophy embracing all three economic, social and environmental pillars. The innovative reforms in the incentive structure for government officials based on the broad development outcomes will be of particular importance. In addition to sophisticated score cards, for which design bias and rigidity persist, the proactive and collaborative interaction between the Government and civil society will greatly help in achieving the objectives and improve government accountability.

Last but not least, China's integration into the global economy is to be further deepened. The rebalancing of the global trade regime and enhanced domestic economic strength require China to further diversify its ties with other economies through structural upgrading of trade composition and proactive outward investments. Further opening of the domestic market on the other hand will bring in critical know-how, especially for the development of modern service sectors.

In looking specifically at the financial reform package, which has generated significant international interest, three key components may be observed. The first is the increasing use over time of indirect tools and instruments to steer money supply and demand. The second is the liberalization of interest rates, with lending rates already liberalized and deposit rates to follow. The third component is the strengthening of financial regulatory oversight. These reforms are likely to have numerous positive impacts which will strengthen the overall efficiency and stability of the financial system. These include diversifying sources of financing

Box 1.3. (continued)

away from banks, which had mainly benefited State-owned enterprises and the corporate sector; creating improved efficiency of the financial market and capital allocation, which will improve access to credit for SMEs and those excluded from the formal financial system; generating a win-win situation for both households and corporations, with the former having better opportunities to diversify their savings and the latter access to alternate sources of financing; reducing and regulating the shadow banking system and therefore decreasing risks for the financial system and investors; and levelling the playing field in the regulatory and supervisory system and therefore reducing the opportunities for regulatory arbitrage.

One of the key approaches to mitigate the risks associated with the wide-ranging reform programme will be the proper pace and sequencing of reforms. It will be important, for example, to ensure that macroeconomic fundamentals are strong as the country moves towards full interest rate liberalization and capital account convertibility and that this is sequenced with strengthening of the financial system. A gradual approach has always been China's approach to transition. As the experience of China and other countries shows, the gradual approach has a better chance of success – a point reiterated in ESCAP *Surveys* since the 1990s.

China's transformative process over coming years will have profound implications for itself and for the Asia-Pacific region. Overall, more sustainable and balanced growth in China will be vital for the economic stability of the region. However, countries in Asia and the Pacific will have to adjust themselves to explore the opportunities opened and to be prepared for potential challenges. The opportunities include expanded consumption demand from China, growing FDI by China and the outward reallocation of low-tech industrial sectors from China. The challenges for economies in the region include slower demand growth by China for oil and industrial resources.

- Deepening integration into the global economy through accelerated FTA negotiations and policy experimentations in the newly established special economic zones (SEZs).

The economic growth rate of India in 2014 is forecast to recover to 5.5%, after being below 5% in 2012-2013. The inflation outlook is also slightly better for 2014, declining from 9.5% in 2013 to 8%. Faster growth is constrained by tight monetary and fiscal policies to reduce inflation and government debt. Supply-side factors, such as infrastructure bottlenecks and surges in food prices, were mainly responsible for higher inflation. Deregulation of administered prices and currency depreciation were also contributory factors. Monetary tightening was applied to prevent formation of inflationary expectations. The impact of higher interest rates on growth is the dilemma that policymakers face in dealing with supply-side inflation. This is especially so when a country is open to capital flows and does not have enough fiscal space to take countervailing measures to support growth.

Indonesia's growth is forecast to decline in 2014 to 5.4% – the lowest rate in recent years. As in India, the growth slowdown is partly the result of monetary tightening to halt capital flight and currency depreciation, as well as to combat inflation – estimated at 6.4% in 2013, compared with 4.3% in 2012. Inflation was driven mainly by fuel subsidy cuts, currency depreciation and food price rises. The Government of Indonesia, with a budget deficit estimated at 2.3% of GDP in 2013, is in a better position than India in terms of fiscal resources to support the economy amid the current slowdown.

Malaysia and Thailand are expected to record growth rates of 5% and 2.2% respectively in 2014 with moderate recovery in their external sectors. Growth for Thailand is projected to rebound in the second half of 2014 due to the easing of political uncertainty in recent months. Growth potential in both Malaysia and Thailand is being held back by growing domestic debt. Government debt in Malaysia at 53% of GDP is the highest in South-East Asia

and higher than in many emerging economies in Asia and the Pacific. Household debt (87% of GDP in 2013) is also one of the highest in the region. As in Malaysia, household debt in Thailand is one of the highest in the region at 82% of GDP in 2013. The Government of Malaysia reduced public spending in 2013 in an attempt to cut public debt, while measures taken to control household spending on assets such as property also reduced private consumption. The slowdown in consumption in Thailand can also be attributed partly to consumers paying off some of their debt. Growth in Thailand was further hampered by the effects of political uncertainty, for example the inability to implement a proposed multibillion dollar infrastructure development plan.

The Philippines, in contrast to other major economies experiencing moderate growth, is forecast to experience a high growth rate of 6.7% in 2014. This is, however, lower than the strong growth performance of 7.2% in 2013 despite the destruction wrought by Typhoon Haiyan in November that year. The Philippines provides an example of growth driven by a conducive policy climate. The Government has engaged in significant productive public spending in infrastructure and social areas, while private investment has also increased. Inflation has remained low, offering the opportunity to support growth through accommodative monetary policy. A relatively small budget deficit (1.4% of GDP in 2013) also allowed for substantial government development spending on infrastructure and other basic services during 2013.

Gradual trade recovery

Exports for the region are expected to pick up modestly in 2014 after a difficult time in the previous year in line with increases in global trade as the developed economies experience somewhat higher growth in 2014. Merchandise export growth for Asia and the Pacific is likely to be slightly higher than the 2.3% posted in 2013, although commodity exports may experience slower growth. Among other factors, limited progress in multilateral trade negotiations is preventing an even more favourable outlook for trade. The multilateral trading system

has remained fragmented, as could be observed at the Ninth Ministerial Conference of the World Trade Organization (WTO), which was held in Bali, Indonesia, in December 2013. Global uncertainties also threaten trade recovery.

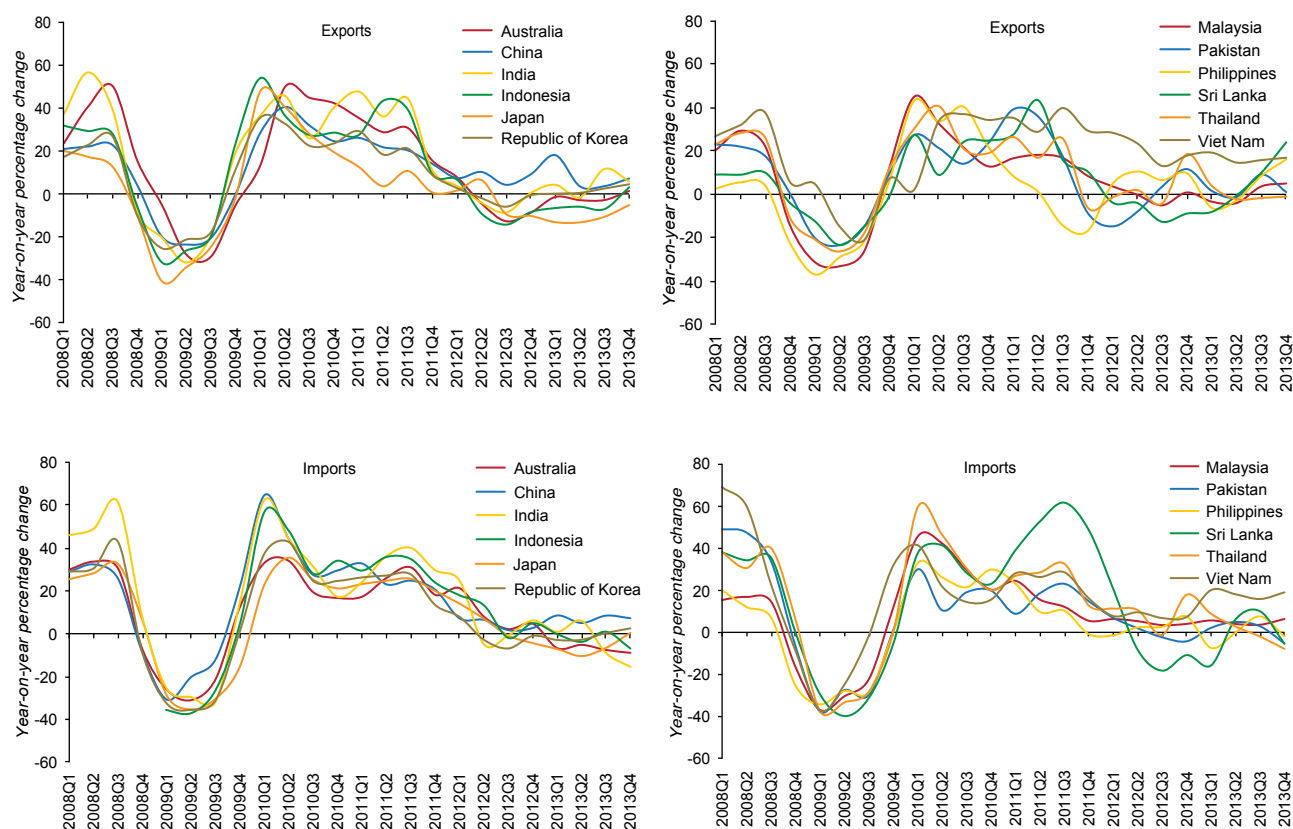
Exports for the region are expected to pick up modestly in 2014

During 2012 and 2013, weak global demand adversely affected Asia-Pacific trade. Most of the major economies in the region had low and volatile export growth in 2013 as compared with their previous peak in 2011 (see figure 1.6). Import trends are similar. In China, soft industrial output and fixed investment performance resulted in a lacklustre import demand for commodities and intermediate goods. For countries highly involved in global value chains, such as Malaysia, the Republic of Korea and Thailand, imports of electronic parts and components slowed significantly due to weak final demand in global markets.

The low share of least developed countries in Asia-Pacific trade continues to be a concern. These countries account for only 0.7% of total regional exports, valued at \$50 billion in 2012. It is, therefore, particularly important to integrate least developed countries more fully into regional supply chains by providing preferential market access and improving their productive capacity. At the same time, better connectivity is needed through improved hard and soft infrastructure for deeper trade integration across countries and subregions.

ESCAP analysis indicates that export growth has been hampered by trade-reducing measures globally and regionally.⁵ It further shows that trade policy measures of major developed economies outside the Asia-Pacific region could result in an estimated reduced opportunity of merchandise exports of some \$255 billion in the region, which could translate into a cumulative decline of more than 1.6 percentage points of regional output, during the period 2009-2013 (see box 1.4). This would be an underestimate

Figure 1.6. Quarterly changes in merchandise trade of selected Asia-Pacific economies, 2008-2013



Source: ESCAP, based on data from CEIC Data. Available from www.ceicdata.com (accessed 15 June 2014).

Box 1.4. Opportunity loss due to trade-reducing measures for developing Asia-Pacific economies

Since the onset of the 2008/09 financial crisis, trade related measures have remained high and a sizeable number of countries have raised tariffs and introduced new non-tariff measures. These measures have often been used in the form of trade defence mechanisms, which are contingency type instruments, including antidumping and countervailing duties, and safeguard measures. These types of policies are complex in their application. At the same time, many countries have introduced direct subsidies (including agricultural export subsidies) and support (often non-trade related support) for domestic industries over the past five years. However, the smaller and poorer Asia-Pacific countries (least developed countries, landlocked developing countries and small island developing States) that cannot apply similar support measures have suffered adverse impacts, if not directly then indirectly.

As demonstrated below, trade-reducing measures globally in the aftermath of the crisis have had negative impacts on the export prospects of Asia-Pacific developing economies and subsequently constrained the growth momentum of many economies.

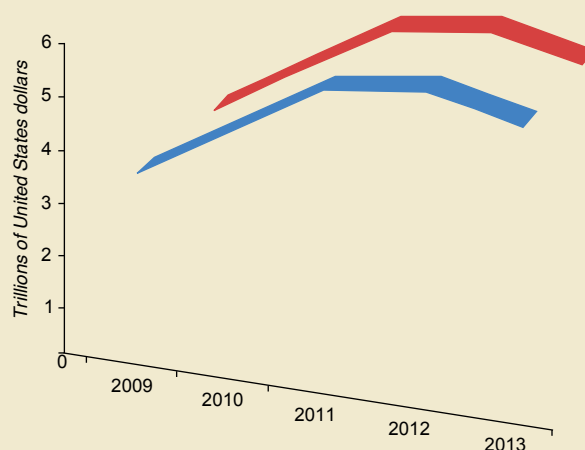
Using data from 43 Asia-Pacific economies, covering more than 99% of total exports from the region, ESCAP analysis estimated the impact of trade-reducing measures imposed by economies outside the region on their exports.^a The estimation of the trade-reducing impact on exports and GDP depends on the depth of exposure of the economies to the markets of the eurozone, United States and other key developed markets via direct exposure (final goods exports) and indirect exposure (intermediate

Box 1.4. (continued)

goods, or value chains), which are computed on the basis of their shares of exports to these economies' total imports. The analysis shows that the impact on exports due to the economies' exposure through participation in the value chains are often substantial, and should be explored adequately for any impact assessment of restrictive trade policy measures. The estimation of the impact on the Asia-Pacific economies has made use of the database and various reports of the measures imposed by G20 economies during the period 2009-2013.^b

Assuming that the overall fall in economic growth has contributed to a decline in import demand from extraregional sources, the imposition of trade-reducing policy measures has further reduced the export potential of the economies in the Asia-Pacific region. Given this, ESCAP estimates show that the trade-reducing policy measures of the developed economies reduced opportunity of merchandise exports worth some \$255 billion from the Asia-Pacific region during the period 2009-2013. The cumulative reduction in exports could translate into more than a 1.6 percentage point decline in regional output during the period 2009-2013 (see figure A).

Figure A. Costs of trade-reducing measures: actual versus estimated loss in exports for Asia-Pacific region, 2009-2013



Source: ESCAP, based on data from United Nations COMTRADE database (accessed 1 April 2014).

Notes: Blue line: actual merchandise exports; red line: potential merchandise exports without the introduction of trade-reducing measures.

At the subregional level, the trade-reducing measures were found to reduce export opportunity by \$138 billion in East and North-East Asia, followed by \$52 billion in South-East Asia, \$39 billion in North and Central Asia, and \$26 billion in South and South-West Asia during the period 2009-2013. Over the same period, the Pacific island developing States experienced a reduction in export opportunity of some \$500 million. The impacts were also significant in countries with special needs, negatively affecting merchandise export prospects worth \$2 billion in the least developed countries, about \$9 billion in landlocked developing countries and more than \$500 million in small island developing States in the region (see figure B).

ESCAP analysis at the country level further shows that China was the economy that suffered the greatest impact, with reduced opportunity for merchandise exports worth more than \$57 billion affected in the period 2009-2013, followed by the Russian Federation (exceeding \$18 billion), the Republic of Korea (more than \$14 billion), Singapore (more than \$10 billion) and India (about \$8 billion). Among other economies greatly affected were Indonesia, Malaysia, Thailand and Turkey. In general, it is clear

Box 1.4. (continued)

that trade-reducing policy measures affect most those countries with higher direct and indirect exposure through regional value chains and that many countries could experience substantially reduced export prospects (see figure C).

Figure B. Costs of trade-reducing measures in subregions and countries with special needs, 2009-2013

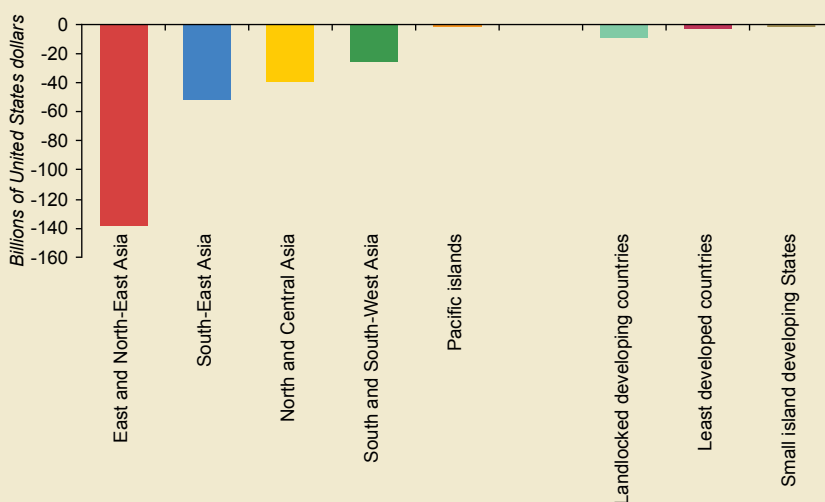
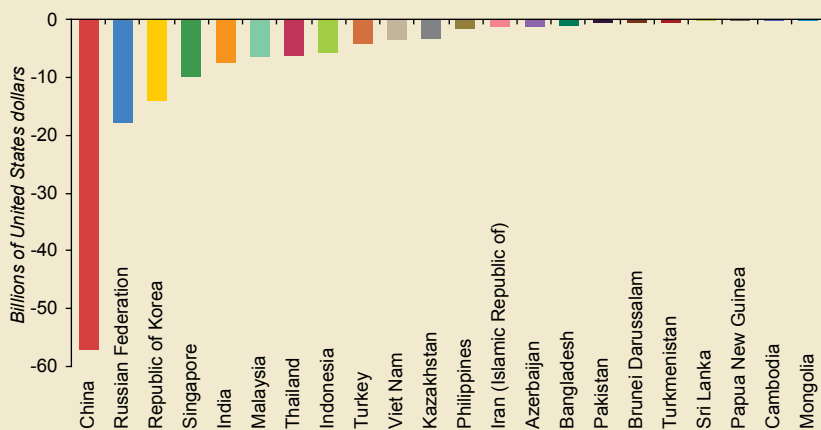


Figure C. Costs of trade-reducing measures in selected developing Asia-Pacific economies, 2009-2013



Sources: ESCAP, based on Sudip Ranjan Basu and others, “Euro zone debt crisis: scenario analysis and implications for developing Asia-Pacific”, *Journal of the Asia Pacific Economy*, vol. 18, No. 1 (2013), pp. 1-25. The trade restrictive policy measures were taken from the WTO-OECD-UNCTAD Report on G20 Trade and Investment Measures (all reports), Trade Monitoring Database of WTO, and the UNCTADStat and ESCAP Statistics for trade and GDP data.

Notes: The figure shows the estimated impacts of trade-reducing policy measures by the developed economies including the United States and the European Union in terms of export opportunity losses from 2009 to 2013. The regional estimates are based on 40 developing countries and three developed countries in the Asia-Pacific region.

^a Basu et al. (2013).

^b The trade restrictive policy measures were taken from the WTO-OECD-UNCTAD Report on G20 Trade and Investment Measures (all reports are available from [http://unctad.org/en/pages/publications/G-20-Trade-and-Investment-Measures-\(Series\).aspx](http://unctad.org/en/pages/publications/G-20-Trade-and-Investment-Measures-(Series).aspx)), Trade Monitoring Database of WTO, and also the UNCTADStat and ESCAP Statistics for trade and GDP data.

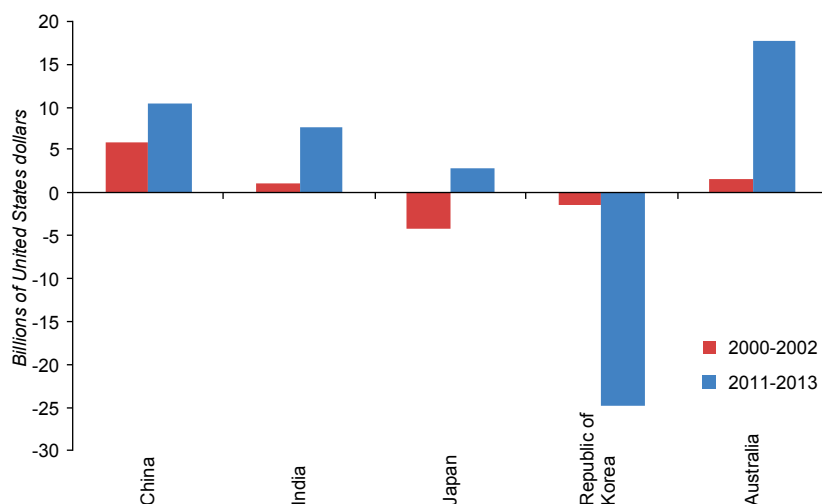
as the analysis did not take into account the trade measures from within the region, as described in a recent ESCAP publication.⁶ The negative impact of the extraregional measures varies across subregions and countries depending on the degree of export dependence on the economies outside of the region, and on their exposure through regional value chains. For example, the estimated negative merchandise export impact was largest in East and North-East Asia given that subregion's close trade ties with the eurozone, United States and other developed economies.

Intraregional trade has expanded in recent years between countries in the Association of Southeast Asian Nations (ASEAN) and other countries in the region. Between 2000 and 2012, the total share of intraregional exports in Asia and the Pacific jumped from 40% to 51%. Regional trade integration between ASEAN and other countries in Asia and the Pacific has increased in recent years due to reductions in bilateral trade costs, as well as through a deepening of and larger number of trade agreements. Analysis of five key ASEAN trading partners from the region, namely Australia, China, India, Japan and the Republic of Korea, illustrates the direction and pattern of trade. In recent years, ASEAN had a

trade surplus with Australia, China, India and Japan while it had a trade deficit with the Republic of Korea (see figure 1.7). The expanded trade with those countries also resulted in an acceleration of intra-ASEAN trade in parts and components for manufacturing sectors, such as electronics products, automobiles, and textiles and clothing. For example, Japan and the Republic of Korea have exported more products requiring medium and high skills to the ASEAN economies, while countries such as China and India are linked more through products that are labour-intensive and requiring low-skilled labour. Furthermore, merchandise exports to China from ASEAN countries are mostly intermediate parts and components, which benefit from economies of scale and the availability of low-cost inputs.

Linkages with China remain particularly important for intraregional trade, with the relationship evolving as the country alters its economic structure. China accounts for more than 30% of the exports from Asia-Pacific developing economies, of which, after processing in China, a substantial portion are destined for re-export. China's bilateral trade surplus in goods increased with several countries in 2012, including India (\$29 billion), Viet Nam (\$18 billion) and Singapore (\$12 billion). On the other hand, China recorded

Figure 1.7. Trade balance of ASEAN with selected Asia-Pacific economies, 2000-2002 and 2011-2013 or latest available data



Source: ESCAP, based on data from United Nations COMTRADE database (accessed 16 April 2014).

Notes: Trade balance is the difference between exports and imports of ASEAN economies with five trading partners. Positive trade balance implies more exports than imports in value terms. The data for Japan and the Republic of Korea are based on the average for the period 2011-2013, and for Australia, China and India are based on the average for the period 2010-2012.

bilateral trade deficits in 2012 with the Republic of Korea (\$81 billion), Australia (\$47 billion), Japan (\$26 billion) and Malaysia (\$22 billion). China's reform policies, as described previously (see box 1.3), to improve the quality of growth by boosting domestic consumption will be a critical factor for the region's trade relationships. ESCAP analysis, reported in the 2013 *Survey*, indicates that rebalancing in China is likely to generate significant benefits for economies in the region exporting consumer goods. It further indicates a likely positive overall macroeconomic impact on the Asia-Pacific region, as any fall in imports of capital goods into China as a result of reduced investment should be offset by the boost in demand for imported consumer goods.⁷

There has been an acceleration of negotiations on free trade agreements (FTA) since the stalling of the WTO Doha Development Agenda, and the global financial crisis. Both of these events have shaped the nature and scope of trade agreements across countries in the region and beyond. There are now a growing number of FTA initiatives at the transregional, regional and subregional levels. As of 20 June 2014, globally 379 notifications of FTAs had been received by GATT/WTO amounting to 249 "physical" agreements in force.⁸ According to ESCAP statistics, there are currently 151 FTAs in force and more than 70 under negotiation (some in prolonged early stage of negotiations) associated with Asia-Pacific countries, where each country is concluding a trade agreement with others under varying degrees of trade liberalization intent. These are creating a "noodle bowl syndrome", often causing a stumbling block to ensuring gains from freer and fair trade for liberalizing countries.

There are now also several "mega-regional FTA" initiatives involving the countries in the Asia-Pacific region, which can have significant implications for Asia-Pacific economic cooperation and integration. For instance, the 10 ASEAN member States and their 6 Dialogue partners – Australia, China, India, Japan, New Zealand and the Republic of Korea – launched the negotiation of the Regional Comprehensive Economic Partnership on 20 November 2012. The

Partnership is aimed at forming a high-quality and mutually beneficial economic partnership for an open trade and investment environment. Also, the United States-led process of negotiating the Trans-Pacific Partnership (TPP) of 12 members began more than four years ago; it includes 7 countries (Australia, Brunei Darussalam, Japan, Malaysia, New Zealand, Singapore and Viet Nam) from the ESCAP region.

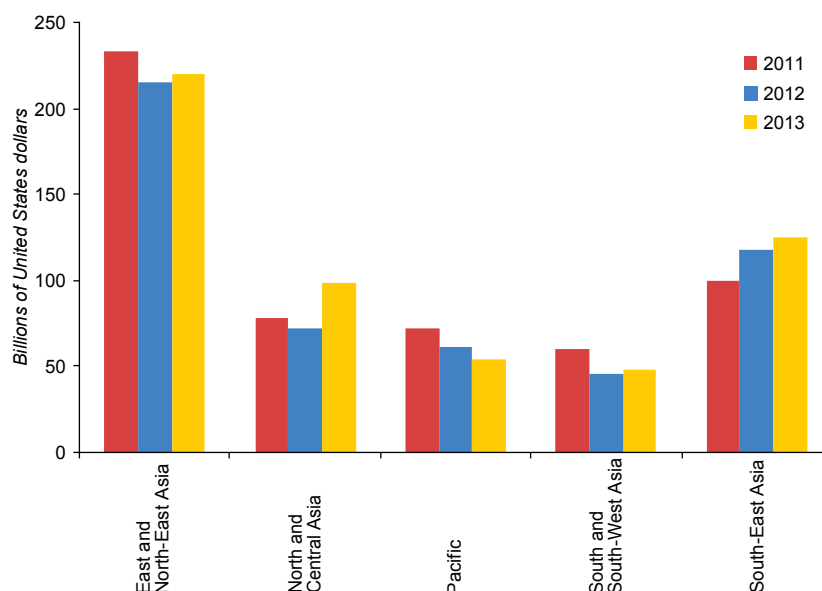
Implementation of specific trade facilitation measures is generally lacking in the region

Promotion of economic development through the adoption of mutually beneficial trade liberalization measures must remain the cornerstone of trade reform policies in the region as this will best contribute to intraregional trade expansion and economic cooperation. Despite significant overall progress in trade integration within the region, implementation of specific trade facilitation measures in the region's developing economies is generally lacking. It is more costly to trade between Asia-Pacific subregions than between subregions and countries or regions outside the Asia-Pacific region. Trade costs for small island developing States and landlocked developing countries often are twice as high as those of other developing countries in the region. ESCAP member States should undertake deep trade reforms and engage in reciprocating with other countries, especially the least developed countries, to offer effective market access for them within the framework of multilateralism under WTO.

Positive outlook for foreign direct investment

FDI within the region has remained large and robust, with variations in FDI inflows across developing subregions in 2013. FDI inflows increased from \$357 billion in 2009 to \$545 billion in 2013 (see figure 1.8).⁹ With the increasing importance of such destinations as ASEAN and China, developing Asia-Pacific countries remained the largest recipient region of global FDI flows, accounting for nearly one quarter

Figure 1.8. Foreign direct investment inflows to developing Asia-Pacific subregions, 2011-2013



Source: ESCAP, based on UNCTAD, *World Investment Report 2014* (Geneva, 2014). Available at <http://unctad.org/en/pages/PublicationWebflyer.aspx?publicationid=937>.

of global FDI. Among the developing Asia-Pacific subregions, East and North-East Asia continues to attract the largest amount of FDI inflows, although the share of South-East Asia is also increasing. Developing economies in the Pacific attracted about 0.55% of the region's FDI inflows in 2013.

Intraregional FDI flows within Asia and the Pacific are on the rise. ASEAN and China are especially attractive destinations for Asian investors. FDI inflows to ASEAN from other Asia-Pacific countries remained stable at \$56 billion in 2013. This grouping had combined FDI inflows of \$326 billion in 2013, accounting for more than 20% of global FDI inflows in recent years. Prospects for intraregional FDI among these economies are promising, as more FDI in the region may come from China, Japan and the Republic of Korea in a wide range of sectors, including infrastructure, finance and manufacturing.

However, a point of concern is falling greenfield FDI. Recent studies have shown that greenfield FDI can have more direct benefits as it creates new investment through the establishment of production

facilities. On the other hand, the benefits from FDI through mergers and acquisitions (M&A) are less clear-cut as this involves purchasing existing assets. The value of global cross-border M&A increased by 5% to reach \$337 billion in 2013 and was driven mainly by deals in East and South-East Asia, particularly in China, Singapore and Thailand. At the same time, the value of global greenfield FDI has fallen significantly since the recent financial crisis, from a peak of \$1.6 trillion per year in 2008 to \$612 billion in 2012, and declined further, by 1.7%, in 2013. Greenfield FDI to developing countries fell by two thirds. Nevertheless, there have been some announcements of increases in greenfield activity in such countries as Myanmar and Viet Nam.

Another concern is related to FDI in agriculture. There have been instances where such FDI displaced smallholders and damaged the environment. The World Bank has highlighted the danger of land acquisition which neglects local people's rights and the susceptibility of smallholders to manipulation by speculators or unscrupulous investors.¹⁰ Questions have been raised about the extent to which large-

scale land acquisition provides local people with long-term benefits and contributes to poverty reduction and sustainable development. Therefore, appropriate policies should be put into place to safeguard against speculative land investment or acquisition, as well as to prevent environmental degradation. Governments need to be vigilant to ensure that FDI projects boost growth, create employment and increase the technological capacity of local industry.

In addition to FDI, there is growing scope for foreign exchange earnings for countries through remittances and tourism. Asia and the Pacific remains the highest remittance-receiving region in the world, both in absolute and relative terms. By 2013 remittances to developing countries in Asia and the Pacific had increased from \$49 billion in 2000 to \$265 billion. International tourism receipts increased from \$169 billion in 2004 to \$320 billion in 2013. For many countries in the region, such as some in the Pacific, the level of dependence on the tourism sector and related services is very significant at around 20% of GDP. Both remittances and tourism have the potential to play a significant role in development in the region. However, policymakers must be cognizant of drawbacks which require government actions. For example, the export of personnel may exacerbate brain drain and worsen inequality. Similarly, uncontrolled expansion of tourism can have adverse ecological and social consequences. Aspects of remittances and tourism are discussed in greater detail in Part II of the *Survey*.

SOCIO-ECONOMIC CHALLENGES

Jobs growth and quality still show mixed progress

Considering the main socio-economic issues facing the region, a principal concern is low job creation despite rapid growth in many economies. Over the past decade, both before and after the crisis, growth in GDP in the region was not accompanied by a commensurate expansion in formal sector employment. The developing Asia-Pacific region

witnessed such “jobless growth” during the period 2009-2013 as average GDP grew by 6.4% while employment grew by only 1.3%. During the pre-crisis period of 2000-2007, employment only grew by 1.7%. This phenomenon was due partly to technological change and labour substitution, but also to the nature and pattern of economic growth that was not rooted in broad-based economy-wide development.

A principal socio-economic concern is low job creation despite rapid growth in many economies

In 2013, labour market outcomes in terms of job creation were decidedly mixed. The rate of job growth in the formal sector was highest in Malaysia (8.8%), Sri Lanka (6.9%) and Singapore (4%). In terms of total job increases, the largest increases were 1.2 million in Indonesia and 1.1 million in Malaysia. Growth in jobs was also positive in Viet Nam (912,000) and the Philippines (620,000). In Thailand, however, job growth turned negative, by 1.2% (466,000), with the largest declines being in agriculture and the hotel and restaurant industry. In the developed economies of the region, job expansion was less than 1% in Australia, Japan and New Zealand. Job creation in the Pacific economies was also mixed.

To boost employment generation, some countries have undertaken active labour market programmes. For example, China initiated labour market policies to improve access to and the quality of training systems, especially to benefit migrants from rural areas to urban industrial jobs. The Republic of Korea has employment programmes to enhance education and training for a specialized workforce. For several low-income and middle-income countries, one of the key areas of focus should be to generate more productive and remunerative rural (off-farm) employment.

There are also concerns about job quality. The majority of workers in the region are informally employed own-account or contributing family workers – with limited opportunities for finding work that is

more productive, secure and salaried. Such informal jobs are more likely to be done by women and other vulnerable groups, such as youth and older persons. In Pakistan, for instance, the share of employment as own-account and contributing family workers was 23.4 percentage points higher for women than for men. Moreover, women are more likely than men to be unemployed: in Indonesia the unemployment rate for men was 5.5% but for women it was 6.3%.

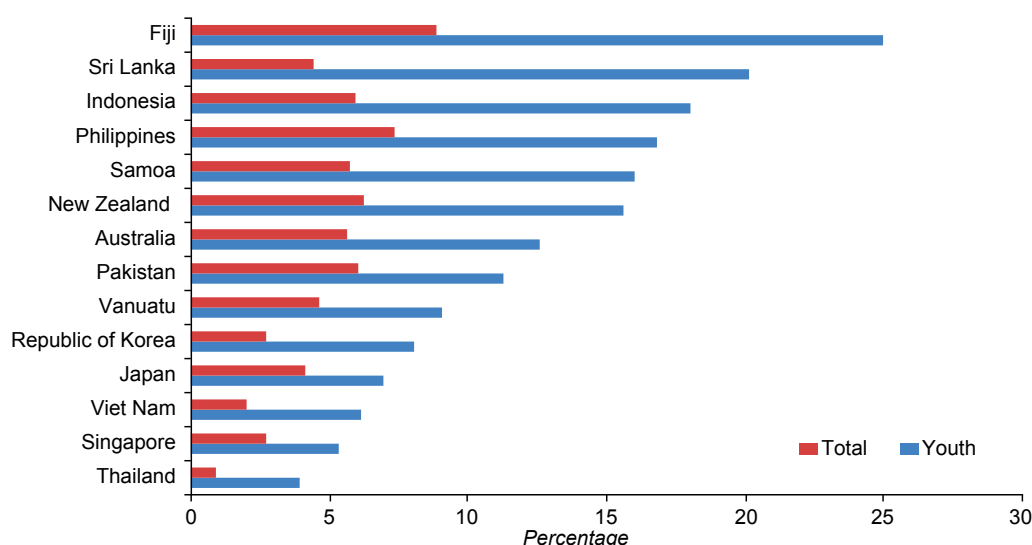
In 2013, an estimated 63.1% of women and 56% of men were engaged in various types of vulnerable employment. There is also an elevated percentage of people in the region working in very low-paying jobs. The number of “working poor”, those who earn less than \$2 a day, was highest in South and South-West Asia. The prevalence of working poverty and vulnerable employment are clear manifestations of the lack of economic and social opportunities.

Young people in particular struggle to find decent and productive employment. The youth unemployment rate in the region is almost three times higher than the adult unemployment rate. Between 2012 and 2013, unemployment among young people rose

from 9.7% to 10.1%. Youth unemployment among developing economies in the region in 2013 was highest in Fiji (25%), followed by Sri Lanka (20.1%), Indonesia (18%), the Philippines (16.8%), Samoa (16%) and Pakistan (11.2%) (see figure 1.9). Among developed economies, New Zealand and Australia have recently had high youth unemployment rates, 15.6% and 12.6%, respectively. At the subregional level, in 2013 employment among young people in East Asia decreased by 6.1 million jobs, or 5.2%. Moreover, this pace of contraction is likely to continue for the next five years, highlighting the mounting challenges facing young graduates entering the labour market.¹¹

There are numerous causes of the high youth unemployment rate in the region. In addition to the lack of adequate decent and productive jobs, this is also an outcome of: the mismatch between education and employers’ requirements; low secondary schooling completion rates; gender discrimination; and high youth aspirations. Many countries now have a potential demographic dividend. Yet, to make the dividend a reality they will need to secure productive employment for the growing pool of young people, especially young women.

Figure 1.9. Total and youth unemployment rates in selected Asia-Pacific economies, 2013 or latest available data



Sources: ESCAP, based on data from ILO and estimates from national labour force surveys. Information on Pacific economies obtained from the Secretariat of the Pacific Community. Available from www.spc.int/nmdi/MdiSummary2.aspx?minorGroup=8.

Note: Total includes ages 15+; youth includes ages 15-24 except for Pakistan (ages 15-19) and Singapore (residents aged 15-29); non-seasonally adjusted.

Inequality hampering sustainability of growth

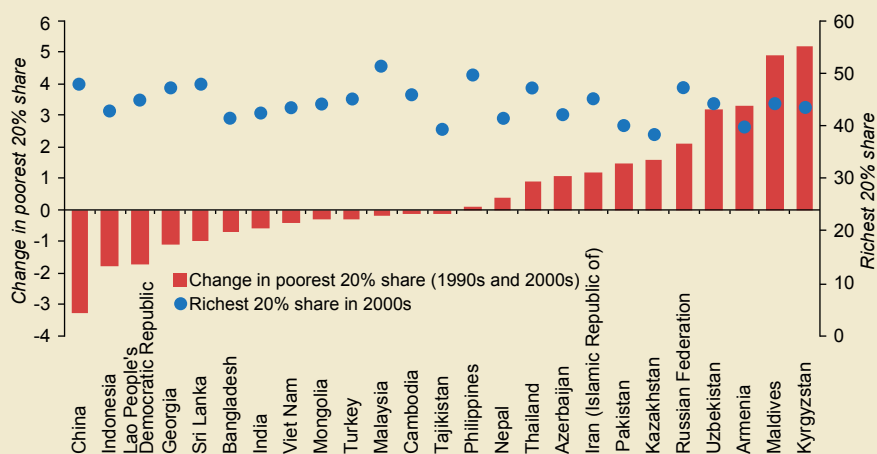
Inequality is another key socio-economic challenge for the region. There is a growing divide between the poor and the rich (see box 1.5). At the national level, there has been an increase in income inequality (Gini coefficient) in many major economies in recent decades. For example, between the early 1990s and the late 2000s, the Gini coefficient increased from 32.4 to 42.1 in China; from 30.8 to 33.9 in India; and from 29.2 to 38.1 in Indonesia (see

figure 1.10). Nevertheless, in some countries – for instance, Cambodia, Kyrgyzstan, Malaysia, Nepal, the Philippines, Thailand and Uzbekistan – it decreased. It is noteworthy, however, that the Gini coefficients for Malaysia (46.2) and the Philippines (43.0) remained among the highest in the region. Widening income gaps across societies and within communities are the consequence of a series of factors, including weaker labour market institutions, inadequate social protection systems, poor-quality education, inadequate access to credit and land and excessive asset concentration.

Box 1.5. Growing divide between the poor and the rich in Asia and the Pacific

The gap between rich and poor is widespread in the region and continuing to grow in many countries. From available data for about 40 countries in the region, it can be seen that the poorest 20% of the population accounts for less than 10% of national income in the latest available year. Among 25 countries with comparable data in two periods (1990s and 2000s), some major developing countries, such as Bangladesh, China, India, Indonesia, Malaysia and Turkey, recorded a falling share of national income for the poorest 20% of the population over the period. However, the share of national income of the poorest 20% increased for some other countries, such as Armenia, the Islamic Republic of Iran, Kazakhstan, Nepal, Pakistan, the Philippines, the Russian Federation and Thailand (see figure A). The share of national income of the richest 20% of the population in the 2000s ranged from a high of 51.5% in Malaysia to a low of 38.4% in Kazakhstan, with average share being 44.2% for the latest available years.

Figure A. Share of the richest 20% and change in share of the poorest 20% in national income in selected developing Asia-Pacific economies, 1990s and 2000s or latest available data



Source: ESCAP, based on Statistics Division online database. Available from www.unescap.org/stat/data/ (accessed 1 April 2014).

Furthermore, an analysis of the ultra-high net worth individuals (UHNWIs) in the region shows that persons with a net worth of \$30 million or more accounted for 30% of the region’s income in 2012-2013. This implies that wealth concentration is a major characteristic of income inequality. The region had around 49,000 persons (0.001% of Asia-Pacific population in 2013) classed as

Box 1.5. (continued)

UHNWIs, with about \$7.5 trillion of net wealth in 2012-2013. In some countries UHNWIs' net wealth is half that of the GDP.^a Interestingly, the net wealth of the Asia-Pacific region's UHNWIs is 17 times more than the combined GDP of the Asia-Pacific least developed countries (\$0.44 trillion in current prices in 2012).

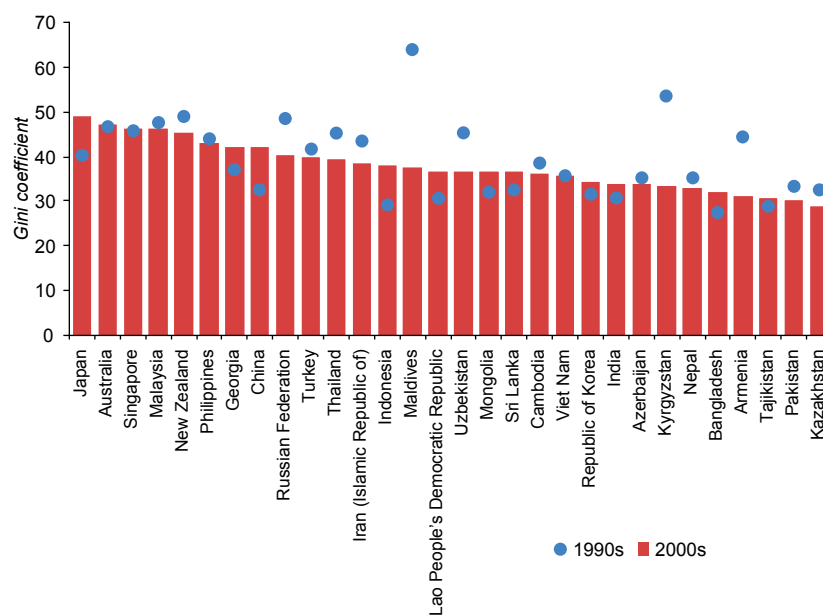
The wide gap in national income held by the ultrarich and the poor is striking. It has been observed that the wealth-income ratio is rising due to the growing share of capital in national income, which is further exacerbating the inequality gap between the top 1% of the population and the poorest 20%.^b A high and increasing ratio of wealth to GDP also illustrates growing concerns regarding concentration of political/business power linked to asset ownership in these countries, as well as financial systems that have lax regulatory and tax structures.

In this context ESCAP *Surveys* since 1950 have contained recommendations on asset redistribution, in particular redistributive land reform, as a key factor for equitable growth. *Surveys* also contained recommendations on progressive taxation, widening of the tax base and public provisioning of basic services, such as education and health care, for this purpose. In reviewing the progress in these areas, it was noted in ESCAP *Surveys* in the 1970s that powerful vested interests largely thwarted land and other distributive reforms in many countries of the region. This has contributed to the phenomenon of growth in many economies over recent decades not being sufficiently translated into equitable development.

^a Wealth-X and UBS (2014).

^b Piketty (2014).

Figure 1.10. Income inequality in selected developing Asia-Pacific economies, 1990s and 2000s



Sources: ESCAP, based on data from World Bank, Financing for Development, Post-2015. October 2013. Available from <http://post2015.org/2013/10/22/world-bank-report-financing-for-development-post-2015/>; PovcalNet data, United Nations Statistical Division, Statistical Databases. Available from <https://unstats.un.org/unsd/databases.htm>; and OECD, 2012 DAC Report on Multilateral Aid. Available from [www.oecd.org/dac/aid-architecture/DCD_DAC\(2012\)33_FINAL.pdf](http://www.oecd.org/dac/aid-architecture/DCD_DAC(2012)33_FINAL.pdf).

In addition to vertical inequality among individuals, there have also been widening horizontal disparities, especially between rural and urban areas, as well as between coastal regions and the interior. This is particularly worrying for large multiracial countries with significant regional variations, since it can trigger social and political instability.

High levels of income inequality seriously undermine the economic and social achievements of the region. For example, GDP per capita (constant 2005 PPP dollars) for the year 2012 in Singapore declined from \$53,266 to \$28,071 when adjusted for income inequality. In the case of China, the decline was from \$7,958 to \$4,472. The ESCAP social development index,¹² which combines education and life expectancy, shows that inequality in several emerging and low-income economies is having a serious impact on social development.

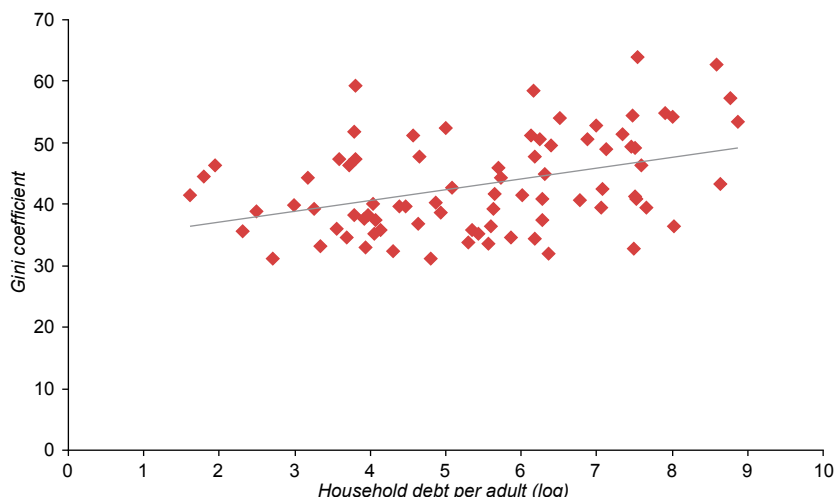
A specific area of concern is gender inequality. Intrinsicly linked to gender inequality is the prevalence of gender-based violence in the region.¹³ These challenges continue to inhibit the full participation of women in public life – affecting not only the well-being of women themselves, but also that of their families and their communities and

can weaken social and economic stability. Policies and legislation that enable women to participate in economic activities specifically, and underpin gender equality more broadly, can improve the quality of lives of all women, men, girls and boys. Allowing women and men to work equally in economic activities with equal pay, and realize their full potential, is integral to a nation's economic resilience and productivity.

Persistent inequality and social disparities are related to the prevalence of undernourishment. In 2013, undernourishment affected 533 million people in Asia and the Pacific, accounting for about 15% of the population.¹⁴ The region accounts for about 63% of the world's hungry people. Undernourishment is high in a number of countries, including Bangladesh, China, India, Pakistan, the Philippines, Solomon Islands and Sri Lanka. Poverty and hunger are intertwined in a vicious cycle since undernourished people are less productive, and are therefore likely to fall into poverty, thus promoting social inequality.

ESCAP analysis of country-level data on household debt and inequality during the post-crisis period shows a positive association between inequality and indebtedness (see figure 1.11). The data were drawn from 81 developing countries globally, including 26

Figure 1.11. Debt per adult and inequality in selected global and Asia-Pacific economies



Sources: ESCAP, based on data from World Bank, *Financing for Development, Post-2015*. October 2013. Available from <http://post2015.org/2013/10/22/world-bank-report-financing-for-development-post-2015>; PovcalNet data, United Nations Statistical Division, *Statistical Databases*. Available from <https://unstats.un.org/unsd/databases.htm>; and Credit Suisse, *Global Wealth Databook 2013*. Available from www.international-adviser.com/ia/media/Media/Credit-Suisse-Global-Wealth-Databook-2013.pdf.

economies from the region. This finding conforms with recent research at the IMF¹⁵ which shows how inequality can lead to household indebtedness. With income growth lagging, the poorer sections of society increase debt-financed consumption. This is made possible by the availability of cheap credit, as higher income groups deposit their increasing wealth in the banking system. Such a transmission process could lead to ever-rising household debt in countries with growing inequality, making them vulnerable to shocks. As households spend more than they earn, countries face growing current account deficits, exacerbated by luxury imports by the well-off.

POLICY OPTIONS TO DEAL WITH LONGER-TERM CHALLENGES AND NEAR-TERM RISKS AND VULNERABILITIES

Productive government spending to support sustainable growth

The obstacles to higher growth in the Asia-Pacific region are partly related to slow economic recovery in the developed world, but also to long-term structural impediments to growth. This highlights the need for productive and countercyclical government macroeconomic support. Such policies can shore up growth in the short term while helping remove structural impediments in the long term. Furthermore, the ongoing reallocation of international capital away from the region as monetary policy in the United States is normalized will increase the need for accommodating policies for domestic investment. This section highlights some possible supportive measures.

- *Social protection spending* – Increasing spending on social protection would help to support growth as well as reduce inequality. Recognizing the importance and necessity of adequate social protection systems, the United Nations System Chief Executives Board for Coordination adopted the Social Protection Floor Initiative, which was endorsed by Member States at the United Nations

Conference on Sustainable Development (Rio+20). Social protection is now a development priority in the development agenda beyond 2015.¹⁶ Public social security expenditure remains low in the region at less than 2% of GDP in half of the countries where data are available. More than 60% of the population of the Asia-Pacific region remain without any social protection coverage.

There is a need for productive and countercyclical government macroeconomic support to address the region's structural impediments

Particularly important areas for action include increased public provision of health and unemployment insurance, as well as pensions. Increased coverage of these needs reduces the need for precautionary savings by citizens and thus increases available income for consumption to support effective demand. As the poorer sections of society spend a greater proportion of their income than the better-off section, there can be positive impacts on growth. There is also a significant positive correlation between the extent of coverage of social protection measures and reductions in inequality. Based on World Bank data,¹⁷ ESCAP finds that, within a universal system, targeted social protection and labour market programmes are likely to reduce inequality. ESCAP has designed a social protection “toolbox” to facilitate the endeavours of policymakers in building stronger and more robust social protection systems.¹⁸ It enables policymakers to identify gaps at the national level, while providing useful examples on how to move forward.

Several countries in the region have recently initiated policies and programmes to enhance social welfare (see box 1.6). These include programmes addressing health in Indonesia, Thailand and Turkey; education in Sri Lanka; food security in India; and employment in the Republic of Korea. Nevertheless, public social protection expenditure still remain very low in a large number of countries in the region. Moreover, coverage of social protection and labour

Box 1.6. Strengthening social services in health and education: Turkey and Sri Lanka

Some countries in Asia and the Pacific have made substantial progress in strengthening health and education services – as exemplified by health insurance in Turkey and universal education in Sri Lanka.

General Health Insurance in Turkey

In 2008, the Government of Turkey launched the General Health Insurance scheme (GHI). This comprises two complementary schemes designed to extend health coverage to the entire population. Turkey's health-care system dates back to the 1990s when lawmakers first began extending coverage to the informal sector as part of its 10-year Health Transformation Programme. Health-care coverage has increased rapidly – from 70% of the population in 2002 to 83% in 2010. Today, GHI provides contributory insurance for those able to pay, while providing a number of different groups with free coverage: persons below the age of 18; pregnant women; people employed by the Social Security Institution; stateless persons; refugees; those with income below one third of the minimum national threshold; and those in receipt of social assistance payments. GHI is implemented by the Ministry of Health through a network of 843 hospitals and 6,463 health centres. The scheme provides access to a comprehensive package and entitlements with reimbursement for a range of preventative, diagnostic and curative services. Co-payment is required for physical examinations, orthodontics and prostheses, healing materials, medicines and fertility treatments.

Universal Education System in Sri Lanka

Sri Lanka's high literacy rates among youth, currently at 98% for boys and 99% for girls, can be linked to policies for free and compulsory education dating back to the 1940s. More recently, in 1997 the Government passed an ordinance on compulsory education, further strengthening the national framework for universal primary education, providing free education at primary, secondary and university levels and compulsory education for all children between 5 and 13 years of age. As part of the education system, children are provided with free textbooks, two sets of uniforms and a mid-day meal (in designated areas). The Sri Lankan education system encourages skills development for suitable employment upon entering grade 9, offering students the option to continue with academic studies, enrol in an apprenticeship to enhance technical capability, or join agricultural production.

programmes varies considerably between countries and between income groups. For example, in the Lao People's Democratic Republic the programmes directly benefit 1.65% of the total population while for the poorest quintile the proportion is only 0.43%. On the other hand, in Thailand the corresponding figures are 99.19% and 99.56%. Encouragingly, in Indonesia, Kyrgyzstan, the Russian Federation, Sri Lanka and Viet Nam the coverage of social protection and labour programmes has flowed more to the poorest quintile of the population.

An important challenge to increase the coverage and depth of social protection measures will be their sustainable financing. Critically, the design of social protection measures will need to address growing budgetary demands due to the changing age structure of populations. The private sector must also

contribute and partner with Governments. Meanwhile, further research needs to be conducted on effective methods for financing national programmes and on the implications for government budgets.

- *Infrastructure spending* – Governments need to address the significant shortage in infrastructure provision across the region. Adequate physical infrastructure in terms of transport, public services provision and telecommunications in both rural and urban areas, is essential for enabling countries to realize their economic potential. Apart from current needs, the demand for infrastructure is projected to increase significantly with growing populations and greater urbanization. A recent study by ESCAP estimated the infrastructure financing gaps in the Asia-Pacific region to be of the order of \$800-900 billion per annum.¹⁹ This total includes the

requirement for national infrastructure in energy, transport, telecommunications, water and sanitation, and cross-country infrastructure projects in transport, energy and telecommunications. The private sector acting alone is not coming close to meeting this requirement, with annual spending on infrastructure over the past 20 years averaging \$13 billion and being concentrated in less risky investments.²⁰

Apart from shortfalls in financing, it is clear that significant improvement is required in legal and regulatory frameworks for infrastructure investment across much of the region. Recent years have seen a lack of clarity in such frameworks and this has been a significant factor in the worsening of investment climates and resulting reduction in new projects in many countries. Without improvements in regulatory frameworks and policy certainty, even in the presence of adequate financing, investors will remain wary of entering into major investments. Political instability also discourages private sector investment in large infrastructure projects.

Existing forms of infrastructure investment in the region could be complemented with a new large-scale lending facility using innovative development financing sources

Existing forms of infrastructure investment in the region could be complemented with a new large-scale lending facility for infrastructure using innovative development financing sources. Such a regional facility could issue securities to enable the region's central banks to be able to park their surplus reserves with it. The infrastructure financing facility could help coordinate other sources of lending, such as that from multilateral and bilateral development agencies and private financial institutions. Its backing for infrastructure projects could also signal opportunities to private investors. As a regional mechanism, the facility could also be in a position to keep track of intraregional spillovers and finance economically significant cross-border projects. Another possible function of the facility could be to provide advisory

services and technical assistance in the financial design of infrastructure projects.

- *Environment-related spending* — Governments will need to undertake spending to address environmental factors which will otherwise hamper growth prospects. Environmental damage is already constraining growth in the region. For example, environmental degradation was estimated in 2012 to have cost India almost 6% of GDP annually.²¹ Air pollution and water pollution are seriously undermining economic prospects in many countries in the region due to serious health impacts. One World Bank study estimates that the health costs of air and water pollution in China amount to about 4.3% of its GDP. By adding the non-health impacts of pollution, which are estimated to be about 1.5% of GDP, the total cost of air and water pollution in China is about 5.8% of GDP.²² Widespread loss of natural ecosystems and biodiversity has also had impacts on economic potential.

Apart from reducing environmental damage, policies are required to improve access to modern energy sources. Using such sources can make growth more sustainable and will contribute to increased growth by making households more productive. To improve access to modern energy, several countries have formulated investment strategies for energy infrastructure – aimed at improving energy efficiency and increasing the use of renewable sources. There are several examples. Bangladesh has initiated a biogas project to provide communities with clean and renewable energy; Nepal has initiated a national programme to integrate alternative energy sources with the socio-economic activities of women and men in rural communities; the Government of Indonesia announced a major reform plan to reduce gasoline subsidies; Thailand has instituted a renewable energy policy; and Viet Nam has adopted a law concerning an environment protection tax.

Another area for action to ensure the sustainability of growth is better addressing climate change through improving climate finance. Sources of climate finance should be mobilized both from

the public and private sectors. Public finance can focus on leveraging private funding to tackle climate challenges. Specifically, climate finance mechanisms should be mainstreamed into the evolving financing framework in the context of the development agenda beyond 2015.

Productive investment in youth

Government policies are required to assist youth to acquire the education and skills required to obtain decent and productive employment. The region is facing the enormous challenge of securing such employment for the largest generation of young people in its history. Nearly 717 million of the region's population are young women and men aged 15 to 24, with the issue being most acute in South and South-West Asia. While some of the problems are caused by a lack of adequate decent and productive jobs, many young people are entering the labour force with skills that are limited or do not match the changing demands of labour markets. Governments therefore need to pay attention to the way in which youth develop from a young age and help prepare them for work with adequate knowledge, skills and experience. In this context, the transition between secondary and tertiary education needs to take into account the capacities and potential of youth. Active labour market programmes will also be important to effectively link education, training and skills development systems with the requirements of employers. The challenge of increasing access to education is especially great for low-income economies, where the probability of obtaining tertiary-level education is low. In these economies, the gross enrolment ratio (GER) in tertiary education is only 10%, while in high-income economies it is 71%. Some of the biggest challenges are in South and South-West Asia where GER is 14%, which is the lowest in the Asia-Pacific region, compared with 56% in North and Central Asia.

Improving education systems will require paying special attention to gender inequalities. Although these have fallen in education in the region over recent years, there are still disparities that translate

into untapped productive potential for both medium and long-term growth. The South and South-West Asian subregion is lagging, with 8 girls for every 10 boys enrolled in secondary education, but an even greater concern is that only 3 women for every 4 men are enrolled in tertiary education. There are many barriers to female education – including the burden of household work, limited appreciation of the benefits of educating girls and women, and negative social and cultural attitudes. Addressing such prejudices will require greater investment in the recruitment of female teachers and targeted support for poor families in order to render educational establishments more female-friendly.

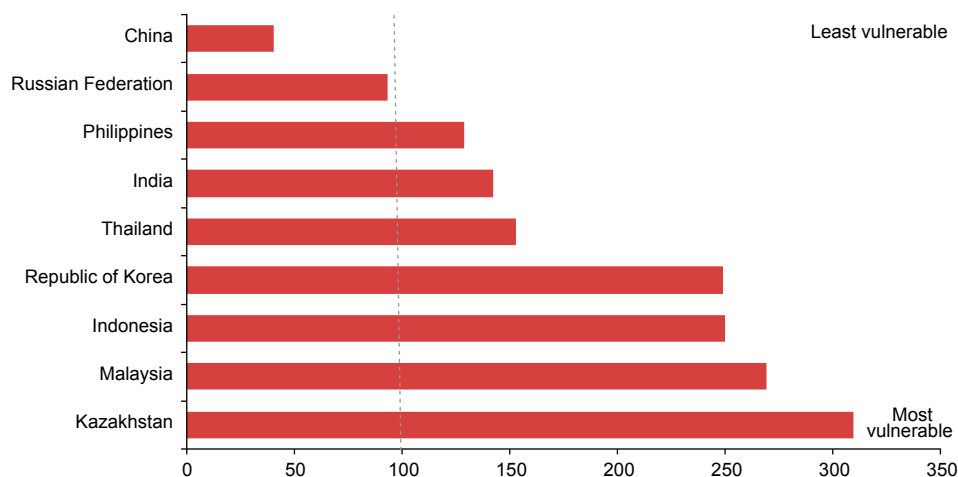
Mitigating risks from volatility of capital flows

Countries should be cognizant of the need to possess sufficient foreign exchange reserves to help defend against excessive depreciation resulting from capital volatility. The build-up of reserves has been one of the main tools of Governments to protect their currencies and prevent the macroeconomic instability resulting from sharp exchange rate depreciation. The ESCAP vulnerability yardstick considers the level of short-term foreign exchange commitments, comprising portfolio investment, short-term debt and quarterly imports, as a percentage of foreign reserves. It indicates that some economies in the region may have insufficient foreign exchange reserves to cover the exit of foreign funds from their financial markets (see figure 1.12); hence they face risks of excessive exchange rate depreciation.

Concerns about the lack of sufficient reserves at the national level to respond to capital volatility have highlighted the need for greater regional support

Concerns about the lack of sufficient reserves at the national level to respond to the risks from capital volatility have highlighted the need for greater regional support. Currency-related difficulties in various countries in 2013 highlighted the lack of use

Figure 1.12. Vulnerability yardstick (short-term foreign exchange commitments as a percentage of foreign reserves) in selected developing Asia-Pacific economies, latest available data



Source: ESCAP, based on data from CEIC Data. Available from www.ceicdata.com (accessed 15 June 2014).

Note: Vulnerability yardstick is the sum of short-term external debt, latest quarterly imports based on four-quarter moving average and estimated international portfolio investment position, expressed as a percentage of foreign reserves.

of current regional schemes, such as the Chiang Mai Initiative Multilateralization. In recent instances when countries have needed currency support, even those within ASEAN+3 have looked to ad hoc regional sources of funds through numerous bilateral swap agreements. Recent experiences have also highlighted the risks facing countries such as India which are not covered by the Initiative. An alternative to current arrangements could be a comprehensive Asia-Pacific financial support mechanism using some of the sizeable foreign reserves available to Governments in the region. A truly regional agreement could offer better protection as it would include many other relatively open economies that are also susceptible to external currency pressure but currently uncovered by agreements. Such a mechanism would be important even for countries that are currently covered by regional agreements, as currency crises in non-protected countries can cause contagion in an interconnected region.

While national or regional pooling of reserves can stabilize currencies after pressure is experienced, they should be complemented by national measures for the management of capital flows. The use of foreign reserves does not deal with the negative impact on

asset markets of any sudden outflow. Therefore, as highlighted by IMF studies,²³ an important additional supportive measure can be capital flows management at the national level to deal with inflow surges in asset markets. Such measures have been gaining in popularity, as recommended by ESCAP over a number of years.²⁴ Some recent capital account management measures have been market-based – as through taxes or levies on particular instruments. Others have been quantitative, such as through caps or prohibitions on the purchase of particular instruments. Furthermore, while most measures have been directed at capital inflows or purchases, some have also been targeted at discouraging capital outflows or sales. A general guideline should be for such regulations to be a component of long-run policies to prevent economic booms and busts.

CONCLUSION

Asia-Pacific economies should undertake policies to revive their robust growth of recent years while also making such growth more inclusive and sustained. The developing Asia-Pacific economies, having recovered strongly in 2010 with an average growth rate of more than 8%, have seen their annual growth

rate dip below 6% since 2012. With constrained growth prospects, productive government spending is critical for reviving growth. The obstacles to higher growth in the Asia-Pacific region are partly related to slow economic recovery in the developed world, but also to long-term structural impediments to growth. This situation highlights the opportunity for productive and countercyclical government macroeconomic support. Such policies can support growth in the short-term while helping remove structural impediments in the long term. These include policies directed towards reducing the high degree of economic insecurity in many economies, large development gaps, significant infrastructure shortages and unsustainable environmental impacts.

In short, policymakers need to ensure that growth-generating activities are inclusive, inequality reducing and environmentally sustainable. This has implications for sources of growth – both sectoral and spatial. Inclusive, equitable and sustainable growth depends on more dynamic industrial and agricultural sector activities which are green or environment-friendly instead of speculative activities concentrated in urban areas. Policymakers also need to identify the sources of growth fluctuations – whether they are due to the business cycle or structural factors – so that they can balance short-term stabilization objectives with long-term sustainable development objectives. Addressing long-term causes would require careful structural reforms. A number of major economies in the region, China and Japan, are already engaged in comprehensive structural reform programmes, and their experiences can provide others with a useful guide. Some of these details are discussed in chapter 2. A critical challenge will be the funding of these policies, which will require raising the resources of Governments. This issue is analysed in chapter 3.

Endnotes

- 1 Xinhua (2013).
- 2 G20 (2014).
- 3 Saez (2013).
- 4 Eichengreen et al. (2013).
- 5 ESCAP (2013c).
- 6 ESCAP (2013a).
- 7 ESCAP (2013b).
- 8 WTO (2014).
- 9 UNCTAD (2014).
- 10 World Bank (2012b).
- 11 ILO (2014).
- 12 ESCAP (2012b); ESCAP (2013b).
- 13 Fulu et al. (2013).
- 14 FAO et al. (2013).
- 15 Kumhof et al. (2011); Cynamon et al. (2013).
- 16 United Nations (2012).
- 17 World Bank (2014).
- 18 Further details of the ESCAP social protection “toolbox” are available at www.socialprotection-toolbox.org/.
- 19 ESCAP (2014).
- 20 ADBI (2013).
- 21 World Bank (2012a).
- 22 World Bank (2007).
- 23 IMF (2012a); IMF (2012b).
- 24 ESCAP (2010); ESCAP (2013b).