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SUBREGIONAL PROSPECTS AND POLICY CHALLENGES

The Asia-Pacific region is enormously diversified in terms of size of population, economic structure and levels of development across countries and subregions. The region is home not only to some of the richest and fastest-growing economies in terms of economic growth but also to numerous poor and struggling economies with serious development challenges. In order to gain a better understanding of economic prospects and structural impediments to inclusive growth and sustainable development, this chapter therefore provides a disaggregated analysis of the macroeconomic performance and outlook at the subregional and country levels. The chapter also contains a discussion of some immediate and medium-term policy challenges specific to each subregion, thereby providing an opportunity to learn from a variety of experiences and policy considerations.

East and North-East Asia. Despite a revival in the United States economy, economic growth in this export-oriented subregion moderated in 2014 due to subdued domestic demand. In China, the shift towards more sustainable, consumption-led growth has resulted in slower growth in fixed investment. Similarly, in Japan output growth has stalled, with larger-than-expected quarterly contractions following the consumption tax hike in April 2014. Fiscal stimulus was launched in both China and Japan, as well as in the Republic of Korea, to combat tepid growth. In terms of outlook, economic growth is projected to increase modestly over 2015 and 2016 due a slight pickup in Japan and stronger growth momentum in the Republic of Korea. China's economic growth, however, is expected to trend downwards slightly more.

An immediate policy challenge for East and North-East Asia is to cope with slowing demand from China. In this regard, efforts are being made to enhance trade connectivity and lower barriers to trade. Examples include the Chinese-led initiative to set up an Asian Infrastructure Investment Bank and the formation of a free trade agreement between China and the Republic of Korea. The Governments of countries in the subregion also introduced policies to boost domestic demand as an alternative source of growth, but their success will be constrained by the currently high debt levels and rapidly ageing population. It is estimated that 1 in 4 persons in East and North-East Asia will be at least 65 years old by 2050. Policies to address the multifaceted nature of an ageing population, such as job sharing and innovative financial products, are critical to overcome medium-term challenges.

North and Central Asia. The already sluggish economic growth in the Russian Federation in recent years was exacerbated by lower global oil prices and geopolitical tensions and related international sanctions. As a result, the economy barely grew in 2014, while considerable contraction is expected over 2015/16. As the Russian Federation accounts for 80% of economic output in North and Central Asia, subregional growth performance and prospects are also bleak. To its neighbouring countries, the Russian Federation is the main trading partner and host country for migrant workers. Already, subdued foreign exchange earnings due to declining commodity prices have led to the weakening of several of the subregion's currencies. Thus, unlike elsewhere in Asia and the Pacific, inflationary pressures are rising in North and Central Asia. This leaves the subregion in a low-growth, high-inflation situation.

Sources of economic growth in North and Central Asia are highly concentrated. In Azerbaijan, Kazakhstan, Turkmenistan and Uzbekistan, natural resources rent, defined as the difference between a commodity's price and its average production cost, amounts to between 37% and 47% of GDP. In Armenia, Kyrgyzstan and Tajikistan, overseas workers' remittances account for between 13% and 41% of GDP. Such concentrated economic structure makes countries in the subregion highly vulnerable to developments in global commodity prices and macroeconomic conditions in the Russian Federation. Policy reforms to diversify sources of economic growth would involve creating a dynamic, entrepreneurial private sector and strengthening the linkages between resource- and non-resource-based sectors.

The Pacific. Pacific island developing economies grew at a three-year high rate in 2014. The expansion took place in nearly all those economies, but growth was driven mainly by mineral resource production in Papua New Guinea, which accounts for close to 60% of output of those economies. A devastating cyclone led to an economic contraction in Solomon Islands in 2014, which highlights the subregion's vulnerability to frequent natural disasters. Catastrophes often disrupt economic growth and macroeconomic stability, given the small populations, limited land area and restricted room for macroeconomic policy response in those island economies. In terms of outlook, economic growth is projected to increase further, benefiting from strong mineral exports in Papua New Guinea, continued post-cyclone reconstruction activity in some countries and expected increases in tourism and remittance receipts. A major obstacle would be any decrease in the price of primary commodities, which could dampen the earnings of rural residents.

Faster output growth is needed to generate more jobs in Pacific island developing economies where many people remain unemployed or still engage in subsistence activities. Limited infrastructure networks and human and institutional capacity have resulted in the subregion's low and uneven economic growth record. A more vibrant business sector would expand the economic base, reduce youth unemployment and support government revenue that could be spent to reduce notable gaps in service delivery in rural areas and outer islands. Countries have made progress in promoting private sector development but more effort is needed to promote niche, higher-value-added industries, such as sustainable tourism and fishery activities.

South and South-West Asia. Economic growth in 2014 edged up but remained far below the subregion's impressive performance prior to the 2008 global crisis. The uptick was led mainly by stronger macroeconomic performance in India, which accounts for slightly more than half the output in the subregion. Economic growth also strengthened in Bhutan, Nepal, Pakistan and Sri Lanka, and was stable at rather high levels in Bangladesh and Maldives. Robust household consumption largely propelled the expansion, which benefited from favourable farm incomes, revived workers' remittances and eased monetary policy. The outlook for 2015 and 2016 is optimistic. Continued domestic reform effort would help unleash high potential growth that the subregion gains from a young population and abundant farm workers who can move to higher value-added manufacturing activity.

Despite the commendable economic growth that helped reduce poverty in past decades, the South and South-West Asian subregion still accounts for nearly 40% of the world's poor. Three interconnected macroeconomic imbalances, namely large fiscal deficits, sizeable current account shortfalls and high inflation, have held back faster economic growth in the subregion. Tax reforms would help lower public borrowings, which have added inflationary pressure to the economies, contributed to wide saving-investment gaps and constrained financing for the private sector. In addition to macroeconomic imbalances, severe power shortages are a key growth constraint. As the root causes of the energy crisis lie beyond energy sector policies, a broad-based policy effort is needed to expand the fiscal space, set up an appropriate framework for public-private partnerships and enhance corporate governance in public enterprises.

South-East Asia. Economic growth momentum softened in 2014 amid monetary tightening and weak commodity exports in Indonesia, political unrest in Thailand and cooling of the real estate sector in Singapore. Growth also slowed, albeit from a high base, in subregional economies with lower income levels, such as Cambodia, the Lao People's Democratic Republic and Myanmar. The near-term outlook is projected to improve, mainly underpinned by an economic recovery in Thailand and more rapid growth in Indonesia and the Philippines. Lower global energy prices would keep prices low, although oil-dependent Brunei Darussalam and Timor-Leste will likely face revenue shortfalls.

An increasing role has been observed in South-East Asia with regard to domestic demand, particularly private consumption, in supporting economic growth. While this helps raise the subregion's resilience against external demand shocks, such consumer spending is financed largely by capital inflows amid a situation characterized by abundant global financial liquidity. In Malaysia and Thailand, an increase in the value of household debt during the period 2008-2013 was equivalent to nearly 30% of those countries' GDP. Regarding medium-term challenges, two key growth constraints are shortages of public infrastructure and skilled labour. As for infrastructure, the subregion needs to mobilize part of its available savings, about $700 billion in international reserves, to reverse the declining trend in public infrastructure outlays. This would complement multilateral initiatives, such as the ASEAN+3 Bond Market Initiative.[1] With regard to workers' skills, while most countries in the subregion have achieved universal primary education, secondary enrolment should be actively encouraged and the quality of education and vocational training should match the needs of job markets.

1. EAST AND NORTH-EAST ASIA

1.1. Key economic and social themes

The East and North-East Asian subregion is composed of economies with diverse economic structures and at various stages of economic development: from labour-abundant China and capital- and technology-rich Japan to the natural resource-endowed Mongolia. Hong Kong, China and the Republic of Korea are also distinctive in their heavily export-driven economic structure. Well-known as two of the "Four Asian Tigers", the two economies achieved rapid economic development based on exports and are now global leaders in financial services and information technology, respectively. The Democratic People's Republic of Korea, on the other hand, is a centrally planned system and has only limited ties to the global market.

These differences enhance economic complementarities and provide opportunities for greater linkages among economies in East and North-East Asia. At the same time, for these economies to create shared prosperity through enhanced connectivity, the subregion needs to bridge the large development gap, which currently has Japan on one end of the development spectrum and the Democratic People's Republic of Korea and Mongolia on the other.

An immediate challenge for economies in East and North-East Asia is the economic slowdown in China, which is part of its process of economic rebalancing. Since the global financial crisis in 2008, the strategy of the Government of China has been to gradually transition from relying on the export of manufactures and investing in support of economic growth to develop the service sector and foster consumption. Consequently, China's growth rate has declined from double-digit levels prior to the global financial crisis to about 7.4% in 2014. Export growth has substantially slowed from an average of about 30% per annum between 2001 and 2008 to less than 10% in recent years. Fixed asset investments, which have been one of the primary engines of growth of the Chinese economy, are also slowing from a growth rate of about 26% between 2008 and 2011 to 15% in 2014.

China has long since been the largest trading partner for all ESCAP subregional economies. The impact of China's rebalancing has been channelled to neighbouring economies in East and North-East Asia through reductions in trade flows (see figure 2.1). In the case of Mongolia, there has been a reduction in demand for commodities, such as coal and copper, and in the case of Hong Kong, China; Japan; and the Republic of Korea, trade in capital and intermediate goods has fallen in recent years.

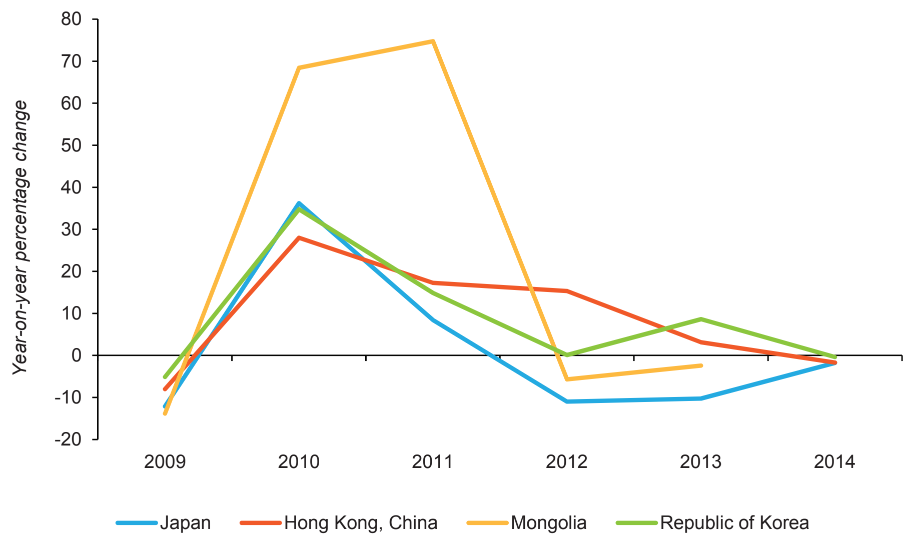
There are various measures that can be taken to mitigate the short-term impact of the decreased trade resulting from China's rebalancing and subsequent drop in economic activity, while maximizing new opportunities. One such measure is to increase trade and logistics connectivity and lower barriers to trade. In launching those efforts, China and the Republic of Korea signed a provisional free trade agreement outlining concessions on manufactured items, with the two countries intending to finalize the agreement in 2015. The agreement is expected to have a direct positive impact on the steel-making industry of the Republic of Korea; the abolishment of the 3% import duty on steel came into immediate effect. Discussions on a trilateral free trade agreement involving China, Japan and the Republic of Korea are also making progress.

Additionally, there are growing opportunities created by new Chinese initiatives on enhancing infrastructure linkages. The rollout of the "one belt, one road" national strategic initiative, which is also known as the "new silk road economic belt" and "twenty-first century maritime silk road", and the proposed establishment of an Asian Infrastructure Investment Bank, as well as the proposed silk road fund should promote large-scale infrastructure investment along the belt and road for the next 5-10 years.

On the social front, population ageing is of increasing concern for the subregional economies. East and North-East Asia is experiencing the fastest population ageing in human history, with the subregional economies having the highest life expectancy (notably Japan) and the lowest fertility rates (Japan and the Republic of Korea) in the world. The speed of population ageing is particularly rapid in China, where persons aged 65 or older are projected to reach close to 200 million (11.7% of the total population) in 2020, and more than 300 million people (22.1% of the total population) in 2040 (see figure 2.2).[2]

The challenges posed by rapid population ageing are multifaceted; they involve the labour force, health services, pension and welfare schemes, housing

Figure 2.1. Annual merchandise export growth to China from selected East and North-East Asian economies, 2009-2014



Source: UNCTAD database.

and issues of poverty and social isolation. In East and North-East Asia, where 1 in 4 persons will be 65 years or older by 2050, the development of policies to support sustainable ageing societies should be a key priority.

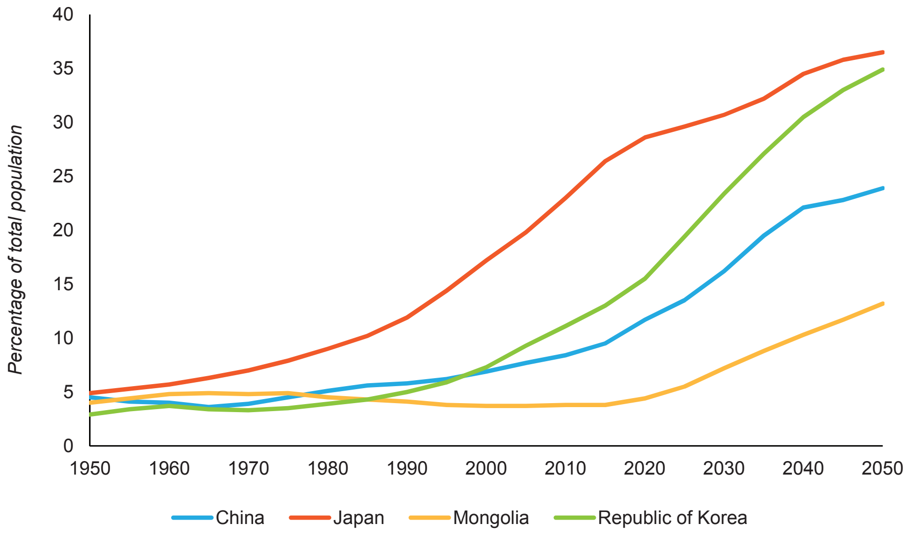
1.2. Recent performance, outlook and main challenges

Economic growth in East and North-East Asia decelerated from 4.2% in 2013 to 3.3% in 2014 (see figure 2.3). The slowdown was recorded in all of the subregional economies except in the Republic of Korea. Despite strong economic recovery in the United States, which helped to mitigate somewhat the impact of slower growth in China, the subregion's growth momentum weakened due to softening private consumption and investment spending. Although export growth slowed in some of the economies, the trade account balance improved across the board as the import bill fell faster.

Sluggish economic activity and subdued international commodity prices resulted in lower inflation in most of the economies in the subregion (see figure 2.4). In fact, deflation became a concern for the Republic of Korea as prices fell below the target of 2%, and deflation continues to be a key challenge for Japan. In response to slower economic growth in most economies in the subregion, the monetary policy stance was broadly accommodative, with China and the Republic of Korea cutting benchmark rates. Japan also expanded its programme of quantitative easing. Mongolia, on the other hand, is struggling to rein in double-digit inflation resulting from rapid depreciation of the domestic currency and added domestic demand generated by the fiscal stimulus in 2013. The pace had started to slow towards the second half of 2014 as credit expansion and currency depreciation moderated with the gradual tightening of monetary policy.

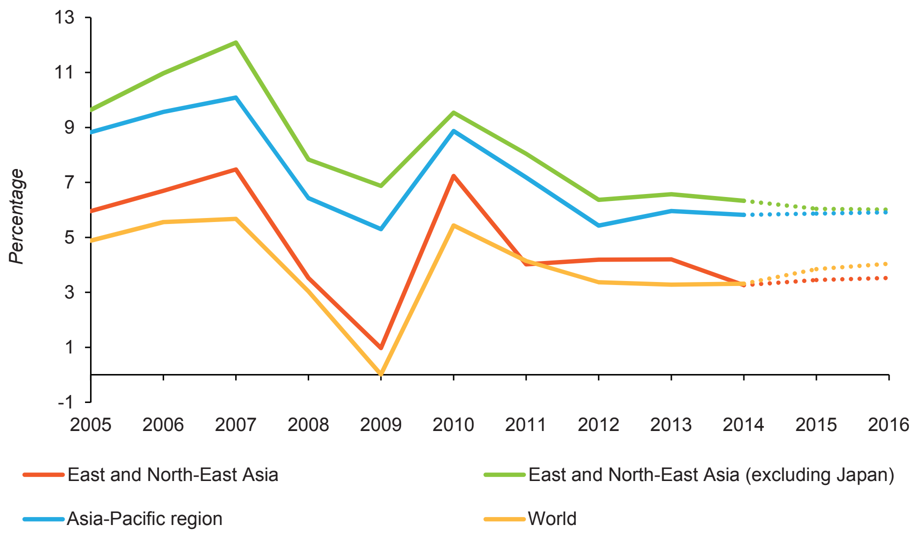
Overall, labour market conditions showed improvement in most economies in 2014. The unemployment rates in China and Japan decreased notably. Hong Kong, China's unemployment rate held steady at 3.3%, which is viewed by the authorities as being close to full employment. The Republic of Korea, on the other hand, experienced worsening unemployment, from 3.1% in 2013 to 3.4% in 2014. For youth unemployment, although the latest available data also showed improvement, the levels remained persistently high at more than double the national unemployment rate in many economies.

Figure 2.2. Proportion of persons aged 65 and older in selected East and North-East Asian economies, 1950-2050



Source: *World Population Prospects:* 2012 Revision. Available from http://esa.un.org/wpp/.

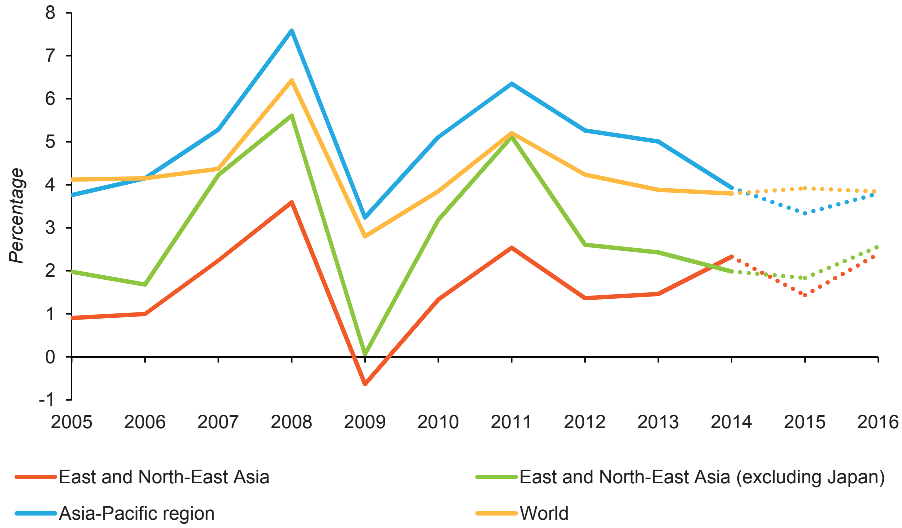
Figure 2.3. Real GDP growth in East and North-East Asia, Asia-Pacific region and the world, 2005-2016



Sources: ESCAP, based on national sources; United Nations, Department of Economic and Social Affairs, *World Economic Situation and Prospects 2015* (Sales No. E.15. II.C.2). Available from www.un.org/en/development/desa/policy/wesp/wesp_current/wesp2015.pdf; IMF, International Financial Statistics databases. Available from http://elibrary-data.imf.org; ADB, *Asian Development Outlook 2015* (Manila, 2015); CEIC Data. Available from www.ceicdata.com.

Note: Estimates and forecasts are as of 31 March 2015.

Figure 2.4. Inflation in East and North-East Asia, Asia-Pacific region and the world, 2005-2016



Sources: ESCAP, based on national sources and CEIC Data. Available from www.ceicdata.com.

Note: Data reflects the changes in the consumer price index. Estimates and forecasts are as of 31 March 2015.

The growth prospects for the subregion remain subdued owing to many challenges ahead. A further slowdown in China, rising geopolitical risks, including in the Middle East and Ukraine, and uncertainties surrounding European economies are likely to weigh down regional economies in 2015. An urgent policy priority would be to develop a clear strategy for shoring up domestic demand while keeping in view high debt levels and a rapidly ageing population in many of the subregional economies.

China

Economic growth slowed to 7.4% in 2014 compared with 7.7% in 2013 and average growth of 9.1% during the period 2010-2012. The contribution to output growth by business investment and household consumption decreased. Nonetheless, net exports remained an important growth driver, underpinned by a significant rise in shipments to the United States and slower import growth on the back of sluggish investment growth, falling commodity prices and currency appreciation.

The rebalancing process, in which the Government seeks to boost consumption to take up the slack from the lower level of investment, has been slow so far. Despite continuing growth in wages and income, national savings have stayed at about half of GDP. On the other hand, policies to boost service sector output are making headway. The services sector continued to expand robustly, accounting for 48.2% of GDP in 2014. To increase the share of services in GDP to more than 50% by 2020, various measures were introduced in 2014, including lowering services taxes, boosting tourism development and increasing access for private investment in the health-care and transportation sectors.

Consistent with the decline in the contribution of investment to GDP growth, FDI inflows were nearly flat in 2014, with a marked shift in investment away from manufacturing to the services sector. On the other hand, the economy recorded strong growth in outward FDI, which already surpassed the inflow of FDI in 2014. FDI outflow from China is going into new sectors, including high technology, agribusiness and food, manufacturing and services.

To maintain growth stability, the Government in April 2014 introduced a mini-stimulus programme that included additional spending on railways, upgraded housing for low-income households and tax reductions for small and medium-sized enterprises. However, implementation of the stimulus packages proceeded cautiously, as local government debt has built up. The Government also reversed restrictions on real estate transactions, such as lowering down payments and mortgage rates for buyers of second homes. Similarly, taking advantage of the low inflation rate of 1.9%, the benchmark lending rate was lowered in November 2014 by 25 basis points, the first monetary easing in two years.

China's economy is forecast to grow by 7% in 2015 and 6.8% in 2016, which is slightly lower than the 7.2% target that the Government previously saw as necessary to ensure stable employment conditions. Importantly, in late 2014, the Government reaffirmed its strong commitment to a new normal of slower but more sustainable economic growth. For instance, in an effort to address the country's severe air pollution problems, the Government plans to cap coal use by 2020, and it agreed with the United States to peak its total carbon dioxide emissions by 2030 or earlier. Without any intervention, China's carbon emissions would have likely peaked in 2050. To reach the carbon reduction target, China has to start rapidly expanding carbon-free energy.

Similarly, the Government is also stepping up measures to tackle the challenge posed by growing income inequality. According to official data, China's Gini index increased from an already high value of 41.2 in 2000 to 49.1 in 2008, before slightly decreasing to 47.4 in 2012. One of the notable policy measures is to reform the non-salary income of government officials and executives at State-owned enterprises.

Hong Kong, China

Economic growth moderated from 2.9% in 2013 to 2.3% in 2014, mainly due to a decline in tourist spending, weaker domestic demand and a decrease in services exports during the first half of the year. The economy saw moderate increases in merchandise exports, but it was not sufficient to offset the slowdown in broader economic activity. Social unrest, particularly in the second half of the year, dampened inbound tourism. Purchases of luxury goods also fell significantly, partially as a result of the strong anticorruption drive of the Chinese Government. Contributing to the growth slowdown was the cooling of property investment, which started in 2013 after the Government introduced measures to manage the sharp increase in real estate prices, which were continued in 2014 in anticipation of a likely interest rate hike in the United States.[3] Meanwhile, overall inflation in 2014 was 4.4%, which is largely stable in view of the rate of 4.3% in 2013. Fiscal stimulus worth about $2.6 billion, tax breaks and one-off cash transfers in the form of rental subsidies lifted price levels.

The economy is forecast to rebound slightly to a growth rate of 2.5% in 2015 and 2.8% in 2016 on an expected improvement in trade-related services. A major challenge is a potential increase in interest rates, which would arise as a result of monetary policy normalization in the United States. After enjoying easy monetary conditions for a long period, which fueled a rise in credit, the higher debt-servicing cost will have negative impacts on consumer spending and business investment.

Macao, China

Macao, China experienced a surprise economic contraction of 0.4% in 2014. The drastic fall in gaming revenue and visitor spending resulted in a 17.2% decline in GDP in the fourth quarter. Although merchandise exports and gross fixed capital formation posted strong growth figures, they could not make up for the fall in the export of gaming services, a sector which accounts for more than 80% of the economy. Moreover, large-scale construction of tourism and entertainment-related facilities is currently adding to concerns about oversupply conditions.

Growth is forecast to contract further by 4% in 2015. Excess capacity in the gaming industry and increasing regional competition from such countries as the Philippines, the Republic of Korea, the Russian Federation and Viet Nam, which are trying to boost tourism through gaming sector development, will be a key policy challenge. As the gaming sector matures in Macao, China, economic diversification towards other services will be critical for achieving stable medium-term growth.

Democratic People's Republic of Korea

The country relies heavily on the export of commodities, such as coal and iron ore, to China as its main source of income. However, with China's economic slowdown and its plan to set a cap on coal consumption as a step towards reducing carbon dioxide emissions by half, the demand from China for coal is likely to fall. This could adversely affect the growth prospects of the Democratic People's Republic of Korea.

In an effort to diversify the economy's structure, the Government is seeking to increase service sector output by streamlining visa processes and designating a special zone for tourism. The Government is also trying to strengthen economic ties with neighbouring countries, including the Russian Federation. The two countries signed an agreement to increase bilateral trade volumes from the current level of $112 million to $1 billion by 2020. Moreover, following the completion of railway upgrades between the two countries in 2013, the Republic of Korea started a pilot project to import coal from the Russian Federation through the Democratic People's Republic of Korea.

Japan

The economy contracted by 0.1% in 2014, after having grown at a rate between 1.6% and 1.8% during 2012/13. Front-loaded consumption spending, especially on capital goods, prior to the consumption tax increase from 5% to 8% in April 2014, resulted in strong economic growth in the first quarter. While some slowing was expected in subsequent quarters, the impact of the tax hike was greater than projected, with economic contractions recorded in the second and third quarters. In response, the Government announced in November 2014 that the second consumption tax increase from 8% to 10%, previously scheduled for October 2015, would be postponed. The unexpected technical recession spurred the Government into enacting another round of stimulus worth $29 billion. The package is aimed at helping low-income households and supporting small and medium-sized enterprises, as well as strengthening disaster prevention and rebuilding disaster-affected areas.

An implication of weak economic growth is that deflation continues to remain a concern. The previous inflation target was set at reaching 2% by April 2015. However, with actual inflation (adjusted for the tax increase) remaining at about 1.5% in 2014 (2.7% if the tax increase is not taken into account), Japan's central bank now expects to reach the target in 2016. The central bank announced in October 2014 that it would expand its quantitative easing programme, aimed at increasing the monetary base from the current 60-70 trillion yen annually to about 80 trillion yen, by purchasing larger quantities of Japanese government bonds alongside riskier assets, such as stocks and property funds. However, without corporations and households tapping in to borrow funds, the link from banks to lenders that creates credit growth and inflation would be weak.

An eased monetary policy stance has already resulted in currency depreciation of more than 30% since 2011. The weaker exchange rate has had a mixed and somewhat unexpected impact on exports. Regarding service exports, tourist arrivals grew by almost 30% in 2014, supported partly by relaxations on visa requirements. However, for merchandise exports there has not been a significant increase. This is potentially due to a low pass-through of exchange rates to export prices, especially among large export-oriented producers, whose import share of the final product tends to be large.[4]

In an effort to meet the 4.1% fiscal deficit target, the Government announced in 2015 that it would cut new borrowings. Japan's public debt has reached 2.3 times GDP, and debt-servicing expenses exceed 23 trillion yen per year. Striking a balance between reining in the debt burden and propping up the economy will continue to be a major challenge, especially in the face of an ageing population.

Growth prospects will continue to be constrained in 2015 with a projected growth rate of 0.6%,before picking up to 0.8% in 2016. Further expansion of the monetary base with plans to switch to higher-yielding stocks has given the equity market a large boost. The wealth effect created by rising stock prices is expected to spur consumption growth. Rising corporate profits may also be translated into larger investment spending in the near term.

Mongolia

Economic growth trended down to a four-year low rate of 7.8% in 2014, from an average growth rate of 13.8% over the period 2011-2013. The key driver of the slowdown is the decline in FDI, along with lackluster performance in non-mining sectors. The mining sector, on the other hand, posted strong growth together with a surge in copper exports. Despite the softening of copper prices amid falling demand from China, which accounts for 40% of global copper exports, production increased significantly from the now operational Oyu Tolgoi mines.

The rapid currency depreciation and strong domestic demand following the fiscal stimulus in 2013 resulted in double-digit inflation in 2014. The price rise nonetheless slowed in the second half of the year, as credit expansion and currency depreciation moderated due to gradual tightening of monetary policy. The policy rate is currently set at 13%, after an increase of 150 basis points in 2014 and another increase of 100 basis points in early 2015.

Economic growth is forecast to moderate to 3.5% in 2015 and 5% in 2016. Mongolia is facing growing challenges from external account vulnerabilities. The sharp decline in FDI has exacerbated the country's deteriorating balance of payments position. Additional pressures will come in the next few years as large external debt repayments are scheduled for 2017/18. Meanwhile, the Government has actively tried to achieve fiscal soundness and deal with the large and growing external debt problem by scaling back government expenditure, as well as by improving transparency through the adoption of the Law of Mongolia on Glass Accounts[5] and the repealing of a law related to the granting of exploration licences, which was one of the main causes of the decline in FDI.

With the mining sector accounting for one fifth of GDP and close to 90% of total exports, as well as 20% of government revenue, the economy is highly vulnerable to the boom-bust cycles of the mineral market. Managing mineral revenue to smooth out the cyclical fluctuations is therefore key to ensuring sustained economic growth. Concurrently, investments of mining proceeds into infrastructure development and viable industries to diversify the export base are an urgent priority.

Republic of Korea

The economy grew by 3.3% in 2014, up from 3% in 2013, but growth remained lower than the average of 4.8% during the pre-crisis years between 2002 and 2007. While the economy gradually recovered, a strong rebound has been difficult to achieve due to mounting domestic and external challenges.

Internally, the ferry disaster[6] in April 2014 notably weakened consumer spending. Property markets remained anaemic, while a large drop in public infrastructure investment in the second half of the year contributed to slowing overall investment growth. Merchandise exports, on which the economy relies heavily to sustain growth, expanded by only 2.1% in 2014 compared with 4.5% in 2013. Meanwhile, inflation in 2014 dipped to 1.3%, significantly below the target range of 2% and sparking concerns about deflation. In response, the Bank of Korea cut rates twice in 2014 and once again in 2015, pushing the benchmark rate to a historic low of 1.75%.

The economy is forecast to expand at the faster pace of 3.4% in 2015 and 3.7% in 2016. Growth should benefit from a $40 billion stimulus package announced in July 2014 and lower borrowing costs. However, further rate cuts may be difficult to execute in the light of the already high level of household debt. The central bank may have to consider alternative means of injecting liquidity in the near future if economic activity remains sluggish and the widening output gap pushes prices down further.

The Republic of Korea has experienced a noticeable decrease in export growth, from double-digit export growth prior to the global financial crisis to less than 3% during 2013/14. In 2014, tepid domestic demand overtook net exports as the main contributor to GDP growth. This sparked concerns about structural issues that may limit the country's medium-term growth prospects. One of these is the weakening of the production value chain. In recent years, the Republic of Korea relied on value-added trade whereby intermediate goods were exported to China and ASEAN countries, where production costs for assembly are lower. However, trade in intermediate goods is expected to diminish more heavily during economic downturns, as exporters of final goods dispose of built-up inventory rather than order new intermediate goods for production. In addition, competition with regard to many of the country's key export products, such as mobile communication devices, display panels and automobiles, is intensifying as markets come close to saturation. The era of export performance feeding into consumption appears to be coming to an end. Innovative strategies for increasing domestic demand are therefore needed to restore growth prospects.

1.3. Selected medium-term policy challenges

In the current economic climate of growing uncertainty concerning external conditions, the subregional economies are increasing their efforts to boost domestic demand in order to close the output gap. Despite the focus of the Governments of countries in the subregion on domestic demand, significant increases in household consumption have been stubbornly difficult to achieve. Given the limitations to what Governments can do through increasing public expenditure, private sector consumption and investment hold the key to sustainable growth in domestic demand.

One of the factors affecting private sector spending is the rapidly ageing population. The impact of an ageing population on national economies is that older persons tend to consume less than younger persons. In a recent analysis in the subregion, it was shown that the rising trend of the current account surplus in the Republic of Korea, which reflects a larger difference between savings and investment, may be attributed partially to the ageing of the baby-boom generation born in the 1960s and 1970s, which has had a positive impact on savings and a negative impact on investment.[7] With further ageing of this population group, both savings and investment rates are expected to deteriorate, along with consumption.

With the exception of Japan, population ageing in the subregion began at an earlier development stage than in other industrialized countries. Finding ways to mitigate the negative impact of an ageing population on economic development is thus a particular challenge. The development of sustainable pension schemes and health-care coverage are the basic requirements to support consistent consumption by the growing elderly population. Governments could also consider innovative policies to support income growth, such as job sharing and creating an environment for finance sector development, in order to diversify investment opportunities for generating additional income.

2. NORTH AND CENTRAL ASIA

2.1. Key economic and social themes

Most North and Central Asian economies rely heavily on the production and export of oil, gas, metals and other commodities. Exports of primary commodities represent more than 40% of total exports in several countries in the subregion. The Russian Federation, which accounts for 80% of output in North and Central Asia, is a significant economic partner of smaller economies in the subregion. Moreover, the Russian Federation is the main host country for migrant workers from neighbouring countries and one of the top three trading partners of most economies in the subregion.

Economic growth in North and Central Asian economies has been driven increasingly by revenues derived from the natural resources sector. Over the last 25 years, total natural resources rent, which is defined as the difference between the commodity price and its average production cost, increased significantly or remained above 30% of GDP (see panel A in figure 2.5). Economies in the subregion are thus being negatively affected by the decline in commodity prices in 2014 (see panel B in figure 2.5). Subdued commodity exports also contributed to the depreciation of local currencies in Armenia, Kazakhstan, Kyrgyzstan and the Russian Federation by at least 10% against the United States dollar at the end of 2014. Azerbaijan and Turkmenistan also devalued their domestic currencies by about 33% and 20%, respectively, against the United States dollar.

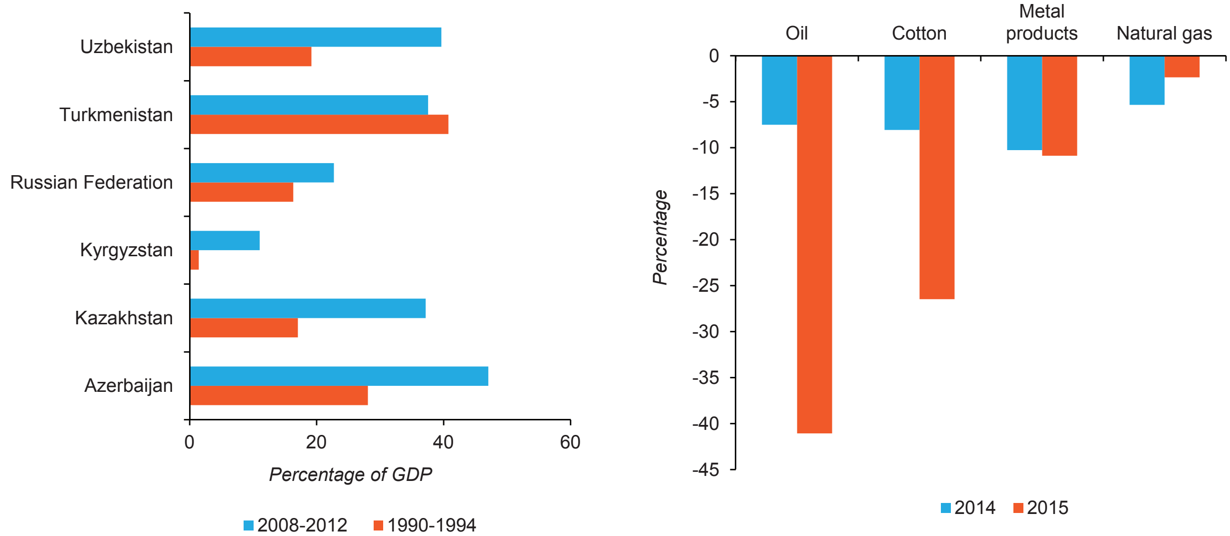
Economies in the subregion are struggling with both slower economic growth amid subdued commodity prices and stronger price pressures as a result of the weaker domestic currencies. In the Russian Federation, the impact of lower commodity exports has been exacerbated by geopolitical tensions and related international sanctions, as well as domestic growth impediments. This is likely to exert adverse spillover effects in the entire subregion. Although most net energy exporters in the subregion have sovereign wealth funds, which can be used to partially absorb the adverse impact of falling commodity prices on economic growth, boosts from government spending will be constrained by the need to maintain adequate medium-term fiscal space.

The spillover effects from the Russian Federation to its neighbouring economies tend to work through various channels, but the most significant channel is potentially through the impact on the balance of payments. The ternary diagram in figure 2.6 depicts workers' remittances, exports and FDI inflows that each subregional economy received from the Russian Federation as a share of its total remittances, exports and FDI inflows, respectively. For example, the diagram shows that about 70% of Uzbekistan's remittance receipts are derived from its workers in the Russian Federation (as

Figure 2.5. Natural resources rent and change in price of commodities

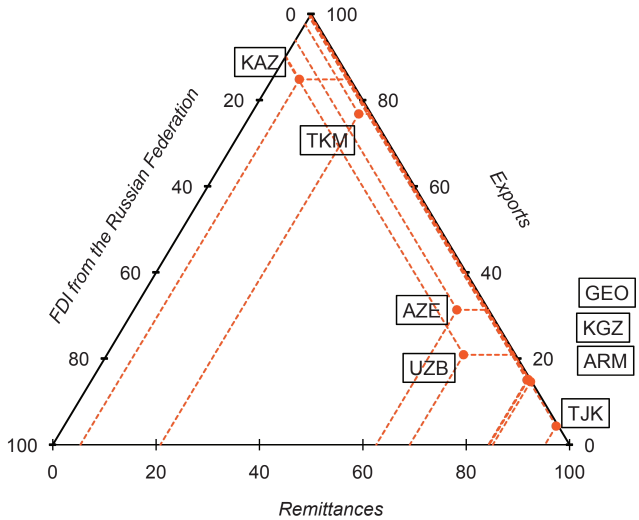
Panel A. Total natural resources rent, 1990-1994 and 2008-2012

Panel B. Change in price of commodities, 2014 and 2015



Source: ESCAP, based on data from World Bank database and International Monetary Fund's Commodity Price Outlook and Risks, 6 January 2015.

Figure 2.6. Ternary diagram: country linkages to the Russian Federation



Source: ESCAP, based on data from the Central Bank of Russia and CEIC Data.

Note: The position of each dot in the Ternary diagram is determined by the share of each of the three variables (exports, remittances and FDI inflows) in the total foreign inflows received by the country from the Russian Federation. AZE=Azerbaijan, ARM=Armenia, GEO=Georgia, KAZ=Kazakhstan, KGZ=Kyrgyzstan, TJK=Tajikistan, TKM=Turkmenistan and UZB=Uzbekistan.

depicted by a dotted line that connects “UZB”, with the triangle side labelled “remittances”). Similarly, about one fifth of Uzbekistan’s exports are destined for the Russian Federation. In Armenia, Georgia, Kyrgyzstan and Tajikistan, remittances from the Russian Federation represent at least 85% of total remittance inflows in each economy. The slowing growth of remittance inflows would affect Armenia, Kyrgyzstan and Tajikistan rather notably, given that remittances accounted for between 13% and 41% of GDP during the period 2009-2013.

Overall, the data show that the linkages between the Russian Federation and other subregional economies in terms of remittance flows and export receipts are closer than the linkage on FDI flows. In box 2.1 below, the drivers of remittance flows between the Russian Federation and other North and Central Asian economies are examined further.

The discussion here highlights the need for the subregion to diversify its economic structure and sources of output growth. Countries also need to make more efforts to strengthen domestic demand through private investments and to secure more inclusive growth. This is important because resource-based sectors will not be able to generate sufficient jobs. The linkages between resource-based sectors and non-resource-based sectors also appear weak. Another challenge is to tackle

Box 2.1. Exploring the determinants of remittance inflows from the Russian Federation

The Russian Federation is an important host country for migrant workers from other economies in North and Central Asia. During the period 2009-2013, close to $60 billion was sent back home by North and Central Asian migrant workers who are based in this country. However, after half a decade of robust expansion, remittance flows contracted by 2% in 2014. This box contains an examination of the determinants of remittance inflows from the Russian Federation to other North and Central Asian economies, and sets forth the challenges being faced by remittance-dependent countries, such as Armenia, Kyrgyzstan and Tajikistan.

Table A shows the results of a regression analysis, which is based on six countries (Armenia, Azerbaijan, Georgia, Kazakhstan, Kyrgyzstan and Tajikistan) during the period 2006-2013. Based on quarterly panel data, the estimation methods are feasible generalized least squares for equations 1-4 and the instrumental variables method for equation 5. As a result of the analysis, three major findings are suggested. First, remittances are countercyclical, that is, increasing during an economic slowdown in a home country and decreasing during an economic expansion. Second, higher inflation in a home country contributes to an increase in remittances, possibly in order to smooth spending by migrants’ relatives. Third, currency depreciation in a home country against the Russian ruble helps to boost remittance incomes.

Box 2.1. *(continued)*

Figure A below shows the impact on remittance flows of the variation of the economic situations in the Russian Federation and in the home country of the migrant worker in 2014. On the one hand, it can be observed that, in such countries as Georgia, Turkmenistan and Uzbekistan, where changes in the economic situation have not been worse than those recorded in the Russian Federation (see figure A: upper left quadrant), migrant workers sent less money to their home countries.

On the other hand, in Kazakhstan and Kyrgyzstan, migrants remitted more in 2014 than they had previously. In the case of Tajikistan, despite the strong contribution of the economic situation, other factors, such as the appreciation of the Tajikistan somoni against the ruble, and the type of jobs held by migrant workers from this country may also be considered in the explanation of the contraction of remittance inflows in 2014 (see figure B). Thus, a deeper deterioration of the economic situation in the Russian Federation may deeply affect households which rely on remittances for their consumption in countries such as Tajikistan and Kyrgyzstan, with poverty rates (national line) above 37%. To support these households, further reforms aimed at improving the efficiency of public expenditures would be essential, given the limited fiscal space in many recipient countries.

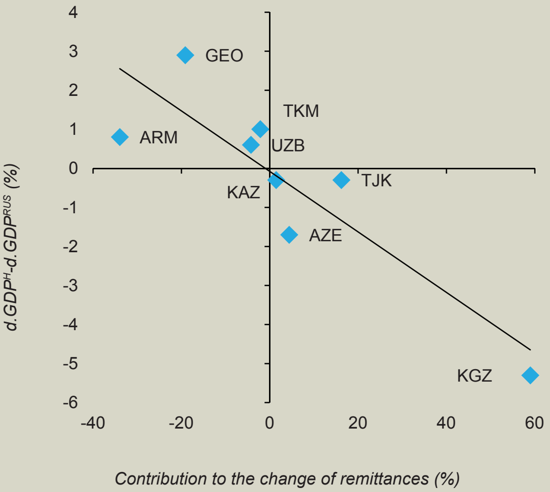
Table A. Empirical analyses of the determinants of remittance flows from the Russian Federation, 2006-2013

Dependent var.: Remittances	EQ1	EQ2	EQ3	EQ4	EQ5
$d.GDP^{H}$-$d.GDP^{RUS}$	-0.002** (-1.99)	-0.002** (-2.30)	-0.003*** (-2.68)	-0.003*** (-2.72)	-0.002* (-1.91)
Exchange rate		0.011*** (7.26)	0.010*** (6.28)	0.010*** (6.30)	0.010*** (6.30)
Inflation [Home]			0.009*** (3.29)	0.008*** (3.12)	0.006* (1.86)
$Interest^{H}$-$Interest^{RUS}$				0.001 (0.55)	-0.001 (-0.43)
Remittances[t-1]					0.314*** (2.43)

Source: Gui-Diby (forthcoming, b).

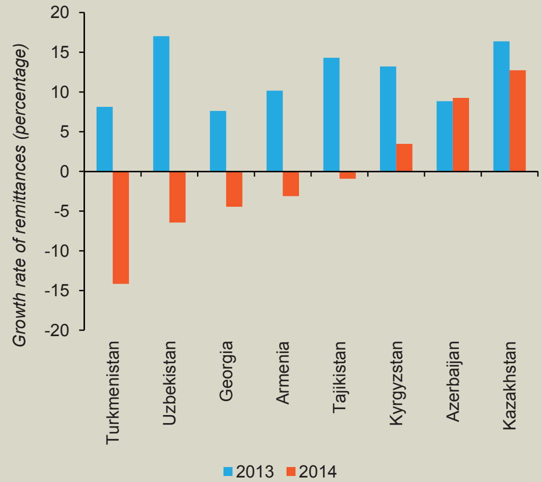
Note: $d.GDP^{H}$ and $d.GDP^{RUS}$ denote the real economic growth rate in a home country and in the Russian Federation, respectively, while $Interest^{H}$ and $Interest^{RUS}$ denote the policy rate in a home country and in the Russian Federation, respectively. The symbols *, **, and *** refer, respectively, to 10%, 5% and 1% significance levels.

Figure A. A scatter plot between economic performance in North and Central Asia and remittance flows in 2014



Source: ESCAP, based on results of equation (4) in table A.
AZE=Azerbaijan, ARM=Armenia, GEO=Georgia, KAZ=Kazakhstan, KGZ=Kyrgyzstan, TJK=Tajikistan, TKM=Turkmenistan and UZB=Uzbekistan.

Figure B. Growth in remittance inflows from the Russian Federation, 2013-2014



Source: Central Bank of Russia.
Note: Data for 2014 is for the first 9 months.

Note: This box was prepared on the basis of Chami and others (2008) and Gui-Diby (forthcoming, b).

vulnerable employment. Close to 20% of the labour force currently works in the agricultural sector, which contributes only 5% of GDP.

2.2. Recent performance, outlook and main challenges

Economic growth in North and Central Asia as a whole slowed to 1.3% in 2014 from 2.1% in 2013 (see figure 2.7). Many economies in the subregion rely on commodity exports, such as oil, gas and metals, as a source of growth, and their economic expansion has been hampered by sluggish global economic recovery and less supportive commodity prices. The contribution of resource-related activities to the overall economic growth declined in many economies in 2014. Moreover, an economic slowdown in Kazakhstan and the Russian Federation adversely affected growth performance in other subregional economies, such as Kyrgyzstan and Tajikistan, through weaker workers' remittance inflows, which had an eventual adverse impact on household spending.

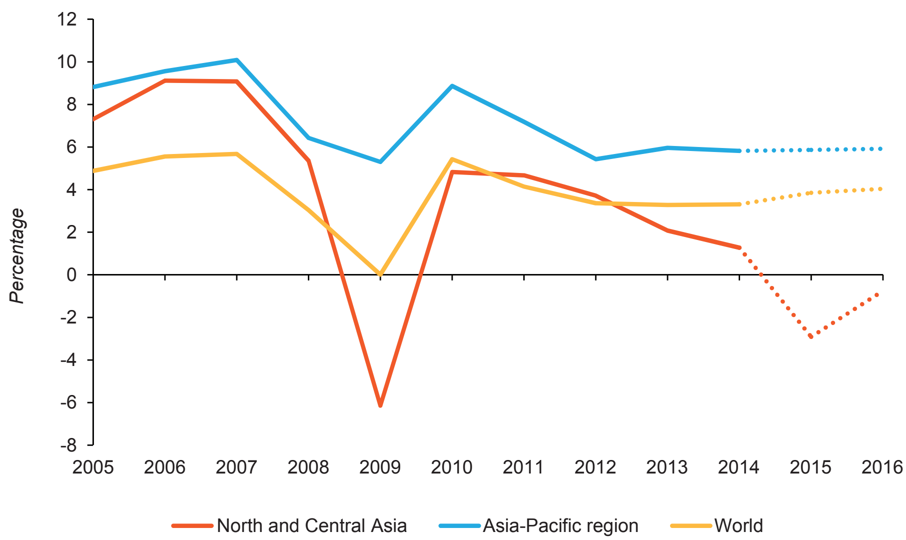
Amid more sluggish economic activity, macroeconomic policy was generally supportive, mainly through an increase in social spending. The outlook for 2015 is expected to deteriorate further, largely due to an expected recession in the Russian Federation. Subregional growth is forecast to contract by 2.9% in 2015. As imported inflation is set to increase because of the depreciation of local currencies, inflationary pressures are expected to increase in all the economies. The subregional inflation rate is projected to be 12.2% in 2015 (see figure 2.8).

Armenia

Economic growth slowed slightly to 3.4% in 2014 from 3.5% in 2013, well below the double-digit growth rates recorded before the start of the global financial crisis in 2008. The mining sector contracted owing to the downward trend of metal commodity prices. Agricultural growth was also sluggish, while the contribution of the construction sector to GDP growth remained negative. Similarly, the contribution of household spending to overall growth decreased due to rising joblessness, a 7% contraction in remittance inflows and a smaller increase in nominal wages. Private consumption was weak despite lower inflation, at 3% in 2014, as the impact of the gas price hike in 2013 started to diminish. The unemployment rate stayed above 15%, while available data on the unemployment trend and job vacancies pointed to a notable mismatch between labour demand and supply.

Growth is projected to soften further to 0.9% in 2015, before rebounding to 2.3% in 2016. The outlook for 2015 is weighed down by likely slower growth in workers' remittances, which account for up to 13% of GDP, and lower private consumption

Figure 2.7. Real GDP growth in North and Central Asia, Asia-Pacific region and the world, 2005-2016



Sources: See figure 2.3 and the website of the Interstate Statistical Committee of the Commonwealth of Independent States. Available from www.cisstat.com.

Note: Estimates and forecasts are as of 31 March 2015.

expenditures amid higher inflation. Armenia's major trading partners, such as Canada and Germany, are also expected to expand at a slower pace, while the Russian Federation is expected to contract. These adverse developments would lower the contribution of net exports to GDP. Nevertheless, growth could benefit from a recent 14% increase in social expenditures on pensions and wages.

Azerbaijan

Maintenance activities on a major platform led to lower output in the oil sector, which accounts for about 45% of GDP. Economic growth thus decelerated to 2.8% in 2014 from 5.8% in 2013. The trade balance deteriorated on the back of lower oil production and exports, as well as less supportive export prices. The non-oil sector performed more favourably, particularly construction activities that benefited from government spending on social housing programmes. Meanwhile, private consumption growth was held back by a slower decrease in unemployment and tightening of consumer lending conditions. Such constrained domestic demand, together with a stable exchange rate, helped to maintain price stability with low inflation of 1.5% in 2014. The monetary policy stance was eased over 2014, with the policy rate having been reduced twice.

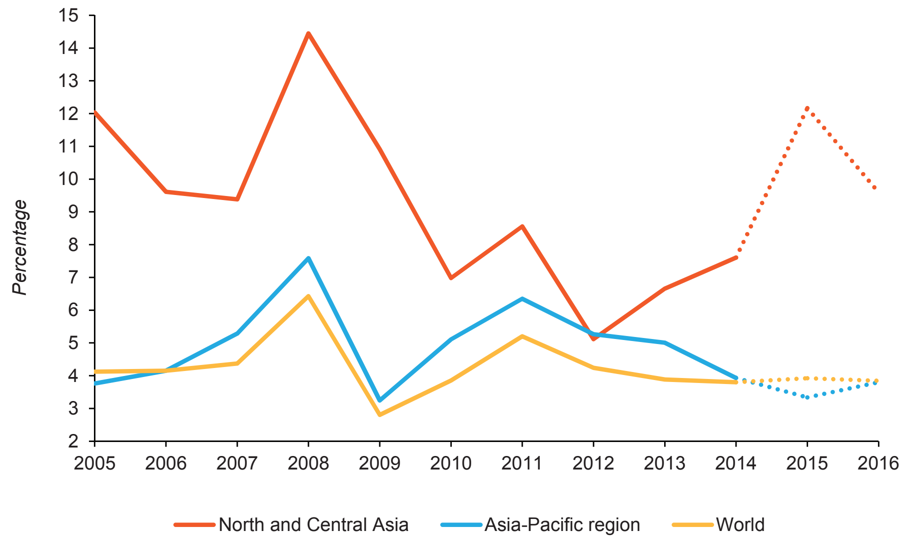
Growth in 2015 is expected to decrease to 2.3% and rebound to 2.5% in 2016. Growth prospects are weighed down by subdued oil prices, higher imported inflation amid currency devaluation and less domestic credits as banks become more reluctant to provide foreign-denominated loans in order to better manage the default risk. Counteracting these adverse factors would be the initiation of operations at a new hydrocarbon project and the ongoing implementation of a public social housing programme throughout the country.

Georgia

Economic growth rebounded from 3.3% in 2013 to 4.7% in 2014, but remained lower than the average growth rate of 6.6% recorded during the period 2010-2012. Lower real interest rates and improved business confidence drove private consumption and investment, which was also reflected in buoyant imports. Ongoing public infrastructure projects supported the construction sector, while the manufacturing and transport sectors also advanced well. Revived domestic demand helped to turn deflation in 2012/13 to inflation of 3.1% in 2014. Nonetheless, inflation remained below the official short-term target of 6% and is expected to remain below this target in 2015.

Steady growth of 4.5-4.8% is projected for 2015/16. Private investments would benefit from the Government's support programmes aimed at improving the business environment and strengthening the linkages between multinational

Figure 2.8. Inflation in North and Central Asia, Asia-Pacific region and the world, 2005-2016



Sources: ESCAP, based on national sources and CEIC Data. Available from www.ceicdata.com.

Note: Data reflect the changes in the consumer price index. Estimates and forecasts are as of 31 March 2015.

companies and local firms. The key headwinds are fragile economic conditions in the European Union and geopolitical tensions in major trading partners, such as Armenia, Azerbaijan and the Russian Federation. Fiscal support could be modest, given the new fiscal rules announced in 2014 that cap government spending and public debt at 30% and 60% of GDP respectively.

Kazakhstan

Growth reached a multi-year low rate of 4.3% in 2014, partly attributable to lower oil production. Non-oil sectors, such as trade, transport and communications, expanded more strongly. Private consumption was held back by higher inflation, which reached 6.7% in 2014, following a 20% currency devaluation announced in 2013. The Government increased spending on wages and social benefits by about 10% to cope with the rising cost of living. On external accounts, the weaker currency pushed up import prices, which together with fragile investor confidence, led to lower imports of investment goods and FDI inflows. To attract more foreign investment, the Government announced an incentive package, including tax exemptions and subsidies on capital investment, to support large-scale investment projects in priority sectors.

Growth is expected to soften further to 1.5% in 2015 owing to lower oil prices and exports. In 2016, recovery at the pace of 2.9% is projected. The Government announced a three-year stimulus package that will provide $3 billion per year for infrastructure development and the construction of schools and social houses. Agro-industry will be provided with support in the form of subsidies on capital expenses. The Government also set aside $2.8 billion to capitalize its problem loan fund and other schemes to maintain financial market liquidity and financial access by small and medium-sized enterprises. A key downside risk is a potential devaluation of the domestic currency against the United States dollar, given the weakening of the Russian ruble that is part of Kazakhstan's basket of currencies.

Kyrgyzstan

The economy expanded at the modest rate of 3.6% in 2014 compared with the high base of 10.5% in 2013. Growth performance over the last few years has been quite volatile, with mild contractions in 2010 and 2012, which were followed by strong recoveries. The volatility was driven mainly by fluctuations in mining output. As with other small, oil-importing economies in the subregion, weak remittance inflows from the Russian Federation constrained consumer spending. Households' purchasing power was also eroded by rising inflation in recent years, which reached 7.5% in 2014. A large share of staple food items consumed in the country is imported, so a currency depreciation of about 9%, along with the low level of domestic food reserves, pushed up overall inflation. Inflation sped up despite a tighter monetary policy stance, which saw the policy rate increasing from 4.1% in January 2014 to 10.5% at year-end. To strengthen the transmission mechanism of monetary policy, the main monetary policy tool has been changed from monetary base management to discount rate adjustment.

A lower growth rate of 2% is expected for 2015. Workers' remittances, which constitute a large share of GDP and are the main source of income for many households, are set to decrease. Exports would be weighed down by the expected slight decline in gold prices. Meanwhile, monetary policy effectiveness could be limited due to a high degree of dollarization in the economy, which weakens the interest rate channel. The inflation rate is expected to increase further to 10.7% in 2015.

Russian Federation

Geopolitical tensions, international sanctions that limit access to foreign funds and high nominal interest rates pushed economic growth in 2014 down to only 0.6%. Growth has indeed exhibited a downward trend since 2012 on the back of weak domestic investment, partly because large infrastructure projects have already been completed. The recent geopolitical developments have dented business sentiments, resulting in the scaling back of investment plans. Amid high levels of economic uncertainty, FDI plunged by 50% in 2014, while total fixed investment also contracted. Similarly, growth in household spending slowed, partly because banks became more reluctant to provide credit despite wider interest rate spreads. Defaults in consumer loans have increased, while household debt surpassed the pre-crisis level and reached 22% of GDP.

Substantial capital outflows widened the capital account deficit to 7.8% of GDP in the first half of

2014 from 2.1% of GDP for the entire year in 2013. As a result, the domestic currency depreciated by about 65%. Although the weaker currency helped improve the trade balance through the fall-off in imports, it pushed up import prices and led to a three-year high inflation rate of 7.8% in 2014. This situation significantly dampens the purchasing power of households.

To support companies affected by international sanctions, the Government has set up a bailout fund that is financed by savings from a temporary suspension in State pension contributions and financial resources from sovereign wealth funds. This included a transfer of $6.6 billion from the National Welfare Fund to two major commercial banks to boost their liquidity, and the establishment of the Loan Guarantee Agency with capital of 50 billion rubles obtained from sovereign funds to support small and medium-sized enterprises. Although the use of public funds to support troubled businesses may help anchor market confidence in the near term, this could potentially crowd out investment in projects with higher economic and social returns. Meanwhile, meeting the short-term fiscal targets, such as reducing the non-oil fiscal deficit and replenishing the country's Reserve Fund, is challenging during a period of economic uncertainty due to unplanned expenditure and lower-than-expected tax revenues and energy prices.

On the monetary policy side, the central bank increased the policy rate to 17% in order to curb inflationary pressures; it started implementing a free-floating exchange rate system in November 2014. The monetary policy framework is also shifting towards an inflation-targeting system.

The near-term outlook is dim. The economy is forecast to contract by 4% in 2015 and 1.6% in 2016. Continued geopolitical instability, uncertainty regarding the extent and timing of international sanctions and lower global energy prices would dampen exports and government revenue, thus constraining growth. As the impact of the weaker exchange rate on prices tends to last for some time, the inflation rate is expected to increase by more than five percentage points to 13% in 2015.

Tajikistan

Growth slowed to 6.7% in 2014 from a stable expansion rate of about 7.4% in the preceding three years. Amid an economic slowdown in the Russian Federation, remittance inflows, which represent almost 50% of GDP, declined by 1% in 2014. Weak capital inflows led to currency depreciation, which raised import prices significantly for such essential food items as wheat and sugar. Subdued remittance incomes and higher inflation, together with a tight monetary policy stance, resulted in a contraction of household spending. Meanwhile, industrial production volume shrank by 1.8% owing to weak orders for aluminium. The aluminium sector exhibits low productivity due to the utilization of a production process that is not very energy efficient.

In an effort to maintain macroeconomic stability, an intervention in the foreign exchange market resulted in international reserves dropping by 47%, from $349 million in January 2014 to $184 million by the end of the year. On the fiscal side, although the Government has increased spending on social protection and education, the deficit dropped to 1% of GDP in 2014 due to improved revenue collection. Tax administration is made more efficient through electronic payment of income tax, among other measures.

Growth outlook is expected to be relatively subdued, at 4% in 2015 and 4.8% in 2016. An expected economic recession in the Russian Federation would dampen workers' remittances and household spending. Moreover, exports of aluminium would be held back by a projected moderate decline in aluminium prices and production that is energy-intensive. Inflation is expected to rise further in 2015, as the weak domestic currency would continue to drive up import prices.

Turkmenistan

Output growth remained buoyant at 10.3% in 2014, which is the fourth consecutive year when growth rates were at double-digit levels. Public and private investments propelled activities in the hydrocarbon and construction sectors. Natural gas exports, which account for more than half of total exports, increased on the back of higher output at a major gas field and the construction of new processing facilities. However, the steady expansion of the economy pushed up the inflation rate to 11% in 2014 from 9% in 2013.

Growth is projected to remain high at 9.5% in 2015 and 9.2% in 2016. New hydrocarbon infrastructure and government spending would support rapid growth. The Government announced an increase in public wages, pensions and student grants by 10%, which became effective in January 2015. Despite the positive outlook, the main headwind is projected high inflation that is a result of a currency devaluation of about 20% in December 2014 and the increase in subsidized prices of petrol and flour. Another adverse factor is a possible decline in hydrocarbon commodity prices.

Uzbekistan

Economic growth remained strong at 8.1% in 2014. Agricultural output increased significantly, although industrial output was hampered by lower gold prices and an economic slowdown in Kazakhstan and the Russian Federation. From the demand side, government spending largely drove the economy. Despite the 20% increase in salaries and pensions, the contribution of private consumption to GDP softened due to a 6% decrease in remittance inflows from the Russian Federation in 2014. The high inflation rate, at 11.7% in 2014, on the back of strong domestic demand and currency depreciation also constrained consumer spending.

Growth is anticipated to remain high at between 7.1% and 7.2% over 2015/16. Domestic factors will continue to support growth, as merchandise exports and remittance inflows are likely to be weak. The Russian Federation recently announced its plan to reduce gas imports from Uzbekistan. Similarly, global prices of gold, cotton and hydrocarbon products are expected to remain subdued.

2.3. Selected medium-term policy challenges

As is evident from the above discussion, economic activities in North and Central Asia are typically concentrated either on commodity exports or workers' remittances. Such economic concentration makes economies in the subregion highly vulnerable to external shocks and macro-economic conditions in the Russian Federation. This highlights the need to diversify sources of economic growth. Economic diversification can be achieved through the production of goods with higher value added within the same industries and participating more in the global value chain (vertical diversification), or by developing new sectors and/or products (horizontal diversification). For both types of diversification, a dynamic and entrepreneurial private sector is required. Governments could play an important role in spurring entrepreneurship and innovation, and private investments in general.

To stimulate innovation and boost private investment, the Governments of countries in the subregion could utilize funds from natural resource rents in four areas: (a) building a creative labour force through an appropriate educational system; (b) establishing research platforms or connections which facilitate access to modern technologies; (c) removing binding obstacles to investments; and (d) supporting entrepreneurs (World Bank, 2010). Specific policy options could include training programmes to enhance business management skills, a government scheme to adapt foreign technologies to reduce high fixed cost of conducting basic scientific research by private firms and the promotion of public-private partnerships in carrying out research and development activities.

In this regard, ESCAP analysis based on firm-level surveys shows that the availability of a labour force with tertiary education, job training and research and development expenditures could significantly foster entrepreneurship and innovation in North and Central Asian countries (see annex I and annex II for more details). The analysis also shows that insufficient competition in domestic markets is holding back innovation efforts in the subregion. Meanwhile, the positive relationship between the exporting share of a firm and its extent of innovation – typically found in other studies – appears absent in the context of North and Central Asia. This underlines the dominance of resource-based, low-complexity exports in the subregion and the need to attract FDI that is not in the natural resource sector.

An effort to attract more FDI into North and Central Asia has been focused on addressing investment constraints. For example, Kazakhstan and Kyrgyzstan are establishing one-stop service windows and streamlining the tax payment process. The countries also introduced trade facilitation measures and constructed or upgraded transport infrastructure to reduce international trading costs. In Georgia, under the programme "Produce in Georgia", the Government supports investors through the provision of land, funds and advice. However, for the subregion as a whole, more policy actions are still required to enforce contracts and resolve bankruptcy cases.

With regard to firms' access to finance, such countries as Kazakhstan and the Russian

Federation provided financial support through subsidies, preferential loans and tax incentives. Similarly, in Georgia, writing-off overdue tax arrears and postponing tax payment by small businesses are considered as means to promote investment. To strengthen the backward linkages between multinational companies and local firms, the Government of Georgia also exempts local producers which are suppliers of multinationals from having to pay value-added tax. Despite the progress made, access to credit is generally constrained by high borrowing costs and strict requirements and regulations on collateral.

Natural resource endowments can also be the plinth for the diversification of an economy, provided that appropriate policies are designed to build the capacity of human resources, to establish an appropriate business environment for private entrepreneurs and to finance innovative initiatives.

3. THE PACIFIC

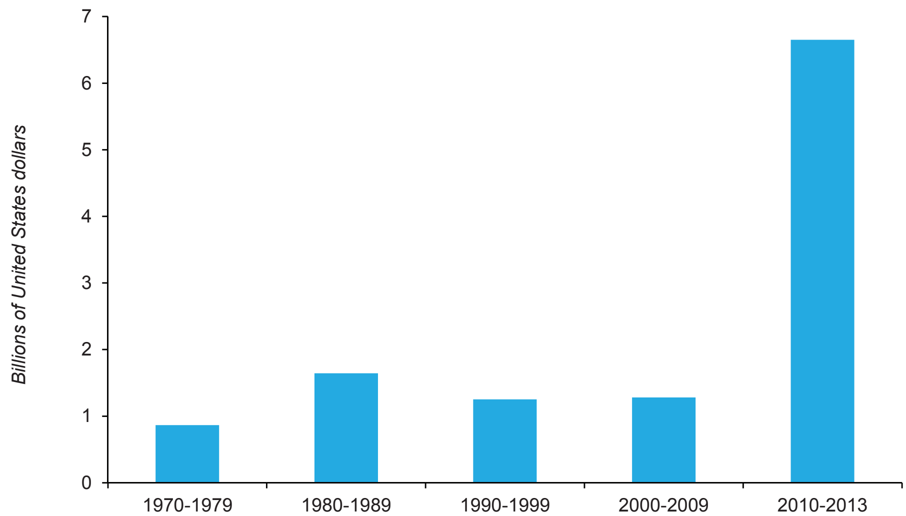
3.1. Key economic and social themes

Pacific island developing economies are typically small in terms of population and land area and have limited resources. Such conditions make them especially vulnerable to external shocks, including climate change-related developments. The reliance on overseas development assistance and workers' remittances is high. On the other hand, the role of the private sector in supporting the economy is generally limited, mainly underpinned by the lack of public infrastructure, shortage of a skilled workforce and high logistics and shipping costs. The public sector is thus dominant and is the main source of employment in many economies in the subregion. These structural impediments are emphasized in the Small Island Developing States Accelerated Modalities of Action, or Samoa Pathway, discussed during the third International Conference on Small Island Developing States in September 2014.[8]

A large proportion of the population in Pacific island developing countries live in rural areas and rely heavily on the agricultural sector, mainly for subsistence living. However, the share of agriculture in GDP, which ranged from 3% in Nauru to 30% in the Federated States of Micronesia in 2012, has declined in many of the economies in the past two decades. Lack of technical skills, poor agricultural extension services and limited access to finance mainly explain the decline. For most economies, the share of the services sector in GDP is much higher, ranging from 31% in Nauru to 86% in Cook Islands.

Pacific island developing countries face various vulnerabilities. The rise in sea level and other expected adverse impacts of climate change continue to pose significant risks to countries' efforts to achieve sustainable development. For many countries, such vulnerabilities represent the gravest of threats to their survival and viability, including through the loss of territory. Many of these economies are frequently affected by natural disasters, causing major havoc and destruction of economic activities, including essential infra-structure, such as roads, bridges and buildings (see figure 2.9). Past reconstruction activities often

Figure 2.9. Total yearly economic losses from natural disasters in the Pacific, 1970-2013



Source: ESCAP (2015b).

relied significantly on donor assistance owing to the magnitude of the damage.

Many countries struggle to deliver basic public services, particularly in rural and remote areas, including outer islands. A large proportion of Pacific islanders lack access to safe drinking water, sanitation, reliable sources of energy, education and health care. As a result, poverty remains relatively high in most countries. The proportion of people falling below the poverty line ranges from 13% in Vanuatu to 39% in Papua New Guinea. While the incidence of poverty has declined in Fiji and Vanuatu over the past decade, poverty has increased in Samoa, Tonga and Tuvalu and remained stagnant in other Pacific island developing economies. There are also wide disparities in poverty across groups within a country. For example, in Fiji and Vanuatu, where the overall level of poverty decreased, poverty in rural areas increased in Fiji and poverty in urban areas rose in Vanuatu. Available data also suggest that the poverty rate among households with three or more children is significantly higher than the national averages.

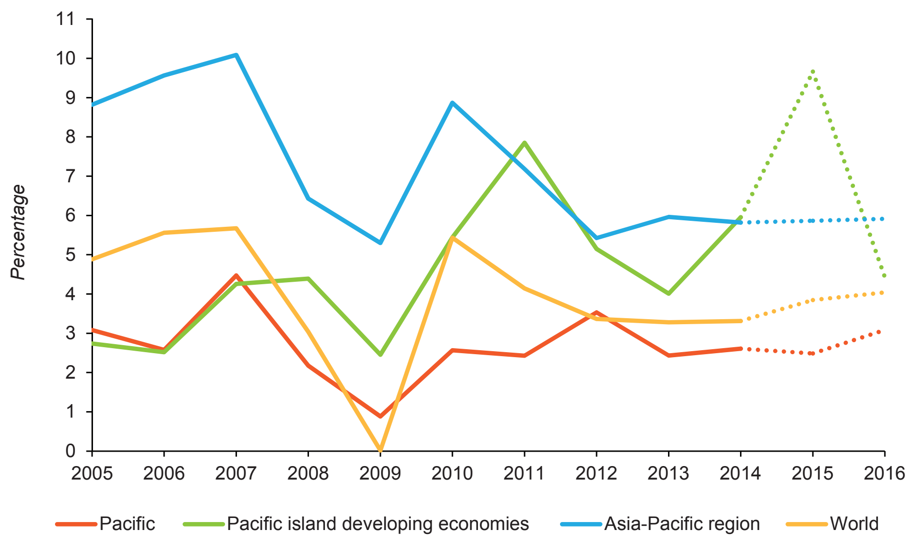
Pacific island developing economies continued to record low and uneven economic growth rates in recent years. During the period 2008-2013, only Nauru, Papua New Guinea and Tuvalu enjoyed annual GDP per capita growth that was higher than 3%. Indeed GDP per capita decreased in Kiribati and Palau. The subregion's ability to sustain rapid, sustained economic growth has been hampered by various factors. On the domestic front, the lack of adequate transport, energy and information and communication technology infrastructure networks and limited human and institutional capacity are key growth constraints. On the external front, ongoing adverse impacts from global economic crises and declining foreign direct investment and foreign aid flows have held back growth in the subregion.

Faster economic growth is needed in order to generate more jobs. In Tonga, the 2011 population census revealed that only 52% of the working-age population was economically active. In Kiribati, more than 30% of the labour force was unemployed, while almost 60% of those who work in Vanuatu were still engaged in subsistence activities.

3.2. Recent performance, outlook and main challenges

Pacific island developing economies as a whole grew by 6% in 2014, a three-year high (see figure 2.10). With the clear exception of Solomon Islands, the economy of which contracted due to the devastating impact of a cyclone, the expansion among those economies was generally broad-based but remained highly uneven across individual economies. Growth was driven particularly by mineral resource production in Papua New Guinea,

Figure 2.10. Real GDP growth in the Pacific, Asia-Pacific region and the world, 2005-2016



Sources: See figure 2.3.

Note: Estimates and forecasts are as of 31 March 2015.

the GDP of which accounts for close to 60% of total output of the Pacific island developing economies as a whole.

Most of those economies continued to register current account deficits, primarily due to weak production and export capacity and reliance on the import of essential goods. Frequent natural disasters disrupt economic growth and macroeconomic stability, giving them limited room for making valuable macroeconomic policy responses.

Pacific island developing economies as a whole are set to record a robust expansion of 9.7% in 2015, underpinned partly by the 15% projected growth rate in Papua New Guinea, which would benefit from mineral exports. The expected steady economic expansion in Australia and New Zealand and continued post-cyclone reconstruction efforts in some economies are some of the key growth drivers. Lower energy import bills would help to keep inflation in 2015 at relatively low levels (see figure 2.11). Lower oil prices would also support household incomes in developed economies, which could translate into higher tourist arrivals in the subregion. On the downside, subdued international prices for agricultural products and primary commodities could constrain commodity shipments from the subregion in 2015.

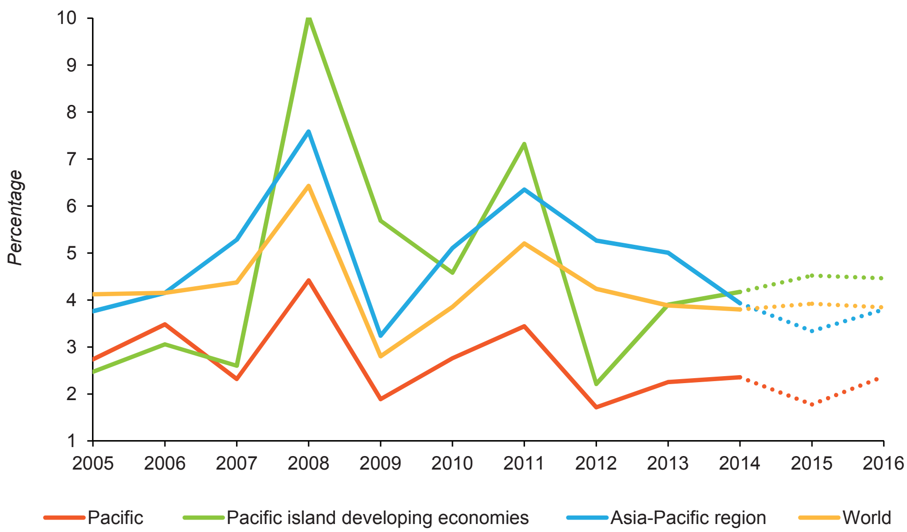
Pacific island developing economies

Fiji

Output growth moderated to a still strong 4.2% in 2014 over the rate of 4.6% in 2013. Growth performance in these two years was more favourable than the average of 1.4% in the preceding five years. Growth in 2014 was largely broad-based. Both public and private investment buoyed the construction sector. Sugar production drove manufacturing activity, which benefited from improved mill efficiency and cane supply. Higher workers' remittances, eased consumer credit conditions and low inflation supported consumer spending and retail trade. Robust tourist arrivals, which increased by 4.2% in the first three quarters of 2014 owing in part to more frequent air services, also supported household spending. Meanwhile, a pickup in growth in recent years has boosted import demand, which pushed up the current account deficit to 8.1% of GDP in 2014. Nonetheless, international reserves remained at comfortable levels due to a surplus in the financial and capital accounts.

Growth is forecast to be slightly lower at 4% in 2015. Ongoing public and private investment, greater political stability following the election in September 2014 and strong sugar and tourism sectors would be among the key growth enablers. A new bill that requires access to free education and health

Figure 2.11. Inflation in the Pacific, Asia-Pacific region and the world, 2005-2016



Sources: ESCAP, based on national sources and CEIC Data. Available from www.ceicdata.com.

Note: Data reflect the changes in the consumer price index. Estimates and forecasts are as of 31 March 2015.

care and adequate public infrastructure will further increase government spending, although the fiscal deficit should remain manageable, benefiting from improved tax compliance.

To address the still high poverty rate of 31% in 2009, the Government expanded the coverage ofits assistance programme and introduced a social pension scheme for elderly groups. New draft labour legislation is also aimed at strengthening social protection, while an inclusive insurance scheme is designed to expand insurance services to low-income earners and workers in the informal sector.

Papua New Guinea

Output growth accelerated to 8.4% in 2014 from 5.1% in 2013, due to early commencement of liquefied natural gas (LNG) production. Favourable production of gold and copra also propelled growth in the second half of the year. Beyond the mining sector, output grew by only 1.4%, as spillover from the now completed LNG construction project weakened. For example, the construction sector contracted by 6.4% in 2014. The project's completion also led to lower import demand, which together with increased commodity exports, helped trim the current account deficit to 3.7% of GDP in 2014.[9] Meanwhile, the inflation rate stepped up to 6.6% in 2014 due to a weaker currency, higher prices for housing and seasonal items. The pace is, however, still in line with the government estimate of 6.5% due to lower-than-expected global commodity prices.

Growth in 2015 is expected to surge to 15%, the fastest pace in Asia and the Pacific, underpinned by a full year of production and export of LNG and an expected rebound in the non-resource sectors, such as the agricultural and fishery sectors. Growth is projected to return to a steadier pace of 5% in 2016. Mining activities will continue to drive the economy in the near term. Fuel, gold and copper together account for about two thirds of total exports. The key downside risk is lower-than-expected international commodity prices.

The immediate policy challenge is to manage windfall commodity revenue to achieve more inclusive growth. The early production of LNG, along with mining and petroleum taxes, boosted government revenue growth by about 24% in 2014. The Government should ensure that spending is beneficial to the productive capacity of the economy and supports the lives of rural people who comprise the majority of the population. Although the official public debt projection is slightly above the stipulated limit of 35% of GDP, the risk of debt default is considered low given that a large share of the public debt is domestic and the external component is on concessional terms.

Samoa

Economic growth in 2014 rebounded to 1.9% from a contraction of 1.1% in 2013 after tropical cyclone Evan caused extensive damage in many parts of the country in late 2012. Improved growth in 2014 was supported mainly by the donor-financed reconstruction programme and economic activity relating to the hosting of the Third International Conference on Small Island Developing States, which was held in Apia in September 2014. However, workers' remittances, which account for about one fifth of GDP, slowed. Meanwhile, despite a 3% hike in public sector wages, the prices for goods and services dropped further by 0.4% in 2014 from a marginal decline in 2013. Lower prices are attributable to improved domestic supply conditions that resulted in lower food prices, subdued global commodity prices and a stable exchange rate.

Growth is projected to gain stronger momentum at 2.5% in 2015. Some of key growth drivers are further post-cyclone infrastructure upgrades, business and tourism activities relating to the hosting of the 2015 Commonwealth Youth Games, construction of new hotels and the expected revival in remittance incomes. In looking forward, medium-term growth will be constrained by a narrow economic base. Close to 40% of the labour force works in the agricultural sector, which is largely on a subsistence basis. In this regard, government policies to reinvigorate agricultural production and boost tourism are critical.

Solomon Islands

The economy contracted by 0.2% in 2014 from a 2.9% growth rate in 2013. Cyclone Ita lashed parts of the country in April and caused extensive damage to major infrastructure and the agricultural, trade and transport sectors. The flooding caused by the storm halted production at a major gold mine that had contributed about one fifth of GDP. The cyclone depressed the domestic supply of fruits and vegetables, thus pushing up the annual inflation rate to 6%, the second highest rate among

Pacific island developing economies. Suspended gold exports and increased import demand for reconstruction widened the current account deficit to 9.5% of GDP. The fiscal deficit was also larger than expected due to the reconstruction costs and below-target government revenue.

The economy is expected to resume expansion and achieve a growth rate of 3% in 2015. A rebound in agricultural output and continued reconstruction work on roads and bridges would support the economic recovery. The prospects are also conditional on the timing of recommencement of operations at the gold mine. The logging industry has tended to stagnate, but the impact will be offset in part by rising investment in the telecommunications sector and increased demand for non-gold commodity exports, such as palm oil, copra and tuna.

Long-term issues in the mining sector pose a key risk for the economy. Growth performance in recent years has been driven mainly by log exports but this trended downward even before the flooding due to flat forestry output. This situation has dampened government revenue, and there is concern over the sustainability of natural forest logging. Despite attempts to diversify the economic base, the economy remains concentrated on a few commodities. Expanding various infrastructure links and developing such sectors as diving and eco-tourism would be important to unleash other growth drivers. There is also a need to expand opportunities for subsistence workers to engage in market activities.

Vanuatu

Economic expansion trended upward in recent years and reached 3.6% in 2014. Major public infrastructure projects boosted construction activity and generated more employment opportunities. This helped to support private consumption even though tourist arrivals declined. Stronger economic growth was also underpinned by higher public consumption that benefited higher value-added tax revenue and import duties. Meanwhile, inflation dipped to 0.3% in 2014, compared with the average of 1.2% in the preceding three years. Lower inflation was due mainly to excess production capacity and a decline in fuel prices.

The economy is projected to contract by 0.5% in 2015 following massive destruction to agriculture and infrastructure caused by cyclone Pam in March 2015. Inflation is expected to increase to 4% in 2015 as the cyclone disrupted the supply of food items. The risk to medium-term growth are the delays on infrastructure projects due to capacity constraints.

Smaller Pacific island developing economies

The economy of **Cook Islands** faced another year of contraction, at the rate of 1.2% in 2014 from a decline of 1.7% in 2013. The overall visitor arrivals grew by a modest 1.6%, although growth in the number of visitors from Asia surged by more than 34%. The economic contraction was also underpinned by a decline in infrastructure spending, while expansion of private investment and consumption also moderated. Growth is projected to rebound to 2.1% in 2015 on the back of ongoing infrastructure developments.

In **Kiribati**, economic growth reached 3% in 2014, relative to the growth performance between 2.4% and 3.4% over the period 2011-2013. Donor-funded public infrastructure programmes, such as a major road project, and higher fishery output boosted consumer confidence and spending. After two years of deflation, inflation stood at 2.6% in 2014 on increased demand from infrastructure spending and the weakening of the Australian dollar, which is pegged to the local currency. Looking forward, output growth in 2015 is projected to slow to 1.5%. Public works would continue to support growth. Volatile primary commodity prices present a key downside risk.

In **Marshall Islands**, despite the recovery in fishery output, the completion of donor-funded infrastructure upgrades led to the growth slowdown of 0.5% in 2014 from the average of 3.8% over 2012/13. Growth is projected to increase to 3.5% in 2015 due mainly to work on infrastructure projects.

The economy of the **Federated States of Micronesia** contracted again at 3.4% in 2014 from a 4% contraction in 2013. Despite some recovery in visitor arrivals and fishery output, inadequate private investment, sluggish business activities and a slowdown in major public infrastructure projects hold back the economy.

In **Nauru**, output growth reached 10% in 2014, the highest rate in a decade. The reopening in 2012 of the Australian Regional Processing Centre for asylum seekers, the second largest employer after the Government, and subsequent expansion of job opportunities boosted domestic demand. Higher consumption was also supported by substantial payments to landowners from final liquidation of the Nauru Phosphate Royalties Trust. Activities relating to the operations of the Regional Processing Centre, such as construction, are expected to support a growth rate of 8% in 2015. There is a need to manage windfall revenue, for example from the secondary mining of phosphate, to help sustain government services over the medium term.

In **Palau**, after a mild economic decline in 2013, the economy recovered strongly at 6.9% in 2014 due to robust tourism revenue and increased construction activities. Tourist arrivals rose, as the second airline started operating chartered flights from Hong Kong, China in September. As a result, the number of tourists from China increased, and in late 2014 China became the largest originating country for visitors to Palau. The outlook for 2015 is optimistic, with growth projected to reach 8% on the back of higher numbers of tourist arrivals and an increase in infrastructure spending.

Tonga was affected by a major cyclone in January 2014, which caused severe damage to the economy. Nonetheless, reconstruction activities, financed by foreign aid and revenue generated by higher numbers of tourists, helped push up economic growth in 2014 to 2.1%, from output contraction of 2.7% in 2012/13. A recovery in agricultural output supported household incomes amid slowing worker remittances, which accounted for more than a quarter of GDP. Tax revenues increased in line with the more rapid economic growth, resulting in a fiscal surplus of 1.7% of GDP in 2014. Stronger growth momentum of 2.4% is expected in 2015, mainly due to a more favourable tourism sector, the preparations for the 2019 Pacific Games, and infrastructure projects on roads and an airport, which are financed by development partners.

Output growth in **Tuvalu** trended up to 2% in 2014, largely underpinned by donor-funded construction work on upgrading an airport and increased retail activity. The public sector continues to be the major source of domestic employment, while job opportunities for seafarers and seasonal worker programmes in Australia and New Zealand have provided the country with remittance income. Growth is projected to remain stable at 2% in 2015, supported mainly by an expected strong fishery sector.

Australia and New Zealand

Australia

The economy expanded at a steady pace of 2.5% in 2014. Commodity exports supported economic growth in the first half of the year but shipments weakened afterwards owing to lower export prices of iron ore and coal. Iron ore accounts for about a quarter of total exports and 4% of GDP. Meanwhile, mining investments, which had driven the economy in recent years, shrank in 2014 as the mining sector shifted to the production stage. Dwelling investments, on the other hand, remained robust. Retail sales rebounded in the later part of the year buoyed by savings from lower retail energy prices, although household consumption has been held back by subdued wage and employment growth. The unemployment rate reached 6.4% in January 2015.

Overall inflation for 2014 stood at 2.5%, virtually unchanged from the rate in 2013. The weakening of the Australian dollar added inflationary pressure in the first half of the year. Price rises softened in the second half amid falling oil prices and the removal of the carbon tax. Inflation dipped to 1.7% in the final quarter of 2014, which is below the central bank's target of 2-3%.

Growth for 2015 is projected to moderate slightly to 2.3%. Exports of liquefied natural gas would benefit from the weaker exchange rate. A 25 basis points cut in the policy interest rate in February 2015, the first cut since mid-2013, should help relieve household debt burden that has been on the upward trend since 2013. Lower borrowing costs would also benefit the already strong investment in the property sector, which warrants close monitoring of house prices. Meanwhile, mining investment is expected to fall, as large projects are completed while new pipeline projects may be deferred given the recent decline in commodity prices. Given the relatively tepid domestic demand, the pace of fiscal consolidation is set to be slower. The government aims to achieve the fiscal surplus by 2019/20. The continued rolling out of infrastructure investment under the Infrastructure Growth Package that is worth over $125 billion would help sustain economic activity.

New Zealand

Economic growth rose to 3% in 2014, the highest rate since 2008. The expansion was underpinned by robust household spending amid low interest rates and increased residential investment owing to high net immigration. Despite strong economic growth, inflation in 2014 remained low at 1.2% due to the fall in global oil prices during the latter part of the year.

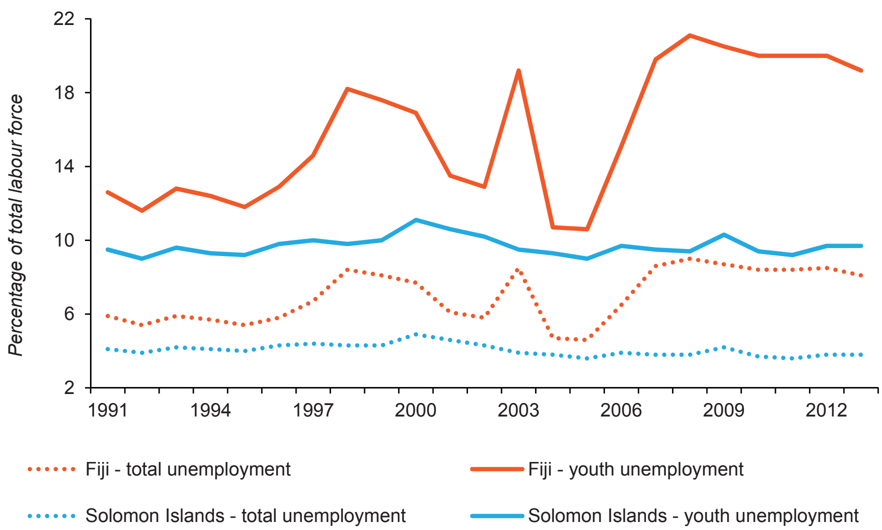
Growth in 2015 is projected to be stable at 3% before edging up to 3.5% in 2016. Post-earthquake reconstruction would continue to boost housing investment in the next few years. Consumer spending would be supported by low inflation and improvement in employment conditions as well as favourable wealth effect from rising house prices. On the downside, government consumption is expected to rise only modestly, constrained by fiscal consolidation efforts. Export growth would likely be slow as a result of weaker orders from major trading partners, such as Australia and China. Increased global supply of milk and dairy products has depressed international prices of these products, which are New Zealand's most important export items.

3.3. Selected medium-term policy challenges

As highlighted above, Pacific island developing economies face various structural impediments to economic growth. These include, for example, a small and narrow economic base and vulnerability to natural disasters and the effects of climate change. Given the limited fiscal space and extensive damage that natural disasters often cause, large public infrastructure projects and post-disaster reconstruction activities typically rely on foreign aid. For example, in Samoa the required spending to rebuild infrastructure after the cyclone of early 2014 kept the fiscal deficit at close to 5% of GDP for the whole year, even after taking into account external grants that were equivalent to 14% of GDP.

In this context, strengthening private sector development would help to address some of the subregion's growth constraints. A more vibrant business sector could expand the currently narrow economic base and support government revenue that could then be spent to reduce notable gaps on service delivery in rural areas and outer islands. An energized private sector would also create more jobs, thus relieving the problem of high youth unemployment and reducing the dominant role of the public sector as a job provider (see figure 2.12). At the household level, jobs in the formal sector would strengthen income security and reduce households' reliance on volatile remittance incomes.

Figure 2.12. Total and youth unemployment in Fiji and Solomon Islands, 1991-2013



Sources: ILO, Key Indicators of the Labour Market and World Bank, 8th ed., World Development Indicators database.

To promote private sector development, countries in the subregion have focused on ensuring an enabling environment for business operations. Papua New Guinea has commenced reviews on market competition and financial sector services. The central bank also introduced a new payment system to improve liquidity management, which includes real-time settlement of high-value payments and electronic submission of cheque imaging. Meanwhile, Fiji reduced the profit tax rate, introduced a plan for capital market development and implemented Internet banking practices. Vanuatu set up a private credit bureau that helped facilitate access to credit and introduced a computerized land registry system. A private credit bureau was also established in Tonga. Finally, Palau reduced customs clearance time and eased access to finance by, among other things, establishing a centralized collateral registry and allowing the use of future assets as collateral.

Despite some progress made on improving the business environment, the subregion still compares rather unfavourably with other economies in the world. The World Bank's Doing Business database, which ranked economies in terms of ease of doing business, placed Samoa, the best performer among Pacific island developing countries covered in the study, at 67th out of 189 economies. Kiribati, Marshall Islands, the Federated States of Micronesia, Palua and Papua New Guinea are ranked between 113th and 145th.

As part of reforms to promote the private sector, countries also sought to promote public-private partnerships, improve the operational efficiency of State-owned enterprises and enhance public financial management. Fiji introduced reforms of public enterprises and financial management that are aimed at strengthening the accountability and transparency of government agencies and ensuring prudent management of public resources. For example, the Government outsourced road and bridge planning, construction and maintenance work in order to raise the efficiency of public service delivery. In Papua New Guinea, public sector and governance reforms are also moving forward in 2015, such as the planned amalgamation of government units with duplicate functions. Its parliament also passed public-private partnership legislation in August 2014 that will facilitate the creation of agencies responsible for coordinating, implementing and overseeing such partnership projects. Kiribati's privatization plan, particularly in the telecommunications sector, also advanced.

Economies in the subregion have comparative advantages in certain niche, higher value-added industries, such as sustainable tourism and fishery activities. Fiji, for example, endorsed in mid-2014 a green growth framework that will incorporate environmentally sustainable initiatives into the country's future development strategies. To move away from producing and exporting primary commodities, the Government may also provide micro-level schemes to boost entrepreneurship and innovation in order to increase the country's competitiveness. To unlock potential growth, Governments of countries in the subregion could also push forward land reform to make use of idle land and financial sector reforms to promote access to finance and thus the development of small and medium-sized enterprises. Box 2.2 is focused on domestic policies to enhance financial inclusion in the Pacific.

4. SOUTH AND SOUTH-WEST ASIA

4.1. Key economic and social themes

Economies in the South and South-West Asian subregion are largely consumption-driven. The share of consumption expenditure, in which a large part is household consumption, ranged from about 70% of GDP in India to more than 90% of GDP in Nepal and Pakistan. The role of exports is thus limited. In India and Turkey, which are better connected to the global economy compared with other subregional peers, the export of goods and services still accounts for only a quarter of GDP. Such economic structures are reflected in a rising share of services in GDP in most countries, while the manufacturing share has been stagnant at below 20%. Owing to the limited role of trade and production networks in South and South-West Asia, subregional output co-movement is limited. Another reason is that, for many countries, economic activities often are concentrated on a few sectors, such as agriculture in Afghanistan and Nepal, garments in Bangladesh, Pakistan and Sri Lanka, hydropower-generation in Bhutan, tourism in Maldives and oil production in the Islamic Republic of Iran.

Despite these limiting features, the commendable economic growth record in the South and South-West Asian subregion has helped to reduce poverty. Within Asia and the Pacific, only East and North-East Asia expanded at a more rapid rate than South and South-West Asia during the period 2000-2014. In line with strong output growth, the poverty rate

Box 2.2. Promoting financial inclusion in the Pacific

Despite good progress made in recent years, access to high-quality and affordable financial services, such as savings, loans, fund transfers and insurance, as well as financial education, appears limited in the Pacific island developing economies. About 6.5 million people, mostly earning low incomes, still lack access to financial services. Poor public infrastructure and sparse populations, situations which lead to high costs for delivering public services, are some of the key barriers to accessing finance.

Government efforts to promote financial access have intensified in recent years. Several economies have set up national agencies to coordinate in-country financial inclusion efforts. For example, Fiji's National Financial Inclusion Taskforce collaborates closely with private and public entities, microfinance institutions, civil society groups and development partners to promote financial inclusion. Papua New Guinea developed a financial inclusion strategy that is designed to reach, by the end of 2015, an additional 1 million low-income residents who do not have their own bank accounts; half of these people will be women. The strategy will be focused on building an enabling regulatory framework that eliminates barriers to financial access and use of financial services to promote innovative technology. Meanwhile, Samoa and Solomon Islands amended their central banking acts to include financial inclusion and financial literacy as core mandates, while financial inclusion units in central banks are common in several other economies.

With regard to financial literacy, major economies in the subregion have prepared national financial competency strategies. Fiji has integrated financial education into the school curriculum from years 1 to 12, which is recognized as a global best practice and is becoming a model for other countries in the Pacific subregion. Cook Islands offers financial literacy classes in partnership with commercial banks, while Solomon Islands is finalizing the expected learning outcomes of financial education. Vanuatu is considering introducing financial education into the national school curriculum, while Papua New Guinea developed financial literacy modules that target rural communities.

Beyond country-level efforts, economies in the subregion and the international development community have also partnered to promote financial access. An example is the Pacific Islands Regional Initiative, in which five central banks in the subregion jointly created a financial inclusion data set for the Pacific. The data set contains, among other things, indicators to measure the growth of mobile financial services, remittance flows and barriers to opening a bank account, as well as indicators to benchmark client protection and financial education across economies. More broadly, the Pacific Financial Inclusion Programme, jointly managed by the United Nations Capital Development Fund and the United Nations Development Programme, is aimed at adding 1 million people in the subregion to the formal financial sector by 2019. Among its activities, the programme provides private companies with grants to create financial services that especially benefit the poor and rural dwellers.

One promising policy direction is to promote financial inclusion through mobile phone-based financial services. The use of such "mobile money" is being piloted in several countries. In Fiji and Samoa, between 90% and 95% of the population have access to a mobile phone. In Papua New Guinea, mobile phone subscriptions jumped from 100,000 to 1.5 million in less than 3 years. Further development in this area would require strong partnerships among mobile network operators, financial services providers and retailers.

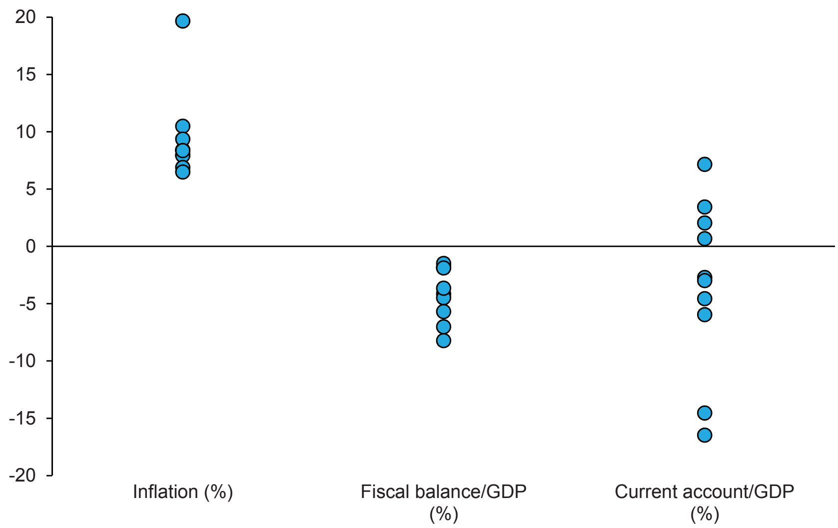
Note: This box is based on contributions from the Alliance for Financial Inclusion's Pacific Islands Regional Initiative and UNDP Pacific Financial Inclusion Programme.

decreased from more than 50% in the early 1990s to about 29% in 2010. Various social indicators also improved, such as the expectation of life at birth, which increased to 66 years in 2011; in other words,10 years longer than that estimated in 1980.

More rapid economic growth, however, is needed to accelerate poverty reduction. More than half a billion people in South and South-West Asia are trapped in extreme poverty. They represent nearly 40% of the world's poor, up from 27% two decades ago. Nearly one fifth of the people in the subregion are undernourished, the world's second highest proportion after sub-Saharan Africa. In Afghanistan, Bangladesh, Bhutan and Pakistan, at least 85% of the total population of these countries do not receive any form of social protection. Income inequality also widened in large countries in the subregion, such as Bangladesh, India and Sri Lanka.

Three interconnected macroeconomic imbalances and issues have hindered faster economic growth in the subregion. First, fiscal deficits are large in most economies owing to both low revenue and high spending (see figure 2.13). The tax base is narrow due to the sizeable agricultural and informal sectors in countries of the subregion, while tax evasion is pervasive. Public spending on infrastructure projects is constrained by high spending to maintain internal security and repay outstanding debts.

Figure 2.13. Distribution of selected macroeconomic indicators in South and South-West Asia, 2005-2014 average



Sources: ESCAP, based on national sources and CEIC Data. Available from www.ceicdata.com.

Note: The chart displays the distribution of three macroeconomic variables among 10 South and South-West Asian economies. Each dot represents an economy. The macroeconomic variables are the average values for the period 2005-2014.

To finance the shortfalls, most Governments of countries in the subregion rely on domestic bank credit and monetization, which tend to crowd out private investment and add inflationary pressure. Recently, such economies as Bangladesh, Pakistan and Sri Lanka have resorted to issuing sovereign bonds in international markets as a debt-financing option. In the short term, this may help to release more funds to the business sector, but countries' vulnerability to exchange rate risk and a sudden shift in global sentiments has also increased.

Second, current account deficits are also sizeable. The reliance on imported food and energy, limited production and export capacity and a generally underdeveloped tourism sector are the key underlying factors. Overseas workers' remittance incomes, mainly from the Middle East, have buoyed foreign exchange receipts in such countries as Bangladesh and Nepal, but this also highlights the lack of decent job opportunities in the subregion. Large current account deficits are a reflection of wide saving-investment gaps in several economies, a situation which is partly underpinned by public dissaving.

The third macroeconomic issue in the subregion is high inflation. During the period 2000-2014, the average annual inflation rate stood at 10.8%, which was higher than that in all other subregions in Asia and the Pacific. In view of the dominance of traditional agriculture, crop yields rely heavily on weather conditions, which led to high and volatile food prices. Inadequate investment to boost agricultural productivity and reduce post-harvest food waste and lack of market competition in general also contributed to high prices. Persistently high inflation also keeps inflation expectations at high levels, a situation which produces an economy-wide impact. For example, gold imports surged in India as a hedge against inflation, but this action widened current account deficits, weakened macroeconomic fundamentals and increased the risk of a sharp reversal of capital flows.

In addition to macroeconomic imbalances, economic growth in the subregion has been severely constrained by infrastructure bottlenecks, particularly electricity shortages. At least half of rural residents in Afghanistan, Bangladesh and Bhutan still lack access to electricity. In November 2014, Bangladesh faced the worst nationwide power outage since 2007. A nationwide blackout also took place in Pakistan in January 2015, where the outages in rural areas were as long as 20 hours per day. This is a significant deterioration from the situation in the early 2000s when power supply still exceeded demand (World Bank, 2014). In India, although the nationwide peak-time power shortage is projected to be moderate in 2014/15, it could exceed 20% in some regions of the country (India, Central Electricity Generating Authority, 2014).

Such severe power shortages have caused significant damage among the subregional economies. In Pakistan, the official estimate in 2012 put the economic cost of the power crisis at about 2% of GDP per year. According to the World Bank enterprise surveys, a large proportion of surveyed firms in Bangladesh, India and Pakistan cited electricity shortage as the most burdensome business obstacle. They estimated that sales values would have been more than 10% higher without those outages. A wide disparity in access to electricity also hampers inclusive development in the subregion.

Addressing macroeconomic imbalances and issues together with power shortages would help South and South-West Asia in realizing the subregion's growth potential. The size of the subregion's market is huge. Its population increased steadily from about one fifth of the total global population in the 1950s to about a quarter in 2014; the population of the subregion is projected to trend upward slightly over the next two decades. A so-called demographic dividend is also expected as the larger number of young people in the population increase the size of the working-age population and lower the age-dependency ratio. The share of the working-age population (persons aged 25-64 years old) is projected to rise from 47% in 2015 to 53% in 2035, compared with close to 50% in both years as the global average. Moreover, abundant labour in the agricultural sector and a low female labour-force participation rate mean that more workers are and will remain available for higher value-added manufacturing activity. The role of merchandise exports and intraregional trade in supporting economic growth could also be increased markedly.

Thus, acceleration of domestic structural reforms is needed to reverse recent subpar economic performance. Part of the slowdown is expected, given that growth in developed economies has trended downward since the global financial crisis began in 2008. For example, the potential growth of India is expected to decrease from about 8% annually before the global financial turmoil to 6-7% in the years that followed (Anand and others, 2014). This highlights the urgent need to push forward wise policy reforms.

4.2. Recent performance, outlook and main challenges

Economic growth in the subregion increased slightly to 5.5% in 2014 from 5.1% in 2013 (see figure 2.14), but remained considerably below its pre-crisis pace during the period 2002-2007. The uptick was led mainly by stronger performance in India, which accounts for slightly more than half the output in the subregion. Growth also strengthened in Bhutan, Nepal, Pakistan and Sri Lanka, while the Islamic Republic of Iran resumed economic expansion after two years of contraction. Growth in Bangladesh and Maldives was stable at high levels.

The near-term outlook is optimistic, with a projected growth rate of 5.9% in 2015 and 6.1% in 2016. Despite more rapid economic growth, inflation is generally expected to trend downward as growth still remains below the potential level along with lower international oil prices (see figure 2.15). In some economies where inflation could speed up, such as Bhutan, expected changes in tax and subsidy policies are the key underlying factors.

The impact of external developments on South and South-West Asia is quite varied. Lower global oil prices would benefit this net oil-importing subregion. The key exception is the Islamic Republic of Iran, although its oil export outlook is complicated by uncertainty over sanctions. On exports, the weak recovery in the European Union would particularly harm the shipment of goods in Bangladesh and Turkey and tourism receipts in Maldives, while a stronger recovery in the United States would benefit shipments in countries such as Sri Lanka. Finally, revived economic activity in India would support growth in countries with close economic ties, such as Bhutan and Nepal. However, as the subregion is still largely disconnected in terms of trade, the positive spillovers from India would be limited.

Afghanistan

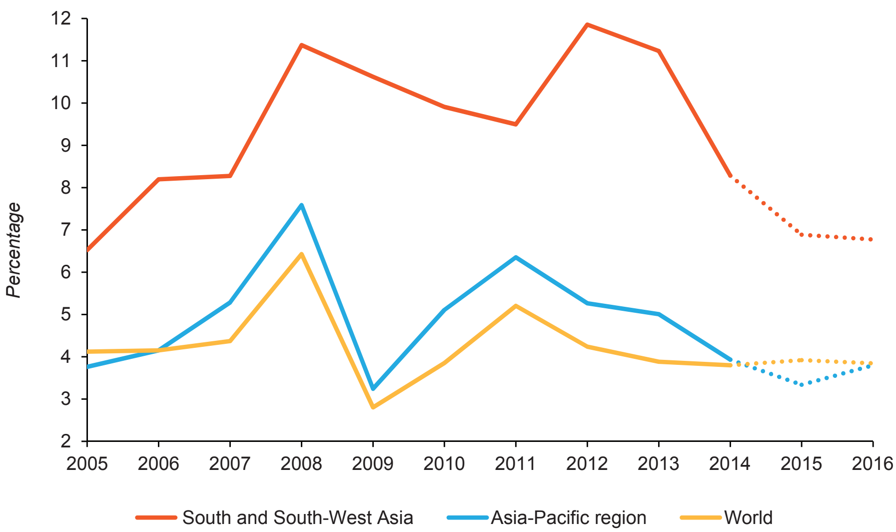
Output growth in 2014 dipped to a decade-low rate of 3.2%. Uncertainty over political transition and dismal security conditions weakened consumer sentiments. Subdued consumption along with a poor investment climate resulted in sluggish private investment and a downward trend in FDI. Similarly, government revenue was lower than expected in the light of slow economic growth and weak tax compliance. This deepened the country's reliance

Figure 2.14. Real GDP growth in South and South-West Asia, Asia-Pacific region and the world, 2005-2016

Sources: See figure 2.3.

Note: The estimates and forecasts for countries relate to fiscal years defined as follows: 2014 refers to fiscal year spanning 1 April 2014 to 31 March 2015 in India; 21 March 2014 to 20 March 2015 in Afghanistan and the Islamic Republic of Iran; 1 July 2013 to 30 June 2014 in Bangladesh, Bhutan and Pakistan; and 16 July 2013 to 15 July 2014 in Nepal. Estimates and forecasts are as of 31 March 2015.

Figure 2.15. Inflation in South and South-West Asia, Asia-Pacific region and the world, 2005-2016



Sources: ESCAP, based on national sources and CEIC Data. Available from www.ceicdata.com.

Note: See note for figure 2.14.

on external grants, which account for up to 70% of government revenue. Meanwhile, the support from monetary policy is limited due to an underdeveloped financial system, for example domestic credit to the private sector was only about 4% of GDP in 2012.

Economic growth is projected to improve in the coming few years, with growth at 4.5% in 2015 and 5% in 2016. The near-term outlook is supported by revived consumer spending amid lower inflation and easing political uncertainty. On the downside, the partial withdrawal of international forces at the end of 2014 could result in smaller donor funds and potentially more social unrest. According to the agreement signed in September 2014, more than 10,000 foreign troops will remain in Afghanistan for at least another decade to train local forces.

Weak government revenue collection, poor business environment, limited production capacity and widespread corruption are some of Afghanistan's medium-term challenges. Given that the agricultural sector is the major source of income for about half the population, expanding the agricultural land base and increasing yields would help to reduce the poverty rate, which has been stagnant at about 35% of the total population. Available data also suggest that inequality has increased between 2008 and 2012, due to volatile agricultural output in view of the dominance of rain-fed farming and the high population dependency ratio. Given the country's young population and rapid expansion of the labour force, job creation would be key to maintain medium-term growth.

Bhutan

Economic growth in 2014 increased to 6% from a low base of 4.2% in 2013. Domestic demand benefited from $72 million in off-budget fiscal stimulus and strong inbound tourism. The lifting of restrictions on housing and vehicle loans, which were introduced in early 2012 in response to rapid credit growth that led to Indian rupee shortages, also contributed to faster output growth. In contrast, hydropower generation that accounts for up to a third of GDP was below the target due to a lower volume of rainfall. Inflation remained high at 8.3% in 2014, partly due to an increase in electricity tariff of between 15% and 30% in July.

Growth in 2015 is set to strengthen further to 6.8%. Four hydropower projects are under construction, while a major hydropower project is expected to start operation in 2015. Domestic demand would be propelled by higher public sector wages and eased restrictions on imports and construction loans. Growing tourism and the disbursement of funds from India to support Bhutan's development projects would also contribute. Unlike most other economies in the subregion, inflation could escalate in 2015 owing to a pay hike for civil servants, the introduction of a 5% green tax on fuel, higher tax on imported vehicles and a scheduled increase in the electricity tariff in mid-year. Counteracting these factors would be lower inflation in India, which accounts for close to 90% of Bhutan's total imports.

The medium-term outlook for the hydropower sector is positive but macroeconomic imbalances would remain high. Hydropower export revenue is set to rise in the coming years with significant untapped potential.[10] Spillovers from hydropower projects, such as construction jobs and retail trade, have contributed to poverty reduction and overall economic growth that appears to be inclusive. Despite this, the current account deficits will likely remain large amid large imports of construction materials. The shortfall has pushed up external debt to 106.3% of GDP in mid-2014 from about 80% of GDP in 2011. Fiscal revenue also relies on foreign aid, mainly from India, which finances about a third of total spending.

Bangladesh

Growth performance was stable in 2014 at 6.1%. Except for 2009 when growth moderated to 5.7%, strong manufacturing and trade activities have helped the economy to grow by at least 6% per year since 2004. The garment sector accounts for about half the country's foreign exchange earnings and directly employs about 4 million workers. In response to the collapse of a large-scale garment factory in April 2013, the Government set up a high-level committee to work on improving working conditions. The accident led to the withdrawal of some export privileges, which appeared to have held back garment exports in mid-2014 given its lagged impact. Meanwhile, workers' remittances picked up in late 2014, in line with a higher number of overseas workers, after the contraction in 2013 that was driven by tighter migration regulations in the Middle East.

The prospects are positive, with growth being projected at 6.3-6.5% over 2015/16. Private consumption should benefit from steady growth in farm incomes and workers' remittances. Lower inflation, which is forecast to decrease to 6.5% in2015 relative to the average of 8.6% in the preceding three years, should also buoy household spending. Fixed investment is likely to rise on schemes to improve safety and the conditions of workers. The Government cancelled tax duties on construction materials and safety equipment to support such investment. Meanwhile, sluggish economic activity in key export markets, such as the European Union, will hold back shipments. This could dampen the prospects for inclusive growth since most garment workers are low-skilled female workers.

The medium-term growth outlook is optimistic, supported by a demographic dividend and the availability of low-wage workers. Rapid economic growth is conditional on greater efforts to enhance government revenue collection, boost infrastructure investment and reduce red tape. Translating growth into poverty reduction is critical, as the poverty rate remained high at 31.5% in 2010.

India

Output growth edged up to 7.4% in 2014, from 6.9% a year earlier. Macroeconomic stability has also improved in recent quarters. For instance, restrictions on gold imports that had been in place since August 2013 were lifted in November 2014, pointing to stronger external account positions. Similarly, inflation has reached a multi-year low, while manufacturing activity has revived, albeit unevenly. Despite the recent rebound, growth has been subpar since 2011.The slowdown coincided with a notable deceleration in investment growth, constrained by economic policy uncertainty, weak market confidence and high real interest rates (Anand and Tulin, 2014).

Growth is forecast to accelerate to 8.1% in 2015 and 8.2% in 2016, benefiting from the acceleration of infrastructure projects, strong consumer spending due to lower inflation and monetary easing and gradual improvements in market sentiments. Investment should also rebound, although unevenly given the still low capacity-utilization rate at about 70%. The current account balance would benefit from lower oil prices. Volatile capital flows that may follow monetary policy normalization in the United States remain the downside risk.

The decline in inflation benefits from lower global energy prices, but structural factors that keep food prices high remain. These include post-harvest food waste that is up to 40%, lack of market competition, higher agricultural input prices and wages and an increase in minimum support prices. More than half of India's farming is rain-fed, so food prices are subject to weather conditions.

Structural reforms are gaining momentum since the new administration took office in May 2014. These include opening up of 120 million new bank accounts to promote access to finance and easing FDI restrictions in such sectors as defence equipment, railways and construction. The "Make in India" initiative was launched in September 2014 to promote India as a global manufacturing hub. The success of this scheme would require broad-based policy actions in enhancing human capital, access to inputs and finance, and better connectivity. In this regard, the Government introduced online services for environmental and forest-related clearances and launched an online system to replace cumbersome labour-related forms.

One of the key remaining challenges is to address labour market rigidities[11] and generate enough jobs for 8 million new job-market entrants per year. According to the 2013 economic census, annual job growth was 4.3% on average during the period 2005-2013, up from 2.5% in the 2005 census. However, as half of India's workers still work in agriculture, the country needs to raise its productivity by engaging more in higher value-added production. This would help the country to realize its potential for growth, which is supported by a high savings rate and emerging middle-class population, and further cut poverty, which remained high at 22% of the total population in 2012.

Islamic Republic of Iran

Economic growth resumed in 2014 after two years of contraction. However, the rebound at 1.9% is modest compared with the cumulative decline of 7.5% over 2012/13. The Interim Nuclear Agreement and Talks on a Comprehensive Accord that was agreed in January 2014 led to suspension of some international sanctions that had depressed oil exports and financial transactions since 2012. Oil exports recovered moderately in 2014, driven partly by a surge in condensate exports, which were not affected by the sanctions. The interim deal also released oil revenues of $7 billion that had been frozen in foreign banks during the first 11 months of 2014.

The central bank's efforts to restrict the monetary base and create a more stable exchange rate contributed to lower inflation in 2014. The inflation rate declined to 17.2% from an average of 32.6% over 2012/13, which was driven by sharp currency depreciation and shortages of goods due to sanctions. However, subsidy cuts pushed up prices of various utility and fuel items by between approximately 20% and 72%. The Government provided cash transfers to mitigate the impact of subsidy cuts. However, as the scheme is weakly targeted, the official estimate suggests that the cost of the transfers exceeds savings from subsidy cuts.

Economic growth is expected to remain relatively low at the rates of 0.9% in 2015 and 1.3% in 2016. Lower global oil prices and subdued oil export volume would serve to dampen government revenue, so fiscal support is expected to be modest. The budget for 2015 is designed to balance the country's public finances through lower capital spending, as current spending is set to rise as the result of a public pay hike. The tax revenue-to-GDP ratio remains low at about 7%, as public finance continues to rely heavily on oil revenue. A key policy effort is to mitigate the impact of sanctions on the economy and to combat inflation.

The medium-term prospects are conditional on additional investment to translate potential in the energy sector into prosperity. The country accounts for close to 20% and 10% of the world's gas and oil reserves, respectively, but efforts to promote large-scale foreign investment projects have been hampered by the sanctions. An enabling business environment, such as a stronger financial sector and greater transparency, would address currently subdued domestic investment and downward trend in FDI.

Maldives

The economy grew at an impressive rate of 8.5% in 2014, underpinned by strong tourist arrivals. Rapid expansion in the number of visitors from China has helped offset a slowdown in arrivals from such traditional markets as Europe. The tourism sector directly accounts for about 30% of GDP and up to 75% of GDP if related sectors, such as construction, transport and communications, are included. Growth is projected to increase to 10.5% in 2015 on buoyant tourism activity.

Adequate fiscal space is needed in small, open economies such as Maldives, which are vulnerable to natural disasters and the adverse effects of climate change. Fiscal deficits amounted to nearly 5% of GDP during the period 2012-2014 despite the high revenue-to-GDP ratio of 32%. A large part of expenditure is on rising public sector wage and pension bills, subsidies on food and electricity, and transfers to State-owned enterprises. Public debt increased to 86% of GDP in 2013 from 58% in 2009, so stronger oversight of budget execution is needed. Meanwhile, weak fiscal positions have led to rapid growth of public loans, which crowded out private sector loans and exacerbated financial sector risk.

The country's medium-term development is constrained by a small, narrow economic base and scattered population that results in high fixed costs of public service provision. Human capital also appears undersized as reflected in the large number of expatriates working in the country. To address economic concentration, the Government promotes special economic zones and plans to develop new, labour-intensive sectors, such as off-port shipping services and financial services. To promote more inclusive growth, the Government plans to ensure equity of public subsidies and reduce skill mismatches among youth. Youth unemployment is high at 32%, while poverty appears to have stagnated at about 8-9% during the period 2003-2010.

Nepal

Growth reached a multi-year high rate of 5.5% in 2014, from an average of 4% in the preceding three years. Agricultural output growth accelerated due to a favourable monsoon season in 2013 and fewer interruptions in the supply of key agricultural inputs. However, the inflation rate stood at 9% in 2014, slightly above the official target of 8%. Remittance incomes, which account for about a quarter of GDP, also rose notably on the higher number of overseas workers. Together with strong farm and remittance incomes, increased tourist arrivals helped to sustain private consumption amid a rapid price rise.

Growth is expected to remain at relatively high rates of 5% in 2015 and 4.7% in 2016. Some of the key drivers are demand in India, which accounts for about 40% of Nepal's exports, and a large increase in fiscal budget as a result of underspending in recent years. FDI is also expected to rebound after a steep decline in 2014. The overall outlookshould also benefit from relatively better security conditions. Meanwhile, inflation is expected to decrease to 7.8% in 2015 from 9% in 2014 due to softer inflation in India given the pegged exchange rate and close bilateral trade between the two economies. Inflation would remain high, however, partly due to liberalization of retail petroleum prices in October 2014. To mitigate the impact of subsidy removals, the Government set up a $5 million fund that would be used to support household incomes if prices rise too sharply.

To secure the goal of becoming a middle-income country by 2022, Nepal may have to rely less on workers' remittances and focus more on strengthening domestic investment. Its poor business climate and infrastructure and energy shortages are key investment impediments. To reduce the poverty rate further, which still stood close to 25% in 2010, the Government could provide incentives for households to spend more remittance incomes on initiatives to enhance agricultural yields.[12]

Pakistan

The economy expanded by 4.1% in 2014, a slight pickup from the average growth rate of 3.7% in the preceding three years. Declining inflation, relatively better growth in private sector credit and robust workers' remittances helped propel consumer spending. More modest price pressure led to a policy rate cut in November 2014 followed by another cut in January 2015. The settlement of the Government's overdue payments to independent power producers also contributed to a more favourable macroeconomic environment, although overdue payments recently increased again. Meanwhile, market confidence in Pakistan's outlook seems to have improved. In April 2014, the country issued sovereign bonds in international markets for the first time in seven years. The oversubscription of the $2 billion in bonds was in part due to the high interest rate offered and the abundant liquidity available in international markets.

The growth outlook is forecast to be favourable at 5.1% in 2015 and 4.8% in 2016. Expected growth acceleration in 2015 would be mainly due to the expected pickup in industrial activity. The economy will still be constrained, however, by macroeconomic imbalances. In recent years, persistently high fiscal deficits, financed by borrowings from the banking system, including the central bank, have crowded out private investment and added to inflationary pressure. Similarly, supply-side constraints, such as poor domestic security conditions, unfriendly investment climate and severe power shortages, remain in place. Sustained economic growth is needed to help generate more jobs and cut poverty, which remained at 13.6% in 2011.

Nevertheless, fiscal consolidation efforts have continued. The fiscal deficit contracted to 5.5% of GDP in fiscal year 2014, mainly due to one-off non-tax revenue receipts, such as proceeds from the sale of 3G spectrum in the telecommunications sector. Similarly, selling stakes in a bank raised $387 million in June 2014. Despite some progress, a narrow tax base, widespread tax evasion and required restructuring of loss-making State-owned enterprises will continue to limit revenue collection. At the same time, improving fiscal conditions through expenditure cuts may be difficult due to the rigid structure of government spending. For example, debt servicing and military spending account for more than half of total budgeted expenditure.

Sri Lanka

Growth performance has strengthened since the civil war ended in 2009, in part due to reconstruction efforts on road networks, hospitals and schools. The economy expanded by 7.4% in 2014, up from an average of 6.8% over 2012/13. Private consumption drove the economy, supported by rapid growth in tourism and remittance receipts, the decades-low inflation rate, a rebound in agricultural output after a drought in late 2013 and monetary easing. Goods exports also advanced well.

Growth is expected to remain at the high rates of 7.5% in 2015 and 7.6% in 2016 on continued strength in private consumption. Investment will be supported by ongoing reconstruction and a planned increase in infrastructure spending. Exports should benefit from an economic recovery in the United States, which remains Sri Lanka's largest export market. State-led development will continue in the light of the planned increase in public sector salaries and State pensions. Meanwhile, output growth in recent years appeared to stay above the estimated potential growth rate of 6.7%. The inflationary impact of excess demand conditions should be monitored closely (Ding and others, 2014).

The strong economic growth record, rising agricultural prices and higher labour productivity translated into a lower poverty rate of 7% in 2012, down from 23% a decade earlier. Overall income inequality indicators have also improved. Despite the impressive growth record, macroeconomic fundamentals are rather weak with large twin deficits. The current account deficit, which stood at close to 5% of GDP per year during the period 2010-2014, reflects the high investment rate of about 30% of GDP and the low domestic saving rate. A greater role for the private sector, including FDI, in the economy is needed in order to raise exports and productivity. On the fiscal side, the deficit amounted to about 6% of GDP per year during the period 2010-2014, largely underpinned by a declining share of revenue in GDP. A significant portion of the fiscal shortfall is financed through foreign funds. As a result, Sri Lanka's external debt-to-GDP ratio is higher than that of most other economies in the subregion. This will make the country more vulnerable to rising global interest rates in coming years.

Turkey

Economic growth declined to 2.9% in 2014 from 4.2% in 2013. Growth in recent years has trended downward from an average of 6.7% in the pre-crisis years from 2002 to 2007. Sharp interest rate rises and measures to control consumer loan growth introduced in January 2014, which were aimed at stopping capital flight and reducing the current account deficit, held back consumer spending. Private consumption was also weighed down by a double-digit non-agricultural unemployment rate. Fixed investment contracted due to weak demand, much higher borrowing costs and a relatively low manufacturing capacity utilization rate. A poor harvest contributed to higher inflation of 8.9% in 2014, which was above the medium-term target of 5%.

Growth is projected to rise to 3.3% in 2015 and 3.7% in 2016. Consumer spending should rebound modestly on stronger sentiments and lower inflation. The weak currency would support exports, although orders from Europe, which is Turkey's main export market, are expected to remain subdued. Improved exports, lower global oil prices and still sluggish import demand would help reduce the current account deficit. A key downside risk is likely volatility in capital flows relating to a possible interest rate increase in the United States. In view of the low domestic saving rate, Turkey has relied on foreign funds to finance its economy, thus being sensitive to sharp changes in global risk appetite. In order to manage currency volatility, the central bank recently expanded its foreign-exchange sales, reduced the interest rates on foreign currencies and raised foreign-exchange reserve requirements.

Part of the reform agenda is focused on creating more jobs. With half the population younger than 30 years of age, pressure on job creation would be high in coming years. The youth unemployment rate is currently close to 20%. Adoption of a new employment strategy to make the labour market more flexible is important.

4.3. Selected medium-term policy challenges

As highlighted in previous sections, power shortages are a serious issue in South and South-West Asia, as they have a critical impact on social and economic development. Governments of countries in the subregion are thus trying to address this energy crisis. In Pakistan, the construction of a coal-fired power plant began recently, while new power plants are being commissioned and State enterprises in the energy sector are under privatization plans. Similarly, privatization deals in Turkey's energy sector are moving forward. In Bangladesh, the Government approved a plan to build a $4.6 billion power plant, and in late 2014 it announced that it would issue sovereign international bonds worth $2 billion in 2015 to finance infrastructure projects. In India, coal mines were auctioned to private firms in late 2014. Coal shortages have limited the operation of power stations to only 75% of their capacity. Meanwhile, Nepal is encouraging more bank lending to the hydropower sector, which is considered as one of the country's strategic sectors. At the eighteenth summit of the South Asian Association for Regional Cooperation, which was held in Kathmandu in November 2014, agreement was reached that promotes the expansion of transmission networks and guarantees non-discriminatory access to electricity within the subregion.

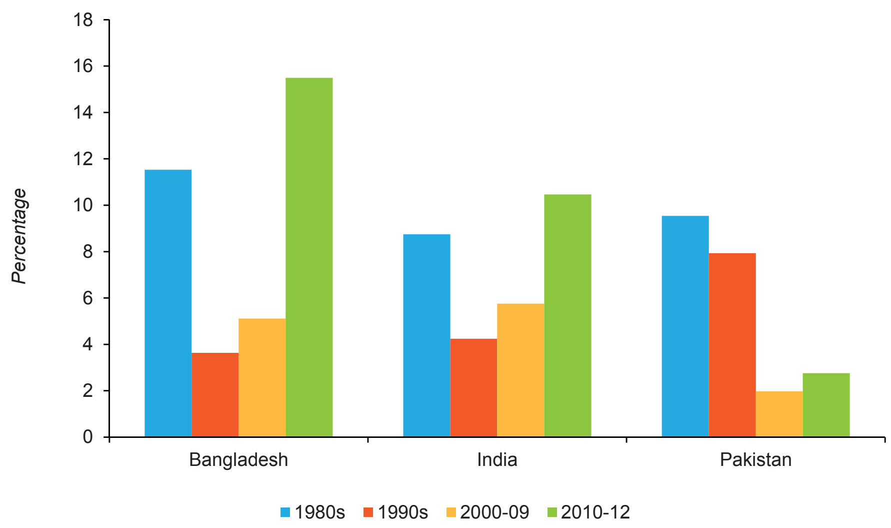
The question remains whether these policy actions are sufficient to help countries in the subregion meet their goals. For example, Bangladesh plans to achieve universal access to electricity by 2021, from about 60% currently. The root causes of energy shortages in South and South-West Asia lie beyond energy sector policies, so addressing the outages also requires a broad-based policy effort.

Persistent electricity shortages are due to a number of factors. First, the underpricing of electricity tariffs and input prices, such as gas and coal, discourages further production and the entrance of new market players. Past efforts to raise prices often faced strong social and political opposition.[13] Second, the limited electricity-generation capacity is aggravated by high rates of transmission and distribution losses, which are due largely to ageing infrastructure, theft and the inability to collect power bills. The losses are estimated at up to 30-40% of total electricity production in Afghanistan and Nepal and close to 20% in India and Pakistan, relative to only 7% in OECD member countries, according to IEA data. Third, weak corporate governance of State enterprises in the energy sector results in inefficiencies and a large subsidy burden. For example, in Pakistan, power distribution companies are unable to collect a large portion of their bills, thus constraining the financial liquidity of power-generation companies and energy suppliers, and causing circular debt in the energy sector.

Addressing the energy crisis requires broad-based policy action. More investment is needed to boost power-generation capacity. For example, figure 2.16 shows that growth in installed capacity in Pakistan has moderated in recent years compared to the rates in the 1980s and 1990s. It is estimated that economies in the subregion would need to spend between 2.2% and 2.9% of GDP per year over a decade to close gaps in the power sector (Andrés, Biller and Dappe, 2014a). To boost more investment in the power sector, Governments need to expand the fiscal space and consider more financing through private-public partnerships.

In this vein, countries in the subregion have introduced various measures to enhance the fiscal space. On the revenue side, Afghanistan, Bangladesh and Maldives adopted more computerized data management systems to improve tax collection efficiency. Various tax rate hikes have recently been implemented or are being planned, such as the tourism goods and services tax in Maldives, the corporate income tax rate for small and medium-sized enterprises in Sri Lanka and the service taxes in Pakistan. Pakistan is also considering withdrawal of tax exemptions for some industries. Similarly, new taxes have recently been introduced or are being planned, such as the telecommunications tax in Maldives, wealth taxes in Bangladesh and a nationwide goods and services tax in India. Finally, there are plans to develop the mining sector in Afghanistan

Figure 2.16. Annual growth of electricity installed capacity in selected South and South-West Asian economies, 1980-2012



Sources: ESCAP, based on data from the Unites States Energy Information Administration.

and to tackle tax evasion in Sri Lanka in order to boost tax revenues. On the expenditure side, India deregulated domestic diesel prices and raised excise duties on fuel items, while Turkey increased prices for household electricity and gas in order to reduce the subsidy burden.

Despite some progress, the fiscal space remains generally limited, which points to the need for an appropriate framework for public-private partnerships. Such a framework includes, for example, setting up institutional frameworks to support project identification, preparation, implementation and monitoring; creating a risk-sharing mechanism that ensures fiscal sustainability; and harmonizing relevant regulations to reduce investment uncertainty. In this regard, the Government of Turkey announced in late 2014 programmes to encourage firms to participate in more public tenders. Bangladesh also set up a committee chaired by the Prime Minister to speed up large-scale investment projects. An enabling public-private partnership framework is expected to boost private investment in public infrastructure projects, which so far has been small. Investment in infrastructure with private participation stood at about $7.2 billion per year during the period 2000-2011, compared with $8.3 billion and $15.8 billion in East Asia and the Pacific and Latin America and the Caribbean, respectively.

On corporate governance, State enterprises should be commercially oriented, with cost effectiveness and operational efficiency being made part of the performance indicators. The Government should ensure open, competitive selection of board members, managerial autonomy and transparent business operations that are subject to review by an independent regulatory body. Recent assessments of State enterprises in the energy sector in Bangladesh, India and Pakistan suggest that State interference is high, a situation that weakens incentives for corporatization.[15] Separation of the Government's role as an owner and regulator is not always clear. As a result, board members are often politically appointed, lack decision-making authority and are not properly evaluated on their performance. Accountability to investors and the public in general is low. Thus, the South and South-West Asian subregion seems to lag behind in this area, and concerted efforts are required to address these concerns.

5. SOUTH-EAST ASIA

5.1. Key economic and social themes

Highly open to international trade, the South-East Asian subregion is well known for its extensive production networks of electronic and automotive parts. However, exports have contributed less to economic growth in recent years as weak global demand was offset by strong domestic demand, particularly private consumption. This trend reflects South-East Asia's place in the world today as both a production base and a growing market of 620 million people; it is also playing a role in the broader rebalancing of the global economy. However, there are concerns that the recent strong expansion of domestic demand was too credit-driven, while weak export performance partly reflects supply-side weaknesses in physical and human capital. For instance, household debt and real estate prices have risen rapidly in some countries, even though long-term investment in infrastructure remains low and the shortage of skilled labour is cited as a major constraint by employers. At the same time, public spending on social protection remains low, making families living just above the poverty line vulnerable to even small shocks. These challenges are discussed below; policy options for addressing them are discussed in the final section.

On aggregate, South-East Asia continues to perform well in terms of exports and FDI inflows, but performance varies widely; the composition of exports raises concern in some countries. South-East Asia's share of global exports rose back to about 7% in 2013, similar to the level in 2000, after falling in the years in between amid China's rapid expansion. FDI inflows rose to a record $125 billion, or 9% of global FDI inflows, in the same year.

However, performance varied widely. Thailand's export growth was flat in 2013 and 2014, in contrast with the strong performance of Malaysia and Viet Nam and with its annual average growth of 13% in the preceding decade. Some argue that Thailand's electrical and electronics sector, which relies heavily on manufacturing hard disk drives, failed to adjust to modern technologies and trends.

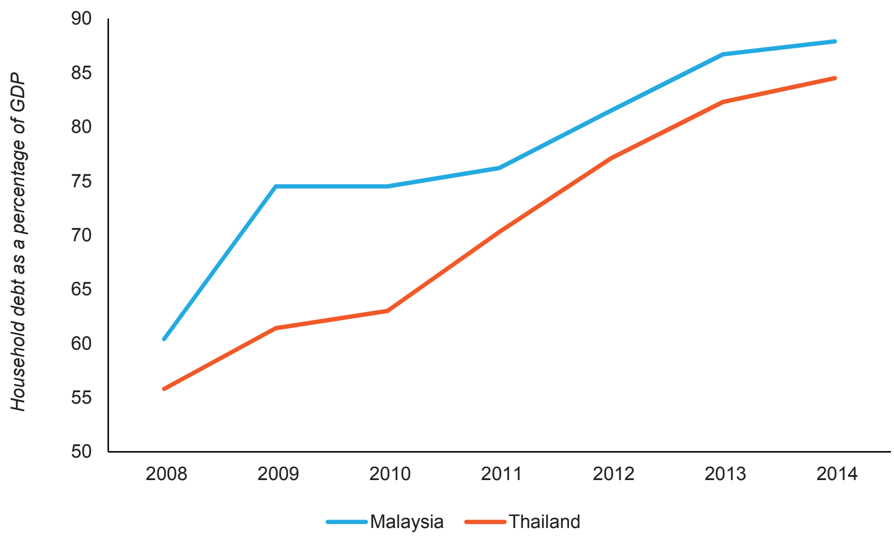
The Philippines has long received far less foreign investment than the size of its economy or labour force would suggest; even with recent improvements, FDI inflows stood at only $3.9 billion in 2013. Restrictions on foreign ownership and otherregulatory barriers are often cited as reasons for this situation. At the same time, the share of high-skill and technology-intensive manufacturing remains relatively low, at about 20% in Indonesia and the Philippines, 10% in Viet Nam and 1% in Cambodia, compared with Singapore's 50%. Cambodia has been unable to diversify beyond the manufacture of garments, while Brunei Darussalam, Myanmar and Timor-Leste rely heavily on the production of oil and gas. Similarly, a number of countries are not well integrated into regional value chains, limiting their ability to diversify their economic structure.

A prolonged period of low interest rates and massive liquidity has resulted in some side effects, including rising household debt and increased exposure of banks to the real estate sector. The consequent increase in domestic private consumption has contributed to strong growth in recent years, supported by stable prices and favourable credit conditions. In Thailand, tax exemptions on first car purchases and farm subsidies also temporarily boosted spending. While much of this has been a positive story of the rising middle class, the period also witnessed increased household leverage and real estate speculation. Between 2008 and 2013, household debt as a percentage of GDP rose from about 60% to 87% in Malaysia and from 55% to 82% in Thailand (see figure 2.17), so that loan repayment as a share of household income rose to 44% and 34% respectively. While largely manageable so far and unlikely to trigger instability, high debt can act as a drag on growth by constraining consumption in the years ahead and limiting the policy space with regard to interest rates.

At the same time, the real estate sector has been booming in some countries and banks' exposure to the sector has increased not only through loans but also through debt and equity securities that finance real estate activities. For instance, in the Philippines, the price of land in the financial district of Makati surged by 28% from 2010 to 2013 to the highest level since 1997, while banks' exposure to the real estate rose to 22%; although lower compared with the level in Singapore or Malaysia, the backdrop of the recent increase raises concerns. Again, there is no immediate risk, as South-East Asia's banks are well capitalized and subject to a number of macroprudential measures. However, it is always better to be cautious against signs of asset bubbles. Another lesson is the need to look at the composition of domestic demand more carefully.

Long-term investment in infrastructure should figure more prominently in domestic demand; this is also vital for South-East Asia's export competitiveness. Since the Asian financial crisis

Figure 2.17. Household debt levels in Malaysia and Thailand, 2008-2014



Sources: ESCAP, based on CEIC Data and national central banks.

of 1997, South-East Asia has largely been a net capital exporter, as reflected in large capital account surpluses. However, as countries built up foreign currency reserves for self-insurance, South-East Asia's surplus savings were invested largely in United States Treasury bills rather than in its own infrastructure development and other needs; central banks in South-East Asia hold reserves worth more than $700 billion.

At the same time, government spending on infrastructure has been chronically low in Indonesia and the Philippines and recently missing in Thailand. On average, public infrastructure outlays dropped from 6% of GDP in the period 1980-2009 to about 4% today, while private participation in infrastructure fell from $38 billion in 1997 to $25 billion in 2010 (Groff, 2014). The consequence is that South-East Asia has barely 10 km of roads and 0.5 km of rail per 1,000 people, compared with the OECD average of 200 km and 5 km respectively; the electrification rate is 72% and only 86% have access to clean water. At the same time, the demand for roads, railways, ports and airports is rising rapidly. Air travel is growing swiftly, with low-cost budget carriers placing huge orders for new aircraft. Urbanization too is progressing rapidly; across South-East Asia, more than 90 million people are expected to move to cities in the next 15 years, putting a strain on transit systems, housing, power and water supplies (Woetzel and others, 2014). Unless action is taken, infrastructure deficits will constrain productivity growth and contribute to inflationary pressures.

Improving people's skills and access to affordable health care should be a priority to address the skills shortage and build an inclusive society. South-East Asia's combined labour force is behind that of only China and India; average wages are lower than in China while manufacturing capability is stronger than in India. However, the shortage of skilled labour is widely cited as a major constraint by employers. Based on the current trend, it is estimated that more than half of all high-skill employment in Cambodia, Indonesia, the Lao People's Democratic Republic, the Philippines, Thailand and Viet Nam could be filled by workers with insufficient qualifications by 2025 (ILO and ADB, 2014). Until recently, public spending on education was less than 1% of GDP in Myanmar. The literacy rate is about 75% in Cambodia and the Lao People's Democratic Republic. Even in higher-income countries, such as Malaysia and Thailand, student performance in essential skills, such as reading, mathematics and science, are relatively weak against international comparisons (Fry, 2013).

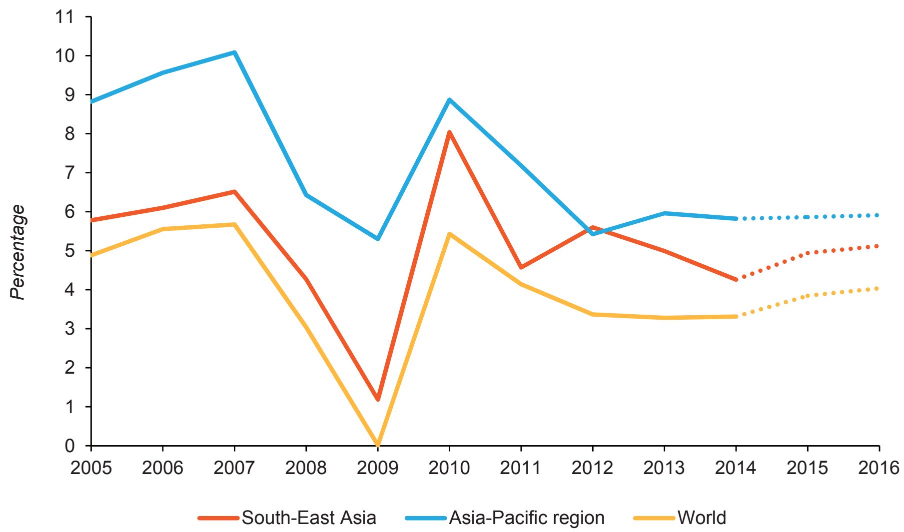
At the same time, out-of-pocket health expenditures remain too high for many families in South-East Asia, often causing them to fall back into poverty. Overall public spending on social protection was more than 3% in Malaysia, Singapore and Viet Nam but only 1% in Cambodia, Indonesia and the Lao People's Democratic Republic. The *Survey* for 2013 contained an estimate that Indonesia and the Philippines would need to increase public health spending by 8% annually in order to raise total health spending to 5% of GDP in line with WHO recommendations.

5.2. Recent performance, outlook and main challenges

Economic growth in South-East Asia as a whole moderated to 4.3% in 2014 from 5% in 2013 (see figure 2.18). Thailand was the clear underperformer owing to political unrest, but growth also slowed in Indonesia to the weakest level in five years as a result of monetary tightening and weak commodity exports. Malaysia, the Philippines and Viet Nam posted robust growth rates of 6% or more on the back of strong investment and export performance. Growth eased, albeit from a high base, in Cambodia, the Lao People's Democratic Republic and Myanmar, slowing the pace of their income convergence with the more developed economies in the subregion. In Timor-Leste, the development of the non-oil economy is urgent as oil production is expected to end within a decade. Brunei Darussalam experienced a mild rebound as oil production picked up, but diversification is a medium-term priority. Growth in Singapore moderated owing to cyclical factors and the cooling of the real estate sector.

In line with slower economic growth, inflation in South-East Asia as a whole decelerated from 4% in 2013 to 3.8% in 2014 (see figure 2.19). However, inflation remained relatively high at 6.4% in Indonesia, at the same rate as the year previously, while edging up in Malaysia and the Philippines by about a percentage point to 3.1% and 4.1% respectively. Current account surpluses have narrowed slightly compared with the levels prior to the global financial crisis. In 2014, Malaysia, the Philippines, Thailand and Viet Nam recorded

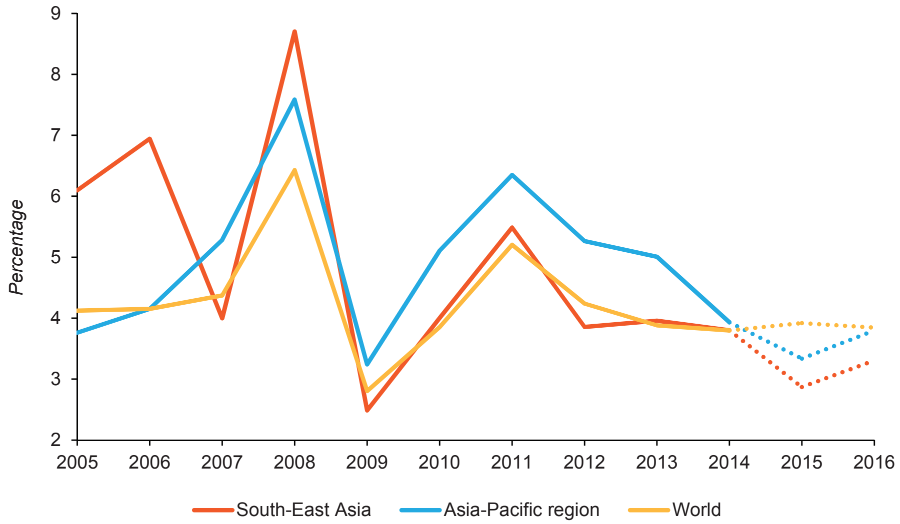
Figure 2.18. Real GDP growth in South-East Asia, Asia-Pacific region and the world, 2005-2016



Sources: See figure 2.3.

Note: Estimates and forecasts are as of 31 March 2015.

Figure 2.19. Inflation in South-East Asia, Asia-Pacific region and the world, 2005-2016



Source: ESCAP, based on national sources and CEIC Data. Available from www.ceicdata.com.

Note: Data reflect the changes in the consumer price index. Estimates and forecasts are as of 31 March 2015.

surpluses in the range of 3% to 4.5% of GDP. Current account deficits were recorded in Indonesia (3%), Myanmar (5.3%), Cambodia (8.7%) and the Lao People's Democratic Republic (25.4%). The fiscal deficit and public debt as a share of GDP remained generally low, but in countries where this was not the case, corrective measures are being taken; Malaysia is introducing a new goods and services tax in 2015 while some fiscal consolidation is taking place in the Lao People's Democratic Republic.

In 2015, growth in the South-East Asian subregion is expected to rise to 4.9%, led by a recovery in Thailand and faster growth in Indonesia and the Philippines. Growth is set to edge up further to 5.1% in 2016. Infrastructure investment will play a critical role in the growth outlook of these economies. While the recent drop in global oil prices should boost consumer spending and investment, oil-dependent Brunei Darussalam and Timor-Leste will experience revenue shortfalls. Malaysia will also be affected, but to a much lesser extent with its diversified export and production base. Inflation is likely to remain low. The medium-term outlook for all countries critically depends on structural reforms. For instance, regulatory reforms could help increase foreign investment in the Philippines while reform of State-owned enterprises and the banking sector could pave the way for a more vibrant domestic private sector in Viet Nam.

Brunei Darussalam

After contracting in 2013, the economy saw a mild rebound of 1.1% in 2014 as oil production picked up. The drop in global oil prices, however, had an offsetting effect; the total value of exports dropped by 15.5% in December 2014 compared with that of a year previously. Flat vehicle sales growth in 2014 indicated relatively subdued domestic demand. In March 2014 the Government released a strategy to raise oil and gas production over the next 20 years by using modern oil-recovery techniques and foreign investment. The non-energy sector continues to be dominated by government consumption and related construction activities, although the private sector's contribution has risen to about 20% in recent years.

Economic growth is expected to edge up in 2015 and 2016 to 1.5-2% in line with the continued recovery in oil and gas production, although lower global oil prices are expected to offset some of this gain. Higher inflation of 0.2% in 2015, from −0.8% in 2014, is expected in line with the weaker currency, which is linked one for one with the Singapore dollar. However, the large reserve assets of Brunei Darussalam, estimated at about $40 billion in 2011, and generous subsidies on food, fuel and housing imply that any adverse impact on output and inflation would be mitigated.

To diversify the economy, the Government has been promoting investment in non-energy sectors, such as agro-processing, aviation, banking, telecommunications and tourism, as well as in downstream petrochemical sectors. Successful cases in recent years include the setting up of a methanol facility, an oil refinery and an agricultural industrial park. An aviation training centre also opened in 2014.

Cambodia

The economy expanded by 7.2% in 2014, slightly lower than the rate of 7.4% in 2013. The garments sector continued to account for a significant share of total output and manufacturing sector employment, but it grew at a slower pace amid strikes initiated by labour demanding higher minimum wages. A recovery in construction activities was financed largely by foreign investment. Growth in tourist arrivals slowed due to political unrest in neighbouring Thailand and tensions between China and Viet Nam. Overall, the services sector continued to expand rapidly; Internet usage grew by more than 40% and the insurance sector by more than 25%. However, growth in the agricultural sector slowed. In particular, exports of milled rice were well short of the government target due to a lack of milling capacity and funding. Inflation edged up from 3% in 2013 to 3.9% in 2014, driven mainly by the price of meat, fruit and non-food items, such as utilities.

Faster economic growth of 7.3-7.4% in 2015 and 2016 is expected, driven by the construction and tourism sectors. The increase in monthly minimum wages to $128 at the end of 2014 has left Cambodia's garment sector less competitive than its rivals, such as Bangladesh. It is time, therefore, to move up the manufacturing value chain. While more than 3 million tons of paddy rice is available for export, the goal of exporting 1 million tons of milled rice in 2015 is unlikely to be achieved. Greater investment in milling capacity as well as in irrigation and extension is needed. Lower inflation of 2% is expected, thanks to lower imported inflation from petroleum products.

The central bank tried to control the speed of credit growth by expanding the base of reserverequirements, so that it slowed from more than 30% in 2013 to about 25% in 2014. Still, the stock of credit remains manageable at about 40% of GDP. With robust imports of construction materials and consumer durables, such as vehicles, the current account deficit widened to an estimated 8.7% of GDP in 2014 from 8.5% in 2013. However, it is expected to narrow in 2015 due to the steep fall in global oil prices. Tax revenues increased by 27% in 2014, thanks to buoyant domestic demand and stronger collection of customs and excise taxes. In January 2015, the earnings threshold for income tax exemption was raised from about $125 to $200, but the impact on government revenues will be minimal.

Indonesia

Economic growth slowed to 5% in 2014, the weakest in five years, as a number of factors weighed on investment growth, which further decelerated to 4.1% from 5.3% a year earlier. Examples of these factors include: a tight monetary policy aimed at controlling inflation and curbing the current account deficit; weak commodity prices and demand, which not only affected export revenues but also investment; and investors' wait-and-see mode in an election year. Growth was driven mainly by robust private consumption, which benefited from improvements in the labour market; employment increased by nearly 1.9 million jobs, or 1.7%, with the largest gains in construction and trade. Exports of primary commodities, such as coal and rubber, fell as growth slowed in large markets, notably China, while a mineral export ban adversely affected shipments of copper and nickel ore. Oil and gas exports also fell. Consumer price inflation rose to 8.4% in December 2014 from a year earlier as fuel subsidies were further phased out.

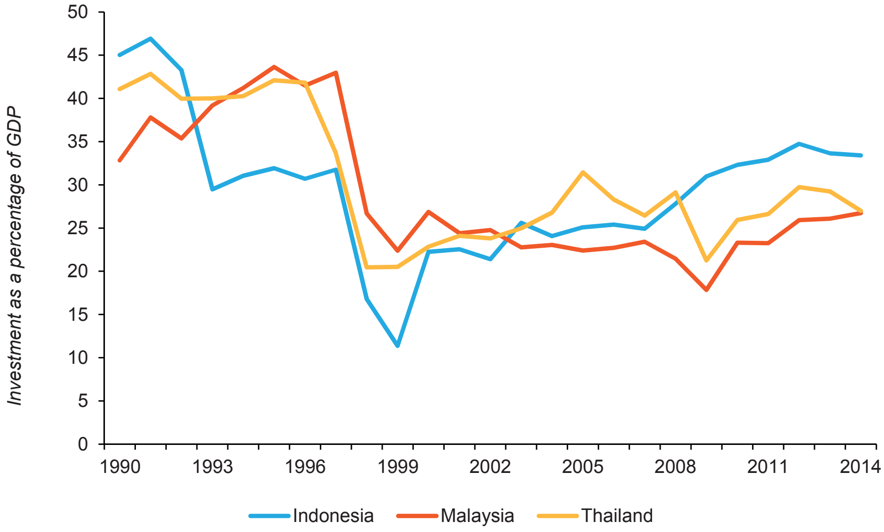
A mild rebound from higher investment and government spending is forecast, raising projected growth in 2015 and 2016 to 5.6-5.8%. Strong fourth quarter data already point in this direction. Inflation also seems to be easing rapidly; it dropped to 7% in January 2015. This may open up the opportunity to lower the interest rate, although such a decision would also depend on the current account deficit, which the central bank intends to maintain below 3% of GDP, compared with about 3% in 2014 and 3.3% in 2013. Perhaps more importantly, the strength of the rebound will depend critically on the progress in reform measures initiated by the new Joko "Jokowi" Widodo administration. The Government submitted a revised budget in January 2015, in which public works, such as roads, housing and irrigation, were more than doubled from the original allocation. If coupled with appropriate regulatory reforms, increased public investment could also help attract more private investment and keep up the strong growth momentum in fixed investment witnessed in recent years (see figure 2.20). In the medium term, this would boost Indonesia's manufacturing capacity and further reduce its reliance on primary commodities.

Macroeconomic policies in 2014 were geared towards stabilization and long-term sustainable growth, rather than boosting short-term growth. Following a series of hikes in late 2013, the central bank further raised the benchmark interest rate by 25 basis points to 7.75% in November 2014, with a view to anchor inflationary expectations amid further cuts in subsidies. Monetary policy was also influenced by the uncertain external financing environment; it was deemed undesirable that large portfolio inflows should be used to finance the current account deficit. On the fiscal side, the new administration cut fuel subsidies in November, raising petrol and diesel prices by more than 30%. Effective January 2015, petrol price subsidies were completely eliminated. This opened up some $18 billion in the budget to be reallocated to more productive areas. In announcing the most drastic subsidy reform, the Government pledged to use 60% of the savings to address the country's severe infrastructure bottlenecks. To mitigate the impact on low-income households, a number of provisions, such as social protection cards, were introduced.

Lao People's Democratic Republic

Economic growth moderated to 7.5% in 2014 from 8.5% in 2013 as mining and hydropower exports declined. The slowdown also reflected the poor performance of its major trading partner, Thailand. Growth was supported by construction in the resource sector and an increase in wood exports. Services also grew rapidly, including in wholesale and retail, transportation, storage and communications. Government consumption growth slowed considerably after having expanded rapidly in the past few years. Inflation also decelerated to 4.2% in line with stable food prices.

Figure 2.20. Investment shares in selected South-East Asian economies, 1990-2014



Source: ESCAP, based on IMF World Economic Outlook Database.

Economic growth is expected to slow further to 7.2% in 2015 and 2016 as mining and hydropower exports remain weak. The Lao People's Democratic Republic is facing increasing pressure from Cambodia and Viet Nam to delay the construction of a 260 megawatt dam on the lower Mekong River, given its potential adverse impact on fisheries and water flow. Medium-term growth will depend on the diversification of the economy. Priority areas include modernizing agricultural production, creating value-added food and agricultural products and improving management of natural resources.

The central bank allowed real appreciation of the kip against the United States dollar to control inflation. Fiscal consolidation efforts were made in 2014. For instance, salary and benefit increases for public servants were put on hold while off-budget spending was reduced, including direct lending for local infrastructure projects. Going forward, the Government needs to invest more in human capital to further diversify the economy and to take advantage of the opportunities presented by its accession to WTO in 2013 and the planned railway connecting the country to southern China.

Malaysia

Economic growth accelerated to 6% in 2014 from 4.7% a year earlier, driven by a vibrant private sector. Consumer spending grew faster, thanks to favourable labour market and credit conditions. Private investment growth too accelerated, continuing to benefit from a pipeline of infrastructure and industry projects created by the Economic Transformation Programme. However, government spending slowed in line with the goal to achieve a balanced budget by 2020 and to keep the public debt below the ceiling of 55% of GDP. Export growth was strong, particularly in the first half of the year, and was led by such manufacturing products as electronics. Still, import growth was faster and the current account surplus narrowed to about 4.6% of GDP in the fourth quarter.

Slower growth of 4.9% is forecast for 2015, before picking up to 5.2% in 2016. The expected slowdown in 2015 is due to two major factors. First, the introduction of the goods and services tax in April is likely to dampen consumer spending in ensuing months. First quarter growth may stay strong due to front-loading. High household debt burdens too will weigh on consumer spending. Second, the drop in global oil prices is likely to further spillover into gas prices in 2015. As Malaysia is a major exporter of oil and LNG, its commodity revenues will be heavily affected. Nevertheless, the overall outlook remains bright. The economy will benefit from cheaper crude oil imports. Also, non-commodity exports will benefit from improving growth prospects in the

UnitedStates and the depreciation of the ringgit. Perhaps more importantly, investment growth is expected to remain resilient as major public infrastructure projects take off.

Malaysia's central bank was the first to raise the policy interest rate in South-East Asia in 2014, by 25 basis points to 3.25% in July, but it has since kept the rate unchanged, maintaining a generally accommodative stance. The rate hike partly addressed concerns related to high household debt and the negative real interest rate as inflation accelerated. On the fiscal side, a number of changes took place. In December 2014, the Government further phased out fuel subsidies. In January 2015, it lowered its oil price assumption to $55 per barrel (from $100); given that oil-related contributions make up almost 30% of revenues, a significant revenue shortfall is forecast for 2015. Regardless, major projects, such as the planned second mass rapid transit line, the light rapid transit extension and the Kuala Lumpur-Singapore high-speed rail line, will proceed as planned. The 6% goods and services tax to be introduced in April will replace the services tax and the sales tax, which cover a narrower range of goods and services. Initially, the net fiscal impact will be almost neutral, as the goods and services tax will be offset by a lower personal income tax rate and cash transfers to low-income households. Given the lower growth outlook, tariff increases for electricity and gas were postponed to reduce the burden for businesses.

Myanmar

Economic growth is expected to ease to 7.8% in fiscal year 2014/15 (ending in March) from 8.3% in 2013/14 due to weak agricultural output. Since the initiation of reforms in 2011, the economy has been expanding at a rapid pace on the back of exports of natural gas and investments in the energy sector. New business registration grew rapidly and capital imports remained strong. This trend largely continued in 2014. With strong import growth and relatively weaker export growth, the trade deficit widened to 5.5% of GDP in December 2014. This, together with the strengthening of the United States dollar, affected the recent depreciation of the local currency. Private sector access to credit continued to grow rapidly, by well over 30%. Inflation was observed to have risen to 5.9% in fiscal year 2014/15 from 5.7% in 2013/14, as food prices increased due to strong domestic demand coupled with weak agricultural output.

Economic growth of 8.3% and 8.2% is projected for 2015/16 and 2016/17 respectively. Performance this year could hinge on important political events, including the planned constitutional referendum in May and the national elections in December. Continued momentum in economic reforms will also be important. In particular, efforts to expand the production base should be accelerated in the light of the downward volatility in global commodity prices. This includes the special economic zone being developing jointly with Thailand, the country's second largest foreign investor. In addition to low-wage manufacturing, the agricultural sector is another area with great potential. Despite a large endowment of arable land and water, the level of agricultural productivity remains one of the lowest in the region.

The central bank awarded licences to nine foreign banks in October 2014, giving them authority to operate in restricted services, such as wholesale banking. Opening of the first stock exchange is planned towards the end of 2015. The World Bank's Doing Business report suggests that enforcement of contracts remains weak. Contracts and judicial system reform will be important for the financial sector to develop. Meanwhile, government consumption has been increasing rapidly, with higher civil service salaries and transfers to local governments. The Government is targeting a budget deficit of 5% of GDP in 2015/16. Envisioned under Myanmar's Social Protection Strategic Plan, adopted in January 2015, are targeted cash transfers, school nutrition programmes, public employment and vocational education programmes, and social pensions to be gradually phased in over the next decade. The introduction of treasury security auctions in January 2015 was a step forward in establishing a non-inflationary alternative to central bank deficit financing, even though only half of the $50 million offering was sold.

Philippines

Economic growth eased to 6.1% in 2014 from 7.2% a year earlier, as government spending slowed markedly due to legislative challenges; the Supreme Court ruled that the Government's Disbursement Acceleration Program was unconstitutional. Nonetheless, growth was still robust and driven by consumer spending, which benefited from improvements in the labour market and steady overseas workers' remittances; more than 1 million jobs were created in 2014 and unemployment fell to 6%, the lowest in a decade; even youth unemployment edged down slightly to about 14%. Fixed investment in equipment continued to exhibit robust growth although construction slowed, albeit from a high base. Electronics and apparel exports posted strong growth; in services trade, the Philippines overtook India as the call centre of the world, with more than 1 million employed at call centres and in related outsourcing businesses. Inflation accelerated from strong liquidity and credit growth and from higher food, electricity and petroleum prices.

With the rebound in government spending and lower inflation, thanks to the drop in global oil prices, higher growth of 6.5% and 6.4% is projected for 2015 and 2016 respectively. Congress passed a supplementary budget in December 2014, and the Government is expected to accelerate spending ahead of the six-month moratorium on project approvals prior to the national election in May 2016. The services sector will continue to drive growth; in particular, the business process outsourcing sector is expected to generate some $25 billion in revenues by 2016, accounting for a tenth of the economy. Remittances from some 11 million overseas workers will also continue to account for a tenth of the economy. In going forward, it is important to keep expanding the traditionally weak manufacturing base through regulatory reforms as well as increased public investment.

As inflation accelerated, the central bank first raised the reserve requirement ratios, before increasing the policy interest rate by 50 basis points to 4% in September 2014. As prices began to stabilize, however, the policy rate has since been kept on hold. A number of financial stability measures were introduced as banks' exposure to the property sector grew rapidly, including the credit risk management framework, the real estate stress test and the expanded definition of real estate exposure. On the fiscal side, the Government has made significant progress in recent years in boosting tax revenues and enhancing private participation in infrastructure. It has rolled out several midsize public-private partnership projects; as of January 2015, nine such partnership contracts had been awarded, mostly to domestic firms, and nearly 50 are in the pipeline. Foreign participation may be needed in larger projects, such as construction of a planned subway and commuter railway. Reconstruction efforts in typhoon-affected areas are ongoing, and a dedicated website was launched to transparently track the progress. The Government intends to increase total infrastructure spending to 5% of GDP by 2016.

Singapore

Economic growth eased to 2.9% in 2014 from 4.4% a year previously. Services continued to drive growth, including finance and insurance, business services and wholesale and retail trade. Manufacturing growth was mainly in the biomedical and chemical clusters. Construction growth was flat owing to the cooling property market and a shortage of labour. Unemployment edged down to 1.9% in the third quarter. Capital investment in the electronics sector fell more than 50% from the year before, but this was due to cyclical factors. Mild deflation was recorded in November and December, mostly from supply-side factors, including the drop in global commodity prices, new health-care subsidies, increases in the availability of car licences, and falling rents.

Growth for 2015 is forecast at 3.1%, before increasing to 3.5% in 2016. As a net importer of oil, Singapore is expected to benefit from the fall in global oil prices. This could translate into lower electricity tariffs and fuel costs, helping businesses to lower their input costs, while boosting consumers' purchasing power. In addition, exports are expected to receive a boost from the slower appreciation of the currency, as announced by the monetary authority. The medium-term outlook is bright as the economy shifts to higher value-added activities; for instance, Singaporean electronics firms are now placing more emphasis on such activities as chip design and delivery of services-driven information technology solutions.

In January 2015, the monetary authority announced that it would maintain the modest and gradual pace at which the Singapore dollar appreciates against a basket of other currencies but reduce the slope of the band within which the trade-weighted exchange rate fluctuates. The move came in response to a sharp slowdown in inflation, which is forecast at only 0.3% in 2015. Fiscal policy is largely focused on promoting higher value-added activities and strengthening social safety nets and making health care affordable.

Thailand

Economic growth dipped to 0.7% in 2014 amid political unrest. The economy contracted in the first half of the year, as consumer sentiment and investments fell amid significant political uncertainty; another contributing factor was declining domestic demand for vehicles and parts, which resulted in a mild contraction in manufacturing. With the resumption of government functions, the economy began to recover in the second half of the year but very slowly. A stimulus package on the order of $11 billion was announced, with a focus on jobs and helping farmers, but the impact was not felt in 2014 due to delays in disbursement and implementation. Exports, which make up the equivalent of about 70% of the economy, also faltered; 2014 marked the second consecutive year of negative export growth, which contrasts with the annual average pace of growth of about 13% in the period 2002-2012. Employment growth was also negative, with notable declines in agriculture and construction.

In 2015 and 2016, a mild rebound to 3.9-4% growth is forecast. On balance, the economy should also benefit from the lower cost of production due to the drop in global oil prices, although already weak farm income might be worsened by a decline in agricultural commodity prices, such as those for rubber and sugarcane. Consumer spending may benefit from the fiscal stimulus, but will remain constrained by high household debt. A recovery in construction and in tourism will also provide a boost to the economy. Perhaps more importantly, large public infrastructure projects are expected to begin and start making progress in 2015, although more delays in disbursement and implementation are possible. Investment from Japan is expected to rise after having fallen by 37% in 2014. National elections, tentatively scheduled for early 2016, could boost confidence in the economy.

In March 2014, the central bank reduced its policy interest rate by 25 basis points to 2%, the lowest in three years, with a view to support the contracting economy. It has since kept the rate on hold. Unpaid farmers were paid after the military took over in May 2014, but the farm subsidy programme itself was discontinued. Regardless, improving agricultural productivity will be important for narrowing the wide urban-rural income gap. After a number of delays, the planned multi-year public transport investment programme is expected to take off in 2015. This could boost domestic demand while increasing the economy's long-term competitiveness. Thailand's ranking in the global competitiveness index fell from 33 in 2007 to 67 in 2014. Thailand should also take advantage of the integrating market and production base under the ASEAN Economic Community, including in the automotive sector where the country already has a huge advantage. To finance the required expenditures, a number of tax reform proposals are under review. Plans to return the VAT rate to the earlier 10% were postponed, but a 1 percentage point increase from 7% to 8% may go ahead in September 2015 if economic recovery continues. The fiscal deficit is forecast to widen to about 2.9% of GDP in fiscal year 2015/16 from 1.9% in 2014/15.

Timor-Leste

Growth of the non-oil economy rebounded to 7.1% in 2014 from 5.4% in 2013. The non-oil economy is dominated by government spending; current expenditures are about twice those for capital expenditures. The economy as a whole continued to contract as oil production declined. Even before the recent drop in global oil prices, Timor-Leste's oil revenue was falling after having peaked at about $3.9 billion in 2012. The current account surplus shrank to about 24% of GDP in 2014 from 45% in 2013. Excluding revenues from the export of oil, there is a huge trade deficit; non-oil exports were estimated to be worth only $20 million, compared with imports into the country of $753 million in 2014. As government spending grew at a more sustainable pace, the rapid expansion in credit to the private sector and in imports also moderated.

In 2015, slightly higher growth of 6.5% is projected for the non-oil economy. Growth is expected to remain largely stable at 6.5% in 2016. There is some uncertainty to the forecast, however, as it depends significantly on the 2015 government budget, which was based on an oil price of $107 per barrel. The recent drop in global oil prices will have a significant impact on the overall economy. Medium-term growth will depend critically on efforts to diversify the economy and develop the private sector. Development of the agricultural sector is important in order to reduce reliance on imported food and support employment.

The Government has scaled back ambitious expenditure plans given the need to smooth fiscal spending over the long term to avoid a fiscal cliff. Investment income from the Petroleum Fund of Timor-Leste is expected to provide an ongoing income stream once hydrocarbon reserves are exhausted within a decade. That fund, which was established in 2005, was valued at $16.5 billion as of December 2014. The medium-term priority is to build human capital and infrastructure and develop sectors, such as agriculture, tourism and petrochemicals, in line with the national Strategic Development Plan 2011-2030.

Viet Nam

Economic growth accelerated to 6% in 2014 from 5.4% a year earlier, driven by strong exports and increased foreign investment on the back of stable macroeconomic conditions. Total investment grew by 8.9%, supported by increased investments made by manufacturers, such as major electronics firms from the Republic of Korea, while household final consumption grew by 6.1%; exports grew by 13.6%. On the supply side, expansion in industry and construction was relatively stronger than in services. While these figures may paint a picture of strong recovery compared with the weak growth in recent years, it is important to note that domestic demand remains subdued. The number of domestically owned businesses that have closed or suspended operations remains high. Credit growth also remained weak for most of the year, although rising to 12.6%, within the target band, in December 2014. Even in exports, the performance of foreign-investment firms was much stronger than that of domestically owned firms. Modest job growth of 0.8% was mainly in industry and construction.

In 2015 and 2016, growth is forecast to edge up to 6.1-6.2%, driven by exports and investment and possibly a mild recovery in household consumption and the domestically oriented sectors. Stable prices will continue to benefit consumers and businesses. Inflation has dropped from double-digits in 2011 to only 4.1% in 2014; it is expected to trend further downward to 2.5% in 2015. Viet Nam's crude oil exports will suffer from the drop in global oil prices. On balance, however, the welfare gains from lower inflation should offset the revenue shortfall. Moreover, the successful diversification of the manufacturing and export base over the past decade effectively mitigates the impact of oil price volatility. Tourist arrivals are also expected to recover, after being affected by a maritime territorial dispute with China in 2014. Most critical to the medium-term economic outlook is the ongoing restructuring of banks and State-owned enterprises and its impact on domestic private sector development.

In 2014, the central bank lowered its main reference interest rates and the ceiling on deposit rates to help banks lend at lower rates. The effectiveness of such measures, however, has been limited due to the still high share of non-performing loans, which had fallen in the course of 2014 but still remain high. The central bank is now directly facilitating the acquisition and mergers of a number of struggling banks, with a view to reducing by 50% the number of commercial banks over the next three years. Reform of State-owned enterprises is a related priority. The Government issued a comprehensive action plan to step up divestment of State-owned enterprises; 74 such enterprises went through equitization in 2013 and another 40 in the first half of 2014, including large State-owned enterprises, such as Vietnam Airlines and the Vietnam National Textile and Garment Group. With an improved sovereign risk rating, Viet Nam raised $1 billion in government bonds from international capital markets on favourable terms. The overall direction is towards fiscal consolidation and debt reduction.

5.3. Selected medium-term policy challenges

This section starts with a discussion of the ASEAN Economic Community, which will be formally established at the end of this year and mark a milestone in South-East Asia's journey towards closer integration. A discussion follows of three policy options for addressing the issues identified in the first section, namely macroprudential tools for managing household debt and real estate finance; fiscal reforms and regional financial cooperation for increasing infrastructure investment; and education and training and universal health care for a skilled and healthy labour force.

With the launching of AEC this year, countries should accelerate reforms in order to fully realize the potential welfare gains from integration. In 2007, the 10 ASEAN member countries committed to accelerating the integration process with the goal of forming a single market and production base by 2015. At the twenty-fifth ASEAN summit in November 2014, it was noted that 82.1% of the deliverables under the so-called AEC Blueprint had been achieved to date; it was agreed that the implementation of remaining measures would be fast-tracked, including those related to non-tariff barriers, the customs single window, and services and investment liberalization (see box 1.2 in chapter 1). Compared with tariff reductions, these remaining measures tend to require more domestic reforms and are arguably more challenging. However, the potential benefits are also larger; one study estimates that the welfare gains under AEC to be at least 5.3% of GDP, compared with 0.8% from the ASEAN Free Trade Area alone (Plummer and Chia, 2009).

Services and investment liberalization is understandably a sensitive issues as it could intensify competition for domestic market share; countries should, therefore, be adequately prepared. At the same time, appropriate liberalization can help diffuse sectoral best practices and technology among other countries, while deepening and broadening South-East Asia's production networks. With increased economies of scale, South-East Asian businesses will also be able to better compete against global multinationals. This is already happening across a variety of sectors, including aviation, banking, telecommunications and utilities. Malaysia and Singapore have a clear lead in many areas, but others are also active; for instance, Manila Water, a Filipino utility firm, is investing in Viet Nam while Thai food companies are investing in the Philippines.

Appropriate macroprudential tools can be used for managing household debt and real estate finance; other tools, such as stamp duties and structural policies, may also be needed. South-East Asian countries today enjoy financial stability due to prudent measures put into place following the 1997 Asian financial crisis. Recently, there has been renewed focus on macroprudential tools to contain the side effects of low interest rates and massive liquidity. As noted by the IMF, different tools have different effects and should be selected based on the specific objective (IMF, 2014). For instance, limits on loan-to-value ratios in essence imposes a minimum down payment, while limits on debt-service-to-income ratios restrict unaffordable increases in household debt. In contrast, sectoral capital requirements force lenders to hold extra capital against loans to a specific sector, thus discouraging heavy exposure to the sector. There are also hybrid/more tailored measures. For instance, higher risk weights or additional capital requirements can be imposed on mortgage loans with high loan-to-value ratios, as in the case of Malaysia, while stricter loan-to-value limits can be applied in order to differentiate speculators with multiple mortgage loans from first-time home buyers. Importantly, if house price booms are driven by increased demand from foreign cash inflows that bypass domestic credit intermediation, other tools, such as stamp duties, may be more effective, as in the case of Singapore. At the same time, given the low infrastructure stock and the rapid urbanization taking place in many countries, high house prices may also reflect supply bottlenecks. In such cases, structural policies, including urban planning and expansion of government-subsidized housing, would be needed.

South-East Asia should also tackle infrastructure investment from multiple angles, including fiscal reforms, public-private partnerships and regional financial cooperation. The sheer scale of infrastructure financing requirements calls for the mobilization of all possible sources and instruments. Political leadership and government capacity and coordination are critical for selecting and prioritizing the correct projects, allocating more budget for enhancing public infrastructure and then implementing those efforts, creating a pipeline of bankable projects and engaging the private sector and working through land acquisition and other barriers.

As highlighted in the *Survey* for 2014, strengthening of tax and non-tax revenues would also be important. Examples include Indonesia's elimination of petrol price subsidies, which released some $18 billion for infrastructure and other uses, and the country's land acquisition law; Malaysia's pipeline of infrastructure and industry projects under the Economic Transformation Programme, which includes the second line in its mass rapid transport system, the light rapid transport extension and the Kuala Lumpur-Singapore high-speed rail line; and the Philippines tax administration reform and the launch of more than 50 midsize public-private partnership projects.

At the same time, regional financial cooperation can support infrastructure investment by increasing the availability of stable and long-term funds and mobilizing regional savings, including foreign exchange reserves and assets held by institutional investors, such as pension funds and insurance companies. Examples include the ASEAN+3 Bond Market Initiative for developing local currency bond markets; and the ASEAN Infrastructure Fund, which is partly financed by central banks' foreign currency reserves. In the broader picture, the ability to recycle regional savings for regional investment will also depend on the availability of effective global and regional financial safety nets and the reform of the international monetary system.

The level and quality of education and vocational training is also important for reducing skills shortages. While most countries have achieved universal primary education, the quality of the education varies, with students in some cases completing primary education without having acquired basic literacy and numeracy skills. Given the skills required in a modern economy, secondary enrolment should be actively encouraged. Increased public spending on education should be accompanied by other measures, such as enhanced teachers' selection and training. Governments can also improve the range and types of technical and vocational education and training, including apprenticeships, other work-experience schemes and work-based learning to foster youth employment. Setting qualification references at national and regional levels can facilitate employment. For instance, Singapore has a national credentialing system to train individuals in key competencies that companies seek. In 2014, ASEAN endorsed the Qualifications Reference Framework, which enables comparison of the qualifications of skilled labour across ASEAN member countries, as part of the efforts to promote mobility. At the same time, greater progress is needed on the public health front.

Striking the right balance between breadth and depth is needed for universal health care. The 2013 ASEAN Declaration on Strengthening Social Protection called for collective progress towards universal health coverage. This requires advancing along three dimensions: (a) the breadth or extension of population coverage by insurance schemes; (b) the depth or the types of services that need to be provided, such as outpatient and inpatient services; and (c) the height or the financial risk protection, such as co-payments (Tangcharoensathien and others, 2011). Striking a balance within the financial constraints is not easy, and countries can learn from such successful cases as Thailand, which spends less than 5% of GDP on health but is viewed largely as having achieved universal coverage of health services. Prepayment and risk-pooling schemes can expand coverage and reduce out-of-pocket payments (WHO, 2009). Examples include the Philippine government-owned health insurer, whose coverage rose from 62% of the population in 2010 to 81% in 2013; and Viet Nam's government-subsidized health insurance premiums for vulnerable groups.

Annex I. Results of probit regressions: dependent variable – product innovation

Factors	Armenia	Azerbaijan	Kazakhstan	Kyrgyzstan	Russian Federation	Tajikistan	Uzbekistan
Sector 1	0.391 (0.192)		0.205 (0.611)		0.411** (0.013)		-0.166 (0.615)
Sector 2	0.092 (0.863)		1.028 (0.105)		0.089 (0.599)		0.052 (0.883)
Sector 3	0.034 (0.922)		-0.463 (0.246)		-0.113 (0.514)		0.024 (0.943)
Sector 4	0.418 (0.227)		-0.042 (0.930)		-0.034 (0.825)		0.912*** (0.006)
Sector 5	0.621* (0.054)		-0.523* (0.084)		0.236 (0.182)		0.670** (0.037)
Sector 6	0.725*** (0.000)		0.157 (0.452)		0.194 (0.218)		-0.307 (0.150)
Sector 7	-0.178 (0.511)		1.018 (0.153)		0.471 (0.225)		0.454 (0,130)
Small					-0.274* (0.022)		
Medium					-0.099 (0.356)		
Group	0.800** (0.023)	0.460 (0.107)			0.339** (0.023)		
Fown		0.128 (0.714)	0.281 (0.453)	0.545** (0.039)			0.186 (0.412)
Age							0.007* (0.099)
QMS			0.138 (0.532)		0.018 (0.878)		
Flic	0.392 (0.201)		0.316 (0.412)	0.352 (0.275)		0.249 (0.334)	
RDinput	0.633*** (0.001)		1.211*** (0.000)	0.912*** (0.001)	0.862*** (0.000)	0.674*** (0.002)	0.912* (0.077)
Training	0.861** (0.025)		0.267 (0.361)	0.981** (0.014)	0.348*** (0.004)	0.498* (0.083)	0.575* (0.068)
Skillwork	0.009*** (0.000)	0.013** (0.022)	0.004 (0.179)			0.005* (0.061)	
Manager							0.017** (0.041)
Domcompet	0.218 (0.386)				0.228 (0.078)	0.282 (0.129)	
Forcompet			0.465 (0.120)	0.425* (0.073)	0.094 (0.474)	0.481** (0.035)	
Customers	0.117 (0.589)		0.285 (0.258)		0.188 (0.150)		
Exports					-0.035 (0.841)		
Sub					0.221 (0.270)	-0.047 (0.882)	
Nonbankfin		-0.017*** (0.000)	-0.005* (0.056)				
Number of firms	374	171	264	235	1004	360	361
LR statistics (prob.)	77.774 (0.000)	26.746 (0.000)	58.198 (0.000)	39.848 (0.000)	154.518 (0.000)	30.948 (0.000)	50.724 (0.000)

Source: Gui-Diby (forthcoming, a).

Note: P-values are in parentheses under the estimated coefficients.
*, **, and *** refer to significance levels of, respectively, 10%, 5%, and 1% .

Annex II. List of variables used in the regression analyses

Categories and code of variables	Label	Description
Prod_innov	Product or service innovation	Dummy variable = 1 if firm innovates; 0 otherwise
Proc_innov	Process innovation	Dummy variable = 1 if firm innovates; 0 otherwise
Sector	*Manufacturing* *Services*	Five dummy variables for: 1=food; 2=textiles and garments; 3=chemicals, plastics & rubber, and non-metallic mineral products; 4=basic metals, fabricated metal products, and machinery and equipment; 5=electronics and other manufacturing Two dummy variables for: 6=Retail; 7=Hotel and restaurants.
Size	Firm size	Two dummy variables for: 1=small (5-19), 2=medium (20-99), 3=large (100+)
Group	Part of a larger group	Dummy variable if firms belongs to a larger group; 0 otherwise
Fown	Foreign ownership	Dummy variable = 1 if percentage >= 10%, 0 otherwise
Age	Firm age	Numerical variable: computed according to first year of operation
QMS	Quality certification	Dummy variable=1 if firms holds an internationally-recognized quality certification; 0 otherwise
Flic	Usage of foreign licensed technology	Dummy variable=1 if firm uses foreign licensed technology; 0 otherwise
RDinput	R&D expenditures	Dummy variable
Training	Training of staff	Dummy variable
Skillwork	Percentage of labour force with university degree	Percentage
Manager	Manager's experience in the sector	Numerical
Domcompet *Forcompet* *Customers*	Domestic competitors Foreign competitors Customers	Grades with the following values to reflect the importance: 0, ¼, ½, and 1
Exports	Exports	Dummy variable equal to 1 if percentage of exports is above 20%; 0 otherwise
Sub	Subsidies	Dummy variable=1 if firm received subsidies from government or European Union; 0 otherwise
Nonbankfin	Proportion of purchase of fixed assets financed by	Internal funds or retained earnings; or owner's contribution; or issues of new equity shares; credit from suppliers and advances from customers; or other sources such as moneylenders, friends, relatives, non-banking financial institutions

Endnotes

[1] ASEAN Plus Three refers to the ASEAN countries plus China, Japan and the Republic of Korea.

[2] For details of this phenomenon, see the information contained in a number of online publications available from http://esa.un.org/unpd/wup/.

[3] The Hong Kong dollar is pegged to the United States dollar, which requires Hong Kong, China to follow the United States Government's monetary stance in setting policy rates.

[4] To hedge against exchange rate fluctuations, the firms set a buffer markup and adjust the margins rather than passing the price changes on to consumers. This also explains the record-high corporate profits seen in 2014. For more details, see Amiti, Itskhoki and Konings (2014).

[5] The law requires full disclosure of budgetary and financial information related to all public entities.It is expected to curb off-budget expenditure, which in 2013 amounted to more than 8% of GDP.

[6] More than 300 people died, many of them students, when a ferry capsized off the coast of the Republic of Korea,near Byeongpungdo, on 16 April 2014.

[7] Details are available (in the Korean language) in *KDI Economic Outlook 2014*. Available from www.kdi.re.kr/report/report_class_e2.jsp?pub_no=13865.

[8] For more details, see www.sids2014.org/index.php?menu=1537.

[9] Exports from the LNG project are not included here due to the non-availability of data at the time of reporting. After adjustment, the export value in 2014 should be much higher.

[10] ADB estimates that the hydropower sector has an estimated potential of generating 30,000 megawatts, while the installed generating capacity is about 1,500 megawatts. The Government plans to add another 10,000 megawatts by 2020. For further information, see ADB (2013).

[11] Currently, firms with more than 100 employees require government approval for job retrenchment. Although this is a rigid condition, a balance must be struck between protecting workers and promoting the efficiency of the labour market. To promote job-market flexibility, the Government plans to facilitate access to savings with the Government when workers change jobs.

[12] Workers' remittances have helped to raise household incomes in Nepal but they do not help to promote agricultural yields because the funds are not generally invested in productivity-enhancing equipment and techniques. For details, see Tuladhar, Sapkota and Adhikari (2014).

[13] For example, Pakistan's decision to increase power tariffs in October 2014 was reversed only days after it had been announced. Opposition may come from the public's perception that the rich benefit more from public subsidies than the poor. According to Trimble, Yoshida and Saqib (2011), the share of electricity subsidies received by the richest 20% of the population was about 29% in 2011.

[14] For more details, see ESCAP (2015a).

[15] For more details, see Gunatilake and Roland-Holst (2013);Pargal and Banerjee(2014);and Speakman(2012).

[16] According the central bank, the share of non-performing loans fell from 4.7% to 3.9% in the course of 2014. Unofficial estimates are much higher; for instance, Moody's estimate was at least 15% of total bank assets.

[17] Estimates for South-East Asia range from $60 billion annually (ADB, 2009) to about $7 trillion through 2030 (Woetzel and others, 2014). Woetzel and others (2014) estimate, which is uses a global benchmark of 70% of GDP for infrastructure stock, includes housing as well as transport, energy, ICT and water infrastructure.

[18] See ESCAP (2013a), box 2.5.