



CHAPTER

**02**

**PERSPECTIVES  
FROM  
SUBREGIONS**

## 1. INTRODUCTION

The Asia-Pacific region is vast and diverse. The region is home to some of the world's largest economies, such as China, India, Indonesia, Japan and the Russian Federation. Changes in economic conditions and direction of economic policies in these countries have notable implications for other regional peers and beyond. At the same time, the region is home to several small countries, the population size of which is less than 1 million, that are dependent on and influenced by other larger economies in the region.

The economic structure and development challenges that various subregions in Asia and the Pacific are facing differ markedly. In landlocked North and Central Asia and remote Pacific islands, international trade costs are high but for different reasons, and the subregions require different policy solutions. In terms of economic integration, regional production networks in East and North-East Asia and South-East Asia are considered highly interconnected. In contrast, the South and South-West Asian subregion remains one of the least integrated blocs of economies in the world. Similarly, on demographics the East and North-East Asian subregion is facing rapid population ageing, whereas the share of the young in the total population continues to increase notably in South and South-West Asia.

Given such diversity, in this chapter macroeconomic developments and prospects and medium-term development issues are looked at from the subregional and country perspectives. The chapter complements chapter 1 by offering a more disaggregated macroeconomic assessment. This subregional perspective is important because region-wide economic figures are sometimes shaped by developments in large economies. For example, although overall economic growth for developing Asia-Pacific countries edged up in 2016 relative to 2015, economic growth indeed slowed in more than half of the economies where data are available to assess such growth.

This chapter presents five selected subregional development issues which could be seen as case studies on how effective fiscal policy management and good economic governance can contribute to better development outcomes. These topics build upon the thrust of chapter 1, which presented arguments for a more active role to be played by fiscal policy in addressing social and environmental concerns and a reorientation of policy focus towards more inclusive economic growth. The selected topics also support the arguments that will be made in chapter 3, that effective governance helps enhance

the quality of fiscal policy management and that good governance is necessary for delivering domestic structural reforms that have a beneficial impact.

The selected topics for South and South-West Asia and Pacific island developing economies are focused on inclusive and social development. In South and South-West Asia, poverty remains widespread despite rapid output growth as the subregional economies are currently stagnating in informal, low-productivity activities. Policy efforts to reduce economic informality and create more productive jobs will require changes in governance practice and fiscal policy design, such as reducing paperwork requirements and linking financial support with business registration. In Pacific island developing economies, various fiscal policy tools have been introduced to tackle the prevalence of non-communicable diseases. Key policy issues, such as the targeting of health spending on preventive care and considering the potential benefits of public-private partnerships and a user-pay arrangement, require careful fiscal planning as well as enabling institutional settings beyond the health sector. For both subregions, the fiscal space is limited so partnerships with international development partners are crucial.

Turning to environmental concerns, the selected topic for East and North-East Asia highlights how other Asia-Pacific countries can learn from the subregion in promoting clean energy innovation. As in the case of policies to address social issues, the role of fiscal policy and governance is notable here. For example, some of the key policy lessons are the balanced use of fiscal incentives and enforcement of environmental laws, as well as the implementation of institutional arrangements that promote effective monitoring and evaluation of public spending, and the need for multi-stakeholder partnerships.

Finally, the selected issues for North and Central Asia and South-East Asia would suggest that initiatives on regional economic integration could help drive countries to introduce structural reforms to address weak economic fundamentals. Effective economic governance is key to the successful implementation of such reforms. In North and Central Asia, the Eurasian Economic Union and the Belt and Road Initiative will result in fewer trade restrictions and greater transport connectivity. To benefit from such new windows of opportunity, some important steps are necessary, such as reducing bureaucratic burdens and adopting common standards. In South-East Asia, less developed economies of the subregion would benefit more from the ASEAN Economic Community if structural constraints, such as inadequate labour skills and public infrastructure, are addressed. Delivering a successful reform package requires a well-functioning public

sector, but this requirement is currently undermined by governance issues, such as widespread corruption and weak coordination among public agencies.

## 2. SOUTH AND SOUTH-WEST ASIA

### 2.1. Macroeconomic performance and outlook

Economic growth in South and South-West Asia softened slightly to 5.4 per cent in 2016 from 5.8 per cent in 2015. Despite the slower growth, South and South-West Asia was still the fastest-growing subregion in the Asia-Pacific region. In India, which accounts for at least half of subregional output, economic growth slowed amid weak manufacturing activity and fixed investment. In contrast, economic growth accelerated in Bangladesh and rebounded notably in the Islamic Republic of Iran and Maldives. Pakistan recorded stable growth at a relatively rapid pace.

Consumer inflation in South and South-West Asia reached a multi-decade low rate of 6.1 per cent in 2016 in the face of low global energy and commodity prices. Lower inflation was also underpinned by much softer price pressure in the Islamic Republic of Iran after the lifting of international sanctions that enabled the country to gain access to goods and services. The modest inflation environment has allowed monetary easing that supported economic growth in several economies. However, monetary conditions are different in Sri Lanka where a credit boom has led to tightening of monetary policy.

Despite generally low interest rates in the subregion, private investment conditions were mixed. In India, such factors as excess production capacity, corporate deleveraging and a high ratio of non-performing loans deterred business investment, although public infrastructure projects are likely to take up some slack. In Nepal, public investment jumped in 2016 as post-earthquake reconstruction efforts continued, but private investment was held back by supply disruptions following a border dispute and blockade. In contrast, private investment was stronger in Pakistan as the China-Pakistan Economic Corridor helped attract more foreign investment, while Bhutan continued to register robust investment in hydropower projects. More broadly, public infrastructure investments should be geared towards crowding-in private investment to facilitate an industry-oriented structural transformation that promotes the creation of productive jobs (see the next subsection for a more detailed discussion).

Output growth is expected to rebound to 5.6 per cent in 2017 and 5.9 per cent in 2018, with stronger

growth performance being projected in most subregional economies. As in past years, private consumption, as well as public investment in some countries, will be the main driver of growth. In India, despite some disruptive impacts due to currency demonetization, economic growth is likely to trend upward in coming years. A key downside risk is higher-than-expected inflation, which could lead to the unwinding of monetary policy support and dampen consumer spending. In addition to global energy price developments, such price spikes could be due to domestic factors, such as adverse weather conditions that would push up food prices.

The subregion's medium-term economic development has been constrained by significant supply-side impediments, such as inadequate infrastructure and energy. Closing such gaps requires large fiscal spending in this subregion where fiscal space is typically limited. To increase fiscal resources, efforts have been expended on restructuring loss-making State-owned enterprises, expanding the tax base and improving tax administration. Other reforms that are aimed at addressing bottlenecks, such as land acquisition and labour reforms, could help lift the subregion's potential output growth.

#### Afghanistan

Economic growth in Afghanistan was stable at the low level of 2 per cent in 2016, on par with that in 2014 and 2015. Output growth has trended downward notably in recent years, from the 6.5-10.9 per cent growth rates recorded for the period 2011-2013 when large numbers of international forces stationed in the country (mostly withdrawn by end-2014) helped support the economy. Economic growth is generally impeded by rising violence and weak governance and institutional systems, factors which have undermined the business sector. Despite the enormous potential of the country's mineral sector, only a fraction of the potential gains have been realized, and mining output is on a downward trend, with large leakages due to illegal activities. Meanwhile, recent policy efforts have been focused on boosting domestic fiscal resources in order to reduce the country's reliance on foreign aid. In this regard, the Government introduced tax reforms, increased royalties and rationalized the size of public services. These steps helped improve fiscal conditions, although sustained improvement in fiscal positions depends on tax revenue from a more vibrant business sector.

The near-term economic outlook is positive but fragile with growth projected at 3 per cent in 2017 and 4.3 per cent in 2018. A new medium-term development framework for the period 2017-2021 outlines a road map aimed at increasing the country's self-reliance

through enhancement of institutional quality and macroeconomic fundamentals. For example, under the framework, programmes on employment generation have been proposed to complement the low job intensity of Afghanistan's sectors that have high potential, such as mining and energy. Job creation is key to the country's medium-term development as its young population, aged between 15 and 24 years, accounts for one third of the total population.

### **Bangladesh**

The economy of Bangladesh has enjoyed an annual growth rate of at least 6 per cent since 2011. In 2016, growth reached a decade-high rate of 7.1 per cent. Net exports of goods and services drove the overall economic expansion as a result of steady export growth, mainly of ready-made garments, and a much larger decline in import bills due to low oil prices. Overall, domestic demand was solid. Government consumption expanded notably partly owing to the record increase in public sector pay. Capital investment also increased, although this was mainly driven by public investment. Meanwhile, household spending grew more slowly in 2016 in line with lower workers' remittances caused by weak economic activity in host countries, particularly those in the Middle East. Given the important role of remittances, policies related to the establishment of drawing arrangements between overseas exchange houses and the banks operating in Bangladesh were relaxed in order to facilitate the transfer of remittances.

Near-term economic growth is projected to remain high at 6.5-6.8 per cent in 2017 and 2018. Consumer spending is likely to drive the economy, underpinned by the expected rise in farm income, a rebound in workers' remittances and multi-year low inflation rates. Steady growth of FDI and merchandise exports would enable the country to maintain its current account surplus. Despite the positive outlook, there are signs of heightened financial sector risks, such as rising non-performing loans and steep deterioration in returns on equity and assets. These developments have prompted an increase in regulatory supervision. To sustain medium-term economic development, tax collection needs to be further strengthened in order to overcome infrastructure and energy shortages. Despite ongoing efforts to streamline tax administration and encourage compliance, the tax-to-GDP ratio remains below 10 per cent. In this regard, recent policies to enhance the investment climate, such as creation of one-stop services, should help to energize the business sector and enhance future tax collection.

### **Bhutan**

Bhutan's economic growth rate remained high at 6.4 per cent in 2016. That pace is somewhat lower than the high base of 7.7 per cent in 2015 partly due to subdued demand for energy-intensive exports, such as steel, in India. As in past years, economic expansion in 2016 was driven by the construction of large-scale hydropower projects, which have kept the share of gross fixed investment at more than half of GDP. Nonetheless, as these construction projects rely on imported materials, Bhutan exhibits a large current account deficit and a high debt-to-GDP ratio. Although macroeconomic stability risk is not considered excessive in view of future hydropower income, prudent project planning and implementation is important. Meanwhile, inflation decreased to 4 per cent in 2016 from 4.5 per cent in 2015 and an annual average of 8.7 per cent during the period 2012-2014. Such a downtrend trend is in line with inflation in India, which is the main supplier of goods to Bhutan.

Growth is projected to rise to 6.6 per cent in 2017 and 7 per cent in 2018 when more hydropower projects become operational. Risks to the outlook include delays in implementation of these projects and higher-than-expected costs that could push up the cost of debt servicing. To maintain rapid economic development in the medium term, the Government has sought to diversify the country's source of economic growth beyond the hydropower sector. For example, to address a cumbersome and fragmented approval process, the Government has established new agencies responsible for enhancing the business environment. In the longer term, Bhutan's economic and social development will crucially depend on effective spending of hydropower revenues.

### **India**

The rate of India's economic growth moderated to 7.1 per cent in 2016 from 7.6 per cent in 2015. The manufacturing sector was more sluggish in 2016 relative to 2015 owing to weaker domestic demand, rising input costs and subdued bank credit. Fixed investment continued to contract as stressed corporate balance sheets suppressed firms' appetite for additional spending. Overall, the still rapid output growth in 2016 benefited from a modest recovery in agriculture due to an improved monsoon season and robust growth in public administration following public sector salary increases. Meanwhile, the unexpected withdrawal of the two largest denomination currency notes in November 2016 and their subsequent replacement with new currency, a process known as demonetization, weighed down economic conditions in late 2016 and early 2017. For example, the resulting

liquidity crunch led to delays in the payment of wages and purchase of inputs in the industrial sector.

Economic growth is projected to be stable at 7.1 per cent in 2017 before edging up to 7.5 per cent in 2018, underpinned by higher private and public consumption and increased infrastructure spending. Despite the overall fiscal tightening, capital expenditure under the budget for fiscal year 2017/18 is about 25 per cent higher than that in the preceding budget. Meanwhile, inflation is projected to reach 5.3-5.5 per cent in 2017 and 2018, which is somewhat above the official target of 4.5-5 per cent. A key downside risk is heightened financial sector risks related to the concentration of bad loans in public sector banks. The gross non-performing assets ratio in public sector banks reached almost 12 per cent in 2016, which points to the need for bank recapitalization.

While the impact of demonetization on the economy is expected to be transient, a slower-than-expected recovery would particularly diminish the outlook for cash-intensive sectors and supply chains for agricultural products. In this regard, the recent budget calls for various measures that seek to mitigate the large temporary adverse shocks on income and wealth, such as expanding a low-cost housing scheme and providing more relief to the agricultural sector and credit support for small enterprises. Notwithstanding its short-term disruptions, one of the medium-term benefits of the demonetization that took place was to help expand banking sector liquidity. The country's medium-term economic development will also benefit from recent reforms that are aimed at easing domestic supply bottlenecks, such as the implementation of the goods and services tax, amendment of a bankruptcy law and opening up of the pharmaceuticals, defence and civil aviation sectors.

### **Islamic Republic of Iran**

The economy of the Islamic Republic of Iran resumed positive growth in 2016 at 4.3 per cent compared with zero growth in 2015. The lifting of international sanctions in early 2016 helped to restore oil production and exports to pre-sanction levels and attract higher foreign investment. Growth in non-oil sectors was led by increased activity in such sectors as agriculture, trade and transport. Meanwhile, inflation moderated to 8.5 per cent in 2016 from 13.7 per cent in 2015 and an annual average of 28 per cent in the preceding three years. Renewed access to imported goods and services, tight monetary policy and low global food prices are among the contributing factors.

Growth is projected to edge up further to 4.4-4.7 per cent in 2017 and 2018. Oil production and export

volumes should continue to increase at the same time that global energy prices rebound. Relaxed restrictions on foreign investment are expected to support investment in the non-oil sectors, particularly the automotive, petrochemical and infrastructure sectors. The positive outlook is, nonetheless, uncertain. The projected growth pickup assumes no oil production cuts (beyond that agreed by the Organization of the Petroleum Exporting Countries (OPEC) in early 2017) and no renewal of international sanctions. The outlook is also conditional on continued implementation of structural reforms, such as overhaul of State-owned enterprises, bank restructuring and recapitalization, deepening of trade and investment links, and improved fiscal management of oil revenues.

### **Maldives**

The economy of Maldives rebounded from a low base of 2.8 per cent growth in 2015 to 3.9 per cent in 2016. Tourism, which is the country's main source of income, increased with the arrival of more visitors from Europe, which offset the earlier decline in the number of Chinese tourists. Compared with previous years, domestic demand contributed more significantly to economic growth in 2016, particularly the construction and wholesale and retail trade sectors, which have registered notable growth in loans. The economic rebound in 2016 was also supported by public investment in large-scale infrastructure projects. The monetary policy stance was more stable, with the policy rate kept unchanged since 2012, although inflation reached a decade-low rate of 0.5 per cent in 2016.

Growth is projected to pick up to 4.5 per cent in 2017 and 4.6 per cent in 2018. Steady tourist arrival growth is expected to be the main driver of economic growth. However, macroeconomic imbalances cloud the growth outlook. In particular, large budget deficits and the rising public debt level have raised concerns over fiscal sustainability. While the Government foresees a much smaller fiscal deficit in 2017, partly benefiting from abolishment of electricity subsidies, it has recently agreed to pay \$270 million, or more than 20 per cent of total resources for 2016, in compensation on an arbitration case relating to cancellation of an airport expansion project. On external accounts, the foreign exchange reserves fell by about 40 per cent in 2016 as a result of an investment in a corporate bond to raise funds for such compensation and a rise in import bills for infrastructure investments and buoyant construction activity.

### **Nepal**

Nepal's economic growth decreased to a decade-low level of 0.6 per cent in 2016 from an already low base of 2.7 per cent in 2015. Economic activity has not rebounded

from the devastating earthquake that took place in April 2015 and a prolonged border blockade with India in the later part of the year. As a result, industrial output fell notably in 2016 as the earthquake depressed household income and the demand for goods, while the border blockade disrupted the supply of fuel and raw materials from India. While higher public investment was planned, inadequate implementation capacity and procedural bottlenecks continued to impede spending. Meanwhile, inflation sped up to 9.7 per cent in 2016. In the early part of the year higher price rises were recorded due to the limited supply of products from India, which constitute a large share of the goods consumed in Nepal. Inflation has consistently been close to double-digit levels in past years due to supply-side bottlenecks.

The growth outlook is set to improve to 4.6 per cent in 2017 and 4.8 per cent in 2018. Overall exports should improve owing to an expected economic rebound in India, which accounts for about 60 per cent of total shipments. Exports of garments and apparel would also benefit from duty-free access granted recently by the United States. Consumer spending is expected to grow steadily amid stable agricultural income, while fixed investment growth is underpinned by gradual reconstruction efforts. The medium-term outlook is supported by policy reform efforts to enhance the business environment, such as streamlining tax administration and offering new investment incentives. Ongoing construction of hydropower projects will also help the economy to reap the dividends of its abundant resources and spur manufacturing growth.

### **Pakistan**

Pakistan's economic growth in 2016 increased to 4.7 per cent from 4 per cent in 2015. The expansion was, however, uneven. Agricultural output declined slightly, as production of cotton and rice shrank due to abnormal rainfall and subdued prices. In contrast, there was a strong uptick in construction and manufacturing activities, while the services sector expanded robustly. From the demand side, despite subdued farm income, consumer spending largely propelled the economy on the back of a decades-low inflation rate and a modest increase in inflows of remittances. Exports continued to decline in 2016 owing to lower global prices of and demand for textiles, which account for almost 60 per cent of Pakistan's exports. Increased capital inflows from China to finance projects under the China-Pakistan Economic Corridor (CPEC) have helped generate foreign exchange receipts, although imports of transport and construction-related items also increased.

The growth outlook is projected to trend up to 5.2-5.4 per cent in both 2017 and 2018. Private consumption and

public investment would drive the economy, supported by higher consumer credits, improved security conditions and ongoing infrastructure projects under CPEC. On the supply side, the large-scale manufacturing sector should benefit from greater energy security and a notable cut in gas prices for industrial use. Similarly, the agricultural sector is likely to improve, with expanded production of cotton, sugarcane and maize. Meanwhile, a rebound in global oil prices and an upward adjustment in domestic petrol prices would push up inflation in 2017/18 to 5-5.5 per cent, which is still within the official target of 6 per cent. In the medium term, energy shortages would continue to result in the country's below-potential growth. Despite recent improvements, energy sector reforms would need to further reduce subsidies, tackle the accumulation of arrears and improve technical efficiency.

### **Sri Lanka**

Economic growth in Sri Lanka moderated to 4.4 per cent in 2016, from 4.8 per cent in 2015 and an average of 7.4 per cent during the period 2010-2014. Agricultural output contracted as production of key commodities, such as rubber, rice and tea, was impaired by severe weather conditions. For production of food and beverages and textiles and garments, slight declines were recorded. The construction and services sectors were more buoyant, especially in financial services and domestic trade. On the external front, export earnings shrank in 2016, although the current account deficits narrowed thanks to stronger tourism revenues and remittance inflows. Meanwhile, subdued agricultural output and higher wage levels pushed up inflation to 4 per cent in 2016, well within the official target of 4-6 per cent. To contain credit growth, the policy rates were raised twice in 2016 for a total of 100 basis points.

Economic growth is expected to rebound modestly to 4.8-4.9 per cent in 2017 and 2018. Agricultural activity should recover from adverse weather conditions. A major headwind to stronger growth prospects, however, is fiscal tightening that would constrain consumer spending and public investment, especially in an environment of higher domestic interest rates. The country's medium-term economic development is contingent upon the success of reforms designed to reduce stubbornly large fiscal and trade deficits. Public debt currently stands at close to 80 per cent of GDP, with a large share being foreign-currency denominated. In this regard, the Government has strengthened its fiscal consolidation programme by increasing the value-added tax rate from 11 to 15 per cent and imposing various taxes, such as a capital gains tax and carbon tax for motor vehicles. There are also efforts to tax e-commerce transactions, reform State-owned enterprises and improve tax administration.

## Turkey

Turkey's economic growth rate dipped to 2.4 per cent in 2016 from a high base of 6.1 per cent in 2015. Increased political uncertainty in the aftermath of a failed coup attempt in July 2016 and recent geopolitical developments weakened market confidence, resulting in a decline in private investment and tourism revenues. Moreover, capital outflows were sizable, which led to an interest rate rise in November 2016. Unemployment rose to a multi-year high rate of about 12 per cent in late 2016, partly due to job cuts in the tourism sector. Joblessness is much higher among female workers, which is a cause for concern given the already low female labour force participation rate. The economic slowdown in 2016 came despite measures to boost consumer demand, such as a 30 per cent increase in minimum wage levels from January 2016.

Output growth is projected to edge up to 2.8 per cent in 2017 and 3.2 per cent in 2018. Improving job market conditions are expected to support private consumption, while exports would benefit from the removal of trade restrictions with the Russian Federation. However, private investment is likely to remain sluggish, as currency depreciation weakened the balance sheets of corporates with foreign exposure. Overall, the outlook is constrained by concerns over domestic security and the political situation, which would continue to restrain consumer spending and tourist arrivals. Meanwhile, inflation is expected to remain high, at more than 7 per cent in both 2017 and 2018, relative to the official medium-term target of 5 per cent, given the pass-through effect from higher minimum wages and currency depreciation.

While an immediate policy priority is to restore domestic business sentiment, another policy challenge is to make further progress on labour market reforms in order to reduce informal labour, narrow gender gaps in workforce participation and better integrate refugees into formal employment. In this regard, the Government introduced automatic pension enrolment of wage earners younger than 45 years of age in private pension plans in order to supplement the public pension programme and increase retirement savings.

### 2.2. A selected policy challenge: structural transformation for inclusive development

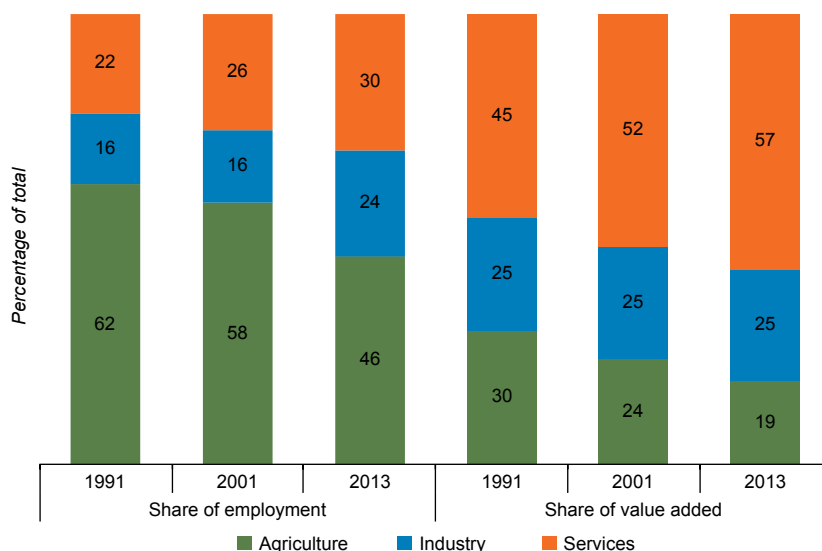
Employment constitutes a crucial link between economic growth and poverty reduction for South and South-West Asia as most households in this subregion remain entirely dependent on income generated through work; access to other sources of income, such as from productive assets and public transfers, is usually limited. Thus, the availability

of decent and high-productivity jobs on a sustained basis is key to tackling poverty in this subregion. In this regard, structural transformation that promotes economic growth and creates productive jobs in sectors where people living in poverty are likely to be employed should be a policy priority for South and South-West Asia (Islam, 2003; Khan, 2007; Aggarwal and Kumar, 2012). Moreover, as the subregion is experiencing a youth bulge, in which the share of those in the working-age population is projected to rise at least until 2030, the need to create a sufficient number of decent jobs becomes urgent.

### Unconventional structural transformation in South and South-West Asia

Conceptually, structural transformation should boost opportunities for productive jobs. In its broadest sense, structural transformation refers to long-term reallocation of the factors of production, such as labour and machinery, to more productive economic activities (Silva and Teixeira, 2008; Harguchi and Rezonja, 2013; McMillan, Rodrik and Verduzco-Gallo, 2013). As resources are used more efficiently, such as by mobilizing excess labour in low-productivity agriculture for employment in other sectors, structural transformation would help to promote a country's economic growth and productivity. The traditional concept of structural transformation implies that opportunities for productive jobs should rise as an economy's income level increases and its structure transforms from reliance on the agricultural and subsistence sectors to higher value-added manufacturing and services sectors (Lewis, 1954).

The dynamics of structural transformation in South and South-West Asia, however, have differed from this conventional narrative. In particular, structural change in the subregion has failed to create a sufficiently large number of productive jobs. This is mainly because most of the economies continue to stagnate between agriculture and low value-added manufacturing. Figure 2.1 depicts the shares of employment and value added over time in the agricultural, industrial and services sectors, and highlights the lack of high value-added industrialization in the subregion. In particular, while the share of industry in total employment increased over the past two decades, from about 16 per cent in 1991 to 24 per cent in 2013, its share in total output has been stagnant at about 25 per cent during the same period. This implies lower productivity in industrial activities in the past decade. Meanwhile, although figure 2.1 suggests higher productivity in service activities, mainly driven by modern and productive jobs, such as those in India's financial and information technology sectors, the vast majority of jobs in services are concentrated in low-productivity areas, such as in retail services.

**Figure 2.1. Sector shares of employment and value added, South and South-West Asia, 1991-2013**

Source: Based on the ESCAP Statistical Database.

Available data on occupational groups point to the dominance of low-productivity jobs in South and South-West Asia. The share of jobs which are generally regarded as more productive and have higher skills requirements, such as professional, managerial and technical work, remains below 20 per cent in most economies in the subregion. In contrast, skilled jobs in the agricultural sector and elementary occupations account for the highest shares of workers in most economies. In Maldives, almost half of all employed persons are performing rudimentary occupations, such as street vending, providing cleaning services and performing simple tasks related to farming, manufacturing and mining. Such shares are also high in India at about 30 per cent and close to 20 per cent each in Bangladesh, Pakistan and Sri Lanka.

In India, structural transformation bypassed high-productivity industrialization and shifted to low value-added services sectors. India's share of manufacturing in GDP, at 17 per cent in 2014, was notably lower than that of other major Asia-Pacific economies, such as China, the Republic of Korea and Thailand, where such shares were close to one third. The lacklustre growth in the share of manufacturing output has been attributed to several factors, including rising capital intensity, the concentration of manufacturing in the informal sector, an absence of middle-sized firms and the reclassification of some tasks that were previously performed by manufacturing but have now been transformed into services (Mazumdar and Sarkar, 2009; Nayar and others, 2012; Thomas, 2013; Bhat, 2014). Within the manufacturing sector, the resource and labour-intensive low-technology sectors, such as food processing, tobacco, wood products and textiles, remain the largest employers.

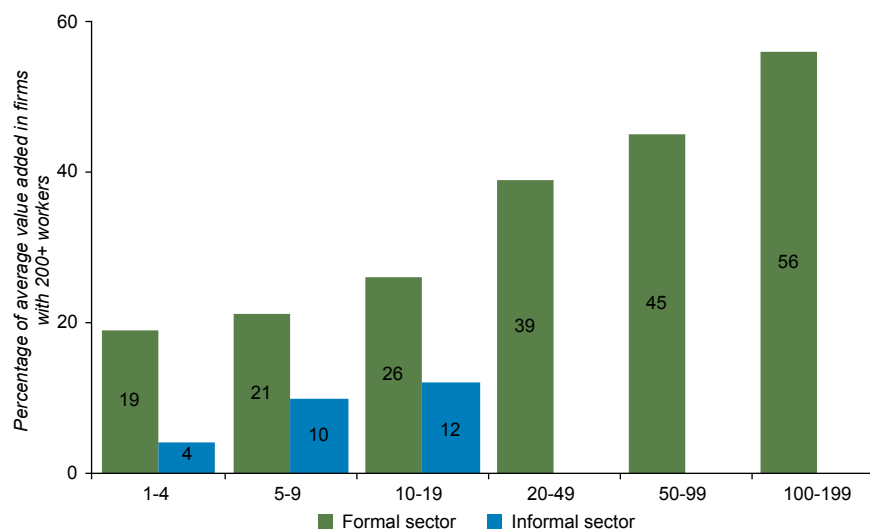
### Informal jobs are common

Even where jobs exist, the quality of jobs, including such aspects as wages, working conditions, social protection and equal access to employment opportunities, is important. In South and South-West Asia, the quality of employment appears to be low, as a large share of workers is being employed in the informal sector. For example, informal employment accounts for about 70 per cent of all jobs in Sri Lanka, almost 90 per cent in Bangladesh, India and Pakistan, and up to 95 per cent in Nepal. When excluding jobs in agriculture, one estimate suggested that the informal economy in Bangladesh, India and Nepal still absorbs at least half the working population (ILO, 2015). These informal jobs are typically characterized by low pay, poor working conditions and little or no protection or rights.

The pervasiveness of informal sector jobs has perpetuated low productivity, poverty and inequality (Chen, Vanek and Heintz, 2006; Inter-American Development Bank, World Bank and ECLAC, 2013). Figure 2.2 shows that in terms of manufacturing in India labour productivity among informal workers is much lower than that of formal workers. For example, while the average value added by producers in the formal sector employing 10-19 workers is about 26 per cent of that of workers in firms that employ more than 200 workers, the share of value added by those in the informal sector decreases to only 12 per cent. In India, informalization of the organized manufacturing sector has been rising through greater use of subcontracting and increasingly employing contract and temporary workers. Typically, casual and temporary workers receive significantly lower wages than regular workers and have limited recourse



**Figure 2.2. Mean value added per worker in manufacturing in India as a share of value added per worker in formal firms with 200+ employees**



Source: Nayar and others (2012).

to adequate social security and other benefits. Evidence suggests that the bulk of new jobs created in the formal sector of Indian manufacturing are low-quality insecure jobs. The increasing informalization of manufacturing is a matter of concern because, if structural change through sustainable industrialization does not create decent jobs for people to attract workers away from low-productivity occupations, such change would fail to have a significant impact on reducing poverty (Aggarwal and Kumar, 2012).

### Policy strategies for guiding structural transformation in South and South-West Asia

Policy strategies to ensure that structural change creates a sufficiently large number of productive jobs could feature at least four related components: introducing multifaceted industrial development policies; investing in human resources development; breaking the informal-formal segregation barriers; and expanding social protection beyond formal sector employment.

On the first component, the goal of an industrial policy should be to offer an enabling business environment that is conducive to creating new high-productivity sectors and increasing the value added for existing economic activities. The latter includes enhancing productivity in the agricultural sector, which still employs nearly half the workers in South and South-West Asia. In order to promote dynamic, high-value-added economic activities, the focus should be on enhancing innovation capacity and entrepreneurship. In this regard, enhanced access to credit facilities and venture capital to support business start-ups is important (ESCAP, 2016a).

There is already a renewed effort to energize manufacturing activities in the subregion, such as the recent “Make in India” policy package that envisions India as a global manufacturing hub. The core part of the initiative is sector-specific industrial policies. The focus is on manufacturing sectors, such as automotives, textiles and pharmaceuticals, as well as the energy and infrastructure sectors, such as oil and gas, power, ports and telecommunications. There is also a range of complementary policies and incentives to avoid the pitfalls of a “picking-winners” approach. Examples include a new microfinance public financial institution that targets innovative small and microenterprises, and “Stand-up India”, which seeks to promote entrepreneurship among women and disadvantaged indigenous groups.

The second component of policy strategies to ensure that structural transformation leads to high-productivity jobs is investment in human resources development to increase the availability of a skilled labour force. On this supply-side policy, studies show that countries which have higher average years of schooling tend to have a higher share of employment in the manufacturing and services sectors and a higher share of wage employment (World Bank, 2012c; Byiers and others, 2015b). These studies also highlight the importance of education for successful structural transformation in Asia-Pacific countries, such as China, Indonesia and Viet Nam.

Several Governments of countries in the subregion have placed greater emphasis on skills formation and human resources development in the past decade. For example, while Sri Lanka passed the Free Education Act in 1945 and Bangladesh adopted the Primary Education Compulsory

Act in 1990, India and Pakistan passed right-to-education legislation only in 2009 and 2012 respectively. Moreover, India established the Ministry of Skill Development and Entrepreneurship in 2014 and launched the Skill India programme in 2015, which seeks to harness the energy of the country's youth.

One policy priority is to strengthen technical and vocational education and training (TVET) schemes. Studies suggest the employment benefits of TVET schemes could be more significant in the informal sector and among some population groups, such as women. In the context of South and South-West Asia, a recent estimate shows that the rate of return of TVET schemes is as high as 42 per cent in Sri Lanka (Byiers and others, 2015a). Despite the high rate of return, enrolment in TVET programmes in the subregion is very low, at about 2 per cent of total school enrolments in 2007. Such low enrolment is largely due to a perception that TVET carries lower social status compared with formal education. Nevertheless, some policy effort has been made to promote TVET. For example, Bangladesh has sought to modernize its TVET system through implementation of the National Education Policy 2010 and the National Skills Development Policy 2011. In Sri Lanka, TVET plans were designed in consultation with representatives from the private sector to ensure that the skills being developed are those that are relevant for work, particularly in the apparel industry.

The third component of the policy package to create high-productivity jobs is labour market innovations that seek to break the informal-formal segregation barriers. Among other measures, formalization of the informal economy should be encouraged by reducing the regulatory cost of formalization, such as by imposing fewer paperwork requirements, and linking incentive schemes, such as eased access to finance, with business registration and basic compliance with labour and environmental regulations. Moreover, as most informal firms are small, the broad policy is to help these firms to grow and graduate into formal economy enterprises. This step requires addressing constraints, such as limited access to credit and inadequate management skills. As for workers, a policy effort that seeks to formalize employment relationships, expand social security benefits to in-service training and enable transferability of qualifications and skills between the formal and informal sectors would help facilitate integration in the formal economy (ILO, 2007).

The fourth component is to expand the provision of social protection beyond formal sector employment. Social protection plays a critical role in promoting inclusive development. For example, income support in case a worker becomes temporarily unemployed or injured in

a work-related accident would help workers avoid falling into poverty. Similarly, pensions provide basic income security in old age, while maternity benefits promote female labour force participation and access to good-quality maternal health care. Despite the importance of such measures, only about 10 per cent of workers in the subregion have social security coverage, although this share is higher, at about 25 per cent, in Sri Lanka (ESCAP, 2016a).

As the subregion has large informal sectors, the provision of social security that is based on employment contributions excludes the vast majority working in the informal economy and the working poor. To address this problem, countries such as Bangladesh and Nepal are taking steps to expand their social protection systems through safety net programmes. Meanwhile, public works programmes intended to support income smoothing during adverse economic shocks and provide safety nets, such as job guarantees in India, have been successful in promoting the productivity of agriculture and diversification whereby male workers have moved out of the casual private sector into alternative occupations (Zimmermann, 2013). Such social protection initiatives could be used as stepping stones towards a more universal and comprehensive social protection system untied to employment status. Such schemes also improve employment dynamics and provide decent work.

## 3. PACIFIC

### 3.1. Macroeconomic performance and outlook

As a group, economic growth in Pacific island developing economies dipped to 2.6 per cent in 2016 from 7.1 per cent in 2015 and 6.2 per cent in 2014. The sharp slowdown was driven by more sluggish economic expansion in Papua New Guinea, which accounts for 60 per cent of the output of the developing economies in the subregion, owing to subdued prices and reduced exports of minerals. The slower overall economic growth in 2016, however, masks the fact that growth performance indeed improved in about half of the subregional economies, including Cook Islands, Marshall Islands, Nauru, Samoa, Tuvalu and Vanuatu. Moreover, 2016 marked the first time in decades that all subregional economies recorded positive economic growth. Such across-the-board economic expansion has been rare because most subregional economies are highly vulnerable to external shocks, such as natural disasters and declining commodity prices.

The near-term growth outlook is expected to improve modestly, with growth projected to be 3.1 per cent

in 2017. The improved prospects benefit from such factors as an expected uptick in global commodity prices, steady economic growth in key trading partners, particularly Australia and New Zealand, stable tourism receipts, continued infrastructure upgrades and post-cyclone reconstruction efforts in some economies. A key downside factor is the persistent risk of natural disasters, which have in the past significantly damaged productive sectors, infrastructure and tourism facilities.

While Pacific island developing economies are vulnerable to a wide range of negative shocks, the room for policy responses is often limited. For example, while public debt levels are generally within established thresholds for fiscal stability, several subregional economies are approaching such thresholds and are considered to exhibit a high risk of debt distress. Moreover, fiscal outcomes are subject to several sources of volatility, stemming from a narrow revenue base, such as fishing license fees, and large fluctuations in economic activity that make revenue less predictable. Spending rigidity caused by a large share of recurrent expenditure for civil service salaries and operations is also an issue.

### **Pacific island developing economies**

#### **Fiji**

Output growth in Fiji trended down to 2 per cent in 2016 from 3.6-3.8 per cent in 2014 and 2015. Tropical Cyclone Winston in February 2016 and a tropical depression in December of the same year impeded activity in the agricultural, timber production and manufacturing sectors. Despite the setbacks from the natural disasters and higher inflation due to supply disruptions, private consumption appeared buoyant as a result higher revenues from increased tourist arrivals and elevated workers' remittances. Investment conditions and reconstruction works benefited from eased fiscal and monetary policy stances.

Growth is forecast to rebound to 3.6 per cent in 2017 before softening to 3 per cent in 2018. Tourism-linked sectors and post-cyclone reconstruction work are expected to drive the economy. Aided by government financial assistance and subsiding inflation, private consumption should increase as households restock consumer goods and rebuild houses. In contrast, the preferential access of sugar from Fiji to markets in the European Union is scheduled to end in 2017. Similarly on the downside, despite higher capital spending budgeted for reconstruction activity, shortages of essential building materials and skilled labour may continue to delay some major construction work. Sustaining the country's medium-term growth will depend on effective implementation of structural reforms that are aimed at enhancing the business

climate, strengthening the civil service and State-owned enterprises and removing impediments to land use.

#### **Papua New Guinea**

The economy of Papua New Guinea recorded much more modest economic growth in 2016 at 2.5 per cent compared with a high base of 9.9 per cent in 2015 when the first full-year production of liquefied natural gas began. In addition to the high base, the completion of construction of major mining projects and lower agricultural production, owing to El Niño-related drought in 2015, also contributed to slower economic growth in 2016.

Economic growth is forecast at 2.5-3 per cent during the period 2017-2018. Mining production and construction activity, including preparations for hosting the APEC Economic Cooperation Leaders' Meeting in 2018, will support the rebound. The key downside risks include lower-than-expected prices for key commodity export items, such as copper and gold, and lower external demand for minerals. This situation could weaken public revenue and necessitate expenditure restraint. In the medium term, fiscal consolidation is needed to decrease risks due to lower-than-expected mineral sector revenues. Given the limited fiscal space, spending on basic public services, such as health, education and infrastructure, should be well targeted. An effort to increase the effectiveness of public spending could be focused on monitoring and evaluation of project implementation together with better assessment of capacity to deliver results.

#### **Samoa**

Economic growth in Samoa surged to 6.4 per cent in 2016 from 1.6 per cent in 2015 mainly because of higher tourism earnings and infrastructure upgrades, including a new airport terminal. Increased visitor arrivals boosted activity in the transport, accommodation and restaurant sectors. Investment in deep-sea fishing operations also helped raise the output of fisheries. Meanwhile, inflation dipped to only 0.1 per cent in 2016 due to lower fuel prices and improved domestic food supply.

Near-term growth is projected to normalize from a high base in 2016 to 2 per cent in both 2017 and 2018. Moderate expansion in agriculture and tourism is expected to support the economy, while a new submarine cable investment would boost output in the communications sector. On the downside, the country's largest manufacturing employer is expected to close its operations in 2017. Given the country's narrow economic base, public policies could focus on promoting such sectors as agriculture and high-value-added industries.

### Solomon Islands

Economic growth in Solomon Islands was largely steady at 2.7 per cent in 2016 relative to 2.9 per cent in 2015. Construction activity and new investment in communications and fisheries-processing capacity supported the economic expansion. In contrast, the prolonged drought conditions in 2015 and in the early part of 2016 weighed on agriculture and fisheries, while the export of logs was hampered by weak demand from China. Together with the weaker exchange rate, lower domestic food supply pushed up food prices, with overall inflation rising to 3.3 per cent in 2016 compared with a small decrease in 2015.

Economic growth is projected to be 2.5-3 per cent during the period 2017-2018. Resource-based sectors would continue to be the main growth driver. The country's medium-term economic development would benefit economic diversification as well as productivity enhancement in such sectors as logging, mining and tuna processing. Among other areas, policy efforts could focus on providing support for small enterprises, linking subsistence farmers with market opportunities and streamlining business regulations and trade facilitation processes.

### Vanuatu

Vanuatu's output growth rebounded to 3.5 per cent in 2016 after a 1 per cent contraction in 2015 as a result of Cyclone Pam, which damaged housing, infrastructure, agriculture and tourism facilities. Reconstruction and infrastructure upgrades and a pickup in tourism and agricultural activities supported the recovery in 2016. Inflation moderated to 1.9 per cent in 2016 as supply shortages subsided relative to the situation in 2015.

Growth is projected to trend upward slightly to 3.8 per cent in 2017. Increased tourism revenue, higher agricultural production and additional infrastructure projects are some of the expected drivers of growth. In contrast, capacity constraints and external funding gaps remain and could lead to delays in implementing major infrastructure projects. In this regard, comprehensive tax reform is already under way, including the introduction of income and corporate taxes. Other policy issues include land reform, productivity enhancement in fisheries and agriculture and the need for public investment to crowd in business investment.

### Smaller Pacific island developing economies

The economy of the **Cook Islands** grew by 4.2 per cent in 2016, up from 3 per cent in 2015, as a result of higher visitor arrivals and ongoing water, electricity and

road infrastructure upgrades. The overall price level fell by 0.3 per cent in 2016 due to lower global commodity prices and the strong New Zealand dollar, the currency used in the Cook Islands. The growth outlook for 2017 is projected to be stable at 4 per cent. Additional flight services from Australia and New Zealand in 2017 are expected to support growth in tourism, although accommodation and infrastructure capacities during peak periods need to be expanded. A key downside risk is possible delays in capital project implementation.

In **Kiribati**, economic growth moderated slightly to 3.1 per cent in 2016 from 3.5 per cent in 2015. Ongoing road, airport, water and sanitation infrastructure upgrades continued to drive the economy. In looking forward, output growth in 2017 and 2018 is likely to trend down further to 2-2.7 per cent, as major public infrastructure works are completed. Private sector development, such as the recent investment in fish processing capacity, is vital for job creation. A policy effort to reform State-owned enterprises and enhance the business climate, through more streamlined business licensing processes and land registration, remains critical.

In the **Marshall Islands**, the economy expanded by 1.5 per cent in 2016, up from 0.5 per cent in 2015. The adverse effects of the drought in 2015 waned, while higher fishery revenue supported public expenditure and donor-funded infrastructure spending resumed. In going forward, the economy is expected to grow by 1.6-2 per cent over the period 2017-2018. The near-term inflation outlook remains manageable.

The economy of **Micronesia** slowed to 2 per cent growth in 2016 from the 3.7 per cent level in 2015, mainly due to the impact of natural disasters. The outlook for 2017 and 2018 is set to improve to 2.5 per cent in both years. Donor-funded infrastructure spending, higher public spending as a result of windfall fishing revenue and tourism activity is expected to support economic expansion.

In **Nauru**, output growth rebounded to 3 per cent in 2016 after a 10 per cent contraction in 2015, which was largely due to depressed phosphate production and exports. Limited domestic supply and rising consumption kept inflation at a high level of 6.6 per cent in 2016. On the outlook for the future, growth is expected to increase significantly to 15 per cent in 2017, with resumption of phosphate exports and the ongoing demand created by operations of the Nauru Regional Processing Centre, an Australian immigration facility for processing asylum seekers; the Centre is the second largest employer after the Government.

In **Palau**, economic growth dipped to 2 per cent in 2016 from 9.4 per cent in 2015. Tourist arrivals declined due to restrictions placed on the number of chartered flight services to Palau as part of the Government's focus on higher-value and more sustainable tourism. An economic rebound is expected in 2017 and 2018, with projected growth of 5 per cent in both years. Ongoing infrastructure projects and upgrades to tourism facilities are expected to support economic growth. Inflation is likely to be moderate at about 2.5 per cent in the near term.

The economy of **Tonga** grew by 3.1 per cent in 2016, down slightly from 3.4 per cent in 2015. Ongoing infrastructure work, tourism revenue and consumer spending supported the economic expansion. Growth is projected at 2.6-2.7 per cent for 2017 and 2018, mainly due to tourism receipts and construction activity in preparation for hosting the 2019 Pacific Games. Inflation is expected to remain moderate in the near term.

Output growth in **Tuvalu** increased to 4 per cent in 2016 from 2.6 per cent in 2015, supported mainly by infrastructure and construction activity. Growth is projected to be 3 per cent in 2017 and 2018, underpinned by ongoing infrastructure projects and higher government spending as a result of windfall fishery revenue. Inflation is forecast to trend down to 2.8-3 per cent in 2017 and 2018.

## Australia and New Zealand

### Australia

The Australian economy grew at a steady pace of 2.4 per cent in 2016. The recent uptick in global commodity prices supported exports of coal and iron ore, while the weaker exchange rate boosted services receipts in such sectors as tourism, education and business services. Growth of private consumption and non-mining investments moderated in the latter part of 2016 on the back of slower wage and employment growth and temporary factors, such as adverse weather conditions, that held back construction activity. The transition from the mining investment boom to the production phase was reflected in a decrease in mining investments, while investments in dwellings were more buoyant. Meanwhile, inflation remained below target at 1.3 per cent in 2016. A high underemployment rate held back wage growth, while macroprudential measures resulted in moderation of housing prices. Given the weaker domestic demand and modest price pressure, the policy rate was cut twice in mid-2016 for a total of 50 basis points.

Growth is expected to pick up slightly to 2.5-2.7 per cent in 2017 and 2018. Export receipts should continue to benefit from higher production of iron ore and liquefied

natural gas and the weaker exchange rate. A likely recovery in wage growth and low interest rates would revive household consumption. However, counteracting these positive factors are the relatively high unemployment rate, at almost 6 per cent in 2016, and high household debt. Non-mining activities would be led by the dwelling sector, as several large-scale projects are still in the pipeline. Meanwhile, inflation is expected to rise to 1.9 per cent in 2017 and 2.3 per cent in 2018, owing to increases in energy prices, labour costs and a tobacco excise tax. Key downside risks include weak commodity demand in China and heightened global economic uncertainty.

### New Zealand

The economy of New Zealand grew robustly at 4.3 per cent in 2016, up from 3.1 per cent in 2015. The solid expansion was underpinned by improved exports following an uptick in dairy prices, higher tourism revenue and high net migration that led to strong housing demand and construction activity. Inflation remained low at 0.6 per cent in 2016. In addition to low commodity prices, moderation in housing prices following the introduction of macroprudential measures helped contain inflation. The stronger exchange rate towards the end of 2016 also contributed to soft price pressures.

The outlook is positive, with projected growth edging up to 4.4-4.5 per cent in 2017 and 2018. The net migration and tourism sector would continue to support the economy. In addition to net migration, construction activity would be buoyed by reconstruction efforts following the Kaikoura earthquake in November 2016. Private consumption would benefit from low inflation and financing costs, although its strength is constrained by rising prices for housing and high household debt. Additional macroprudential measures may be required if housing prices continue to rise rapidly and lead to capacity constraints in the construction sector where skilled workers are already in shortage. Meanwhile, net migration, which has contributed to increased labour supply and employment growth, could moderate in coming years as global economic activity picks up and labour markets in Australia improve.

## 3.2. A selected policy challenge: fiscal policy for better health outcomes

Pacific island developing economies continue to address their unfinished agenda for achieving decent health outcomes. Several subregional economies have not fully achieved the Millennium Development Goals on health issues, such as those relating to maternal health, HIV/AIDS, malaria and tuberculosis. Meeting the Sustainable

Development Goals on health issues, which is arguably a more complex endeavour, would be even more challenging for these economies. In addition to hampering social development, poor health outcomes also undermine economic development through, among other channels, output loss due to illness and death, and forgone income for family members taking care of patients. In the context of Pacific island developing economies, healthy workers are especially needed to enhance the currently low level of labour productivity.

The focus here is on the use of fiscal policy tools to improve health outcomes in Pacific island developing economies, particularly to address the prevalence of non-communicable diseases (NCDs) in most subregional economies. Through both revenue and expenditure tools, fiscal policy has great potential to deal with NCDs as those tools incentivize changes in behavioural factors that drive such diseases. The focus on fiscal policy is especially important in the context of the Pacific, given the limited fiscal space in most of these economies. Moreover, national budgets of Pacific island developing economies are often volatile because the revenue base is narrow, dependent on foreign aid and subject to external shocks, such as natural disasters. Better design and implementation of fiscal policy can help improve health outcomes while ensuring fiscal sustainability.

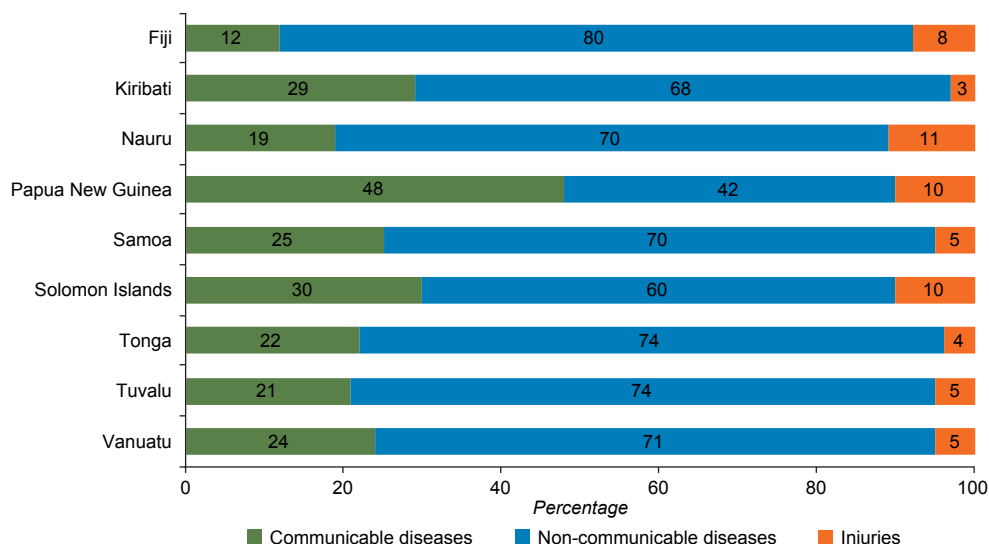
### Behavioural risks are driving prevalent non-communicable diseases in the Pacific

Pacific island developing economies are facing considerable pressure in coping with non-communicable diseases, such as cardiovascular diseases, diabetes,

cancer and chronic respiratory diseases. For example, Cook Islands, Marshall Islands, Nauru and Palau are among the world's top 10 diabetes-prevalent countries (International Diabetes Federation, 2015). In most subregional economies, the proportion of deaths due to such diseases is higher than that in other economies. For example, non-communicable diseases account for up to 80 per cent of deaths in Fiji and 74 per cent in Tonga and Tuvalu compared with the global average of 68 per cent (see figure 2.3).

Behavioural risk factors, such as unhealthy diet, tobacco use and physical inactivity, are responsible for most of deaths related to non-communicable diseases in the subregion. Examples of dietary risk include high consumption of sweetened beverages, trans-fat and sodium (salt), all of which contribute to obesity and raise people's susceptibility to cardiovascular diseases and diabetes. Approximately half of the Pacific island developing economies are listed as having the most obese populations in the world (WHO, 2011; 2014). More than a quarter of the adult population in most Pacific island developing economies are clinically obese, with obesity rates as high as 54-58 per cent in Tonga and Samoa compared with the global average of 13 per cent (Hou, Anderson and Burton-Mckenzie, 2016). Tobacco use is also prevalent, with about two thirds of adult males in Kiribati and between 40 and 55 per cent of their counterparts in Palau, Papua New Guinea, Samoa and Tonga being regular users of tobacco (WHO, 2014). Of particular concern is the high consumption of tobacco by youth, especially females, at 47 per cent and 62 per cent of girls in Cook Islands and Palau respectively (UNDP, 2014).

**Figure 2.3. Proportional mortality, by cause, for selected Pacific island developing economies**



Source: WHO, Noncommunicable diseases country profiles. 2011 and 2014.

### Enhancing the effectiveness of already sizeable public spending on health

Public spending on health in most Pacific island developing economies is not considered small, which raises questions about the effectiveness of such spending. In 2014, public expenditure on health ranged between approximately 4.5 per cent of GDP in Fiji and Papua New Guinea to about 17 per cent of GDP in Marshall Islands and Tuvalu (see figure 2.4). On average, Pacific island developing economies spent close to 9 per cent of their GDP on health in 2014, which was not low compared with the global average. For most subregional economies, public health spending in 2014 was also higher than that in 1995. Meanwhile, when compared with total government expenditure, public health spending remained sizeable at 13.3 per cent on average in 2014, double that of the world's lower-middle-income countries. Although the fixed cost of providing any social services in Pacific island developing economies is naturally high in view of their sparse populations, lagging health outcomes in several countries cast doubts on the effectiveness of health spending in the subregion.

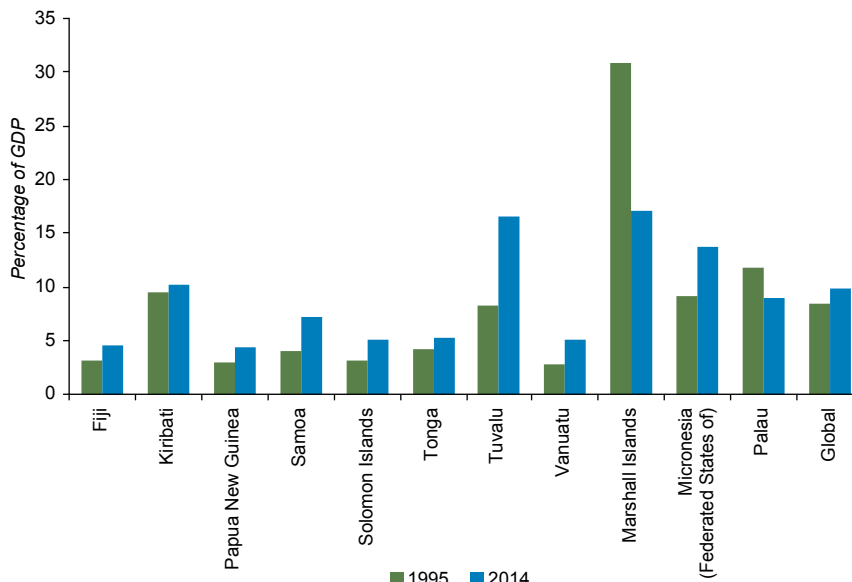
Evidence from Pacific island developing economies shows that reorienting public health spending towards preventive care, specialized health services and early treatment could help improve spending effectiveness. On preventive care, this refers to both primary prevention programmes, which seek to prevent adverse health conditions from occurring in the first place, and secondary prevention programmes that reduce the incidence of reoccurring conditions or further health deterioration. In Vanuatu, every person who

managed behavioural risks through primary prevention and successfully avoided becoming a type 2 diabetes patient saved the Government about \$347 per year. This amount is more than twice the annual per capita public expenditure on health. Moreover, effective secondary prevention where every type 2 diabetes patient did not progress to using an insulin regime saved the Government an additional \$484 per year (Anderson, 2013).

Additional investment in specialized health services can also improve spending effectiveness. In Samoa, a diabetic foot clinic was introduced in order to reduce amputations for patients with diabetic foot ulcers. Previously, patients usually presented late to hospitals, and the admission to treat the sepsis often led to amputation of a lower limb. Through the new clinic, treatment costs are nearly eight times lower when compared with admitting a client with diabetic foot sepsis into hospital, while the outcomes are also better in terms of avoided amputations (McGrath, 2016). When specialized medical care is not available locally or if it is available but not sufficiently, overseas referrals are required, and the cost can be extremely high. For example, Samoa's cost for overseas referrals amounted to 15 per cent of its total public health expenditure in 2010 but benefited less than 0.1 per cent of the total population (World Bank, 2014).

Finally, early treatment also offers great value for money and is cost effective because urgent late-stage patient care is typically costlier and more difficult to access than early interventions. In Tonga, expenditure on non-communicable diseases more than trebles as care progresses from the

**Figure 2.4. Public health expenditure as a share of GDP, 1995 and 2014**



Source: World Bank, World Development Indicators database. Available from <http://data.worldbank.org/>.

level of health centres to the outpatient clinic at the main hospital, and increases ninefold as treatment advances from outpatient to inpatient care (Hou, Anderson and Burton-Mckenzie, 2016).

Beyond the health sector, public spending and fiscal policy management also matter for improving health outcomes. For example, price subsidies for healthful food items, such as fresh fruits and vegetables, can lead to an increase in their consumption and subsequent weight reduction in specific segments of the population (Fountaine and others, 2016; WHO, 2016). However, given the limited fiscal space, Pacific island developing economies will need to design well-targeted programmes and assess the costs and benefits of such a policy. More broadly, strengthening public financial management in the subregion, which is often characterized by slow disbursement of funds, under- and overspending of budgeted expenditure and weak procurement and reporting practices, helps enhance health service delivery (Haque and others, 2012).

#### **Exploring non-tax revenue policies to cope with non-communicable diseases**

A common revenue policy to improve health outcomes is the levy of taxes and customs tariffs on products that are deemed harmful to health. These policy tools are generally effective as they especially discourage unhealthy consumption among youth and low-income earners who are price-sensitive (World Bank, 2014). A recent global study showed that fiscal measures that lead to a 20 per cent increase in the retail price of sugary drinks would result in proportional reductions in the consumption of such products (WHO, 2016). The generated revenue could also be used to boost health spending. For example, when the Philippines introduced a law that increased tobacco taxes by more than eight times in 2013, it earned an additional \$980 million in tobacco tax revenue after the first year. The additional revenue was spent on providing health insurance premiums for nearly 15 million disadvantaged families (Osewe, 2016).

Less commonly used non-tax policy options can also help improve health outcomes but they require careful planning and implementation. For example, a user-pay arrangement, where patients contribute financially to cover a certain portion of health-care costs, would help cushion public health expenditure. However, given the need to ensure affordability of health care and access for all, a tiered payment approach based on income could be considered. Similarly, a public-private partnership (PPP) arrangement to build specialized health-care facilities could help ease fiscal burden. Another example of PPP is the provision of private health insurance schemes, including

microinsurance products that increase the affordability and scope of coverage to benefit the most disadvantaged groups of the population (Leatherman, Christensen and Holtz, 2010). The success of such schemes requires enabling policy settings beyond the health sector, such as regulatory frameworks relating to PPPs and mature domestic capital markets. These conditions are, however, not fully in place in most Pacific island developing economies.

#### **Addressing non-communicable diseases requires stronger and broader policy efforts**

Addressing NCDs has already been regarded as one of the policy priorities in Pacific island developing economies. For example, an NCD road map was adopted by the Joint Forum Economic and Pacific Health Ministers Meeting in 2014. Among other policy actions, the road map emphasizes the use of tax measures to discourage unhealthy consumption, the importance of targeted prevention measures and the need to strengthen the evidence base for greater programme effectiveness (World Bank, 2014). In this regard, tobacco taxes have been raised in recent years in several Pacific island developing economies, such as Fiji, the Federated States of Micronesia, Palau, Papua New Guinea, Samoa and Tonga. Moreover, Fiji, Samoa and Tonga increased taxes on sugary beverages, while Tonga raised taxes on turkey tails and instant noodles.

Despite achieving some progress, more policy efforts to address NCDs could be made. On the revenue side, there appears to be room for further increases in tobacco taxes, as noted in the road map: excise duties should be as high as 70 per cent of cigarettes' retail price over the medium term. At the same time, any hikes in taxes or tariffs on unhealthful products should be accompanied by legislative measures aimed at mitigating illegal trade and ensure policy effectiveness. On the expenditure side, available data suggest that spending on preventive measures remains inadequate, and a higher proportion of budgetary allocations need to be set aside for this purpose. During the period 2006-2007, less than 2 per cent of health funds in Samoa, Tonga and Vanuatu were used for preventive health-care promotion and activities (Anderson, 2013).

More broadly, tackling NCDs requires a multipronged policy approach. As highlighted above, NCDs are driven mainly by behavioural risk factors, such as unhealthy diet, tobacco use and physical inactivity. However, these risks are influenced by a broader set of factors, such as patterns of international trade, agricultural production and urbanization. A multifaceted policy approach is needed



to promote healthier lifestyles for the population. For example, the use of regulatory measures may be desirable, such as declaring smoke-free zones and imposing bans on advertising of unhealthy products during children's television airtime. On international trade policy, opening market access to healthful imported goods that are not locally available would make domestic prices of these products more affordable. At the same time, safeguards against unhealthy imported food and beverages need to be considered.

Finally, another policy area with great potential for producing gains is the more widespread use of information and communications technologies, which are important instruments of effective governance, to overcome the long distance between physicians and patients in this sparsely populated subregion. Examples include teleconferencing with patients in rural areas, seeking specialized opinions on patient cases and test results and instant messaging with a health practitioner for medical advice (Lewis and others, 2012).

Given the diverse characteristics of Pacific island developing economies and their varied national health-care situation, country-tailored fiscal policy measures are required together with an array of complementary policy choices.

## 4. EAST AND NORTH-EAST ASIA

### 4.1. Macroeconomic performance and outlook

Economies in East and North-East Asia continued to expand at the largely stable rate of 3.8 per cent in 2016. The pace previously, at 3.7-4 per cent in 2014 and 2015, was slower than the three years of 4.6 per cent growth recorded during the period 2011-2013. As growth in China has steadily come down since 2014 due to structural reforms favouring household consumption and services, the subregion's stable growth in 2016 was underpinned mainly by a slight economic rebound in Japan and the Republic of Korea. In the context of subdued global trade, economic expansion in these large economies was driven by domestic demand, such as large-scale infrastructure projects in China, increased social spending in Japan and residential construction in the Republic of Korea. Meanwhile, steady economic growth in the subregion masks years of economic contraction in Macao, China due to declining gaming revenues. In 2016, Mongolia also registered the first output decline in seven years owing to lower commodity prices and a decrease in foreign direct investment.

The subregion's consumer inflation rate reached a seven-year low of 1 per cent in 2016 as Japan resumed mild deflation after three years of price increases. The impact of Japan's new monetary policy framework, which features negative short-term interest rates and zero long-term interest rates, remains to be seen. Excluding Japan, inflation edged up to a still low level of 1.9 per cent for the subregion despite steeper price rises in China and the Republic of Korea that were driven by higher food prices. In Mongolia, which has historically recorded higher inflation than its subregional peers, inflation slowed relative to a high base in 2015.

Economic growth prospects in the subregion are likely to remain steady in 2017 and 2018 at 3.6-3.7 per cent. The Chinese economy is projected to continue its new normal growth trend. An uptick in growth performance in Hong Kong, China; and Japan, as well as a stable outlook for the Republic of Korea, should support the subregion's economic expansion. A key downside risk is uncertainty over the strength of global trade, which is clouded by interconnected factors, such as restrained import demand by China, increased economic certainty in developed economies and rising trade protectionism. Weaker-than-expected shipments could act as a significant drag on this export-oriented subregion. Another headwind is the pace of structural adjustment in China. Although the country's economic growth is set to trend downward at a steady pace given its gradual and prudent rebalancing, a sharper-than-expected slowdown could have a significant impact on smaller subregional neighbours that rely on China's commodity import demand, such as the Democratic People's Republic of Korea and Mongolia.

Burgeoning debts are undermining the subregion's economic prospects. China had an estimated 270 per cent debt-to-GDP ratio in 2016, mostly driven by the real estate sector and private firms. The country's rapid credit growth is increasingly a cause for concern amid capital outflows and domestic currency depreciation. In the Republic of Korea, the household debt-to-disposable income ratio exceeded 150 per cent, with many low-income households exhibiting limited capacity for repayment. In Japan, the size of government bonds continued to expand, although largely domestically, and the country's debt-to-GDP ratio is projected to exceed 250 per cent by 2020. Finally, in Mongolia large external debts have become less manageable, with a double-digit fiscal deficit-to-GDP ratio, and declining commodity revenues and foreign exchange reserves. Overall, the rising debt burden needs to be managed, although the balance between maintaining financial stability and reviving economic growth should be kept in view.

## China

China's economic growth has been on a downward trend in the past several years, as the country has implemented supply-side reforms aimed at shifting the economy's growth driver gradually from its excessive focus on manufactured exports and fixed investments towards household consumption and services activities. In 2016, growth moderated to 6.7 per cent from 6.9 per cent in 2015, although this rate was somewhat better than expected. As external demand remained subdued, economic expansion was underpinned mainly by consumer spending and public infrastructure investment. In addition to higher per capita disposable incomes, relatively low inflation and urban unemployment rates at 2 per cent and 4 per cent, respectively, supported private consumption in 2016.

Output growth is projected to soften further to 6.5 per cent in 2017 and 6.4 per cent in 2018. As supply-side reforms continue, industrial sectors are expected to grow at a more sustainable pace. On the demand side, consumer spending is likely to propel economic growth as exports are expected to improve only gradually in the wake of rising trade protectionism. Meanwhile, inflation is projected to edge up to 2.3-2.5 per cent during the period 2017-2018, with upward pressure from global commodity prices and the weaker domestic currency.

The outlook is subject to headwinds and downside risks. Monetary policy tightening in the United States could result in financial volatility and capital outflows, especially in the event that China's growth performance becomes weaker than expected. Capital account restrictions could help curb some volatility, although China's financial linkages with international markets have risen through (a) the inclusion since October 2016 of the renminbi in the IMF special drawing rights basket and (b) a growing number of currency swap arrangements. Domestically, high domestic indebtedness could act as a drag on economic growth. The liabilities of State-owned enterprises are estimated at about 115 per cent of GDP, which could undermine the country's fiscal sustainability, especially in the wake of a rising fiscal deficit. A notable increase in corporate debt is also a major concern.

On the policy front, structural reforms in 2016 were focused on reducing industrial capacity, housing inventory, corporate leverage and production costs. Some progress has been made in these areas. For example, the targets on steel production and coal capacity were achieved ahead of schedule, while lower tax rates and energy and logistics costs helped pull down production costs. For medium-term development, further reforms are

needed to tackle rising social inequality, address rapid urbanization and enhance energy efficiency.

## Hong Kong, China

The economy of Hong Kong, China expanded at a more modest pace, 1.9 per cent, in 2016 compared with 2.4-2.5 per cent in the preceding two years. As an export-oriented economy, the slowdown in growth was driven by subdued global merchandise trade, including more sluggish import demand from China. Domestic demand was somewhat stronger due to sustained government spending. Despite a relatively low unemployment rate at 3.4 per cent in 2016, private consumption was sluggish as a result of declining tourist arrivals and weak spending by local residents. Capital market volatility also weighed down domestic business confidence.

The outlook is set to improve, but only marginally, with growth being projected at 2.3 per cent in 2017 and 2.5 per cent in 2018. There are signs that goods exports to other Asia-Pacific economies picked up towards the end of 2016, although any improvement could be fragile. Fixed investment conditions are expected to improve in 2017 as major infrastructure projects are under way, such as airport runway expansion and the final-phase construction of a bridge that connects this densely populated urban centre with Macao, China. As in past years, consumer inflation is expected to remain relatively low at 2.5-2.7 per cent in 2017 and 2018. Recent cuts in power tariffs and an increase in stamp duties to cool down overheating housing prices also contribute to the outlook for modest inflation. Meanwhile, as one of the world's major financial centres, the economy of Hong Kong, China is exposed to a financial volatility risk due to monetary policy tightening in China and the United States. On the upside, financial services benefit from China's recent move to ease approval of initial public offerings and the increasing internationalization of the Chinese renminbi currency.

## Macao, China

The economy of Macao, China faced its third year of economic contraction in 2016, although the magnitude of the output fall, at 2.1 per cent, was remarkably smaller than the 20.3 per cent decrease recorded in 2015. Gaming sector revenues, which fuelled rapid economic growth during the period 2010-2013, have declined in recent years amid China's economic slowdown and anti-corruption initiative, both of which have deterred high-end visitors. Similar to service exports, merchandise exports continued to decrease, resulting in a wider trade deficit. On domestic demand, consumer spending remained cautious despite low inflation and unemployment rates,

at 2.4 per cent and 1.9 per cent, respectively, in 2016. Retail sales decreased, especially for high-value and luxury items, such as motor vehicles and cosmetics. Overall, the smaller output contraction in 2016 benefited from increased government consumption and a more modest decline in gaming and tourism revenues.

Near-term growth is projected to resume an expansionary mode, at 2.8 per cent in 2017 and 5 per cent in 2018. Such recovery is connected to new developments in a major hotel-casino complex and infrastructure projects, such as construction of a light railway network and a cross-islands bridge. The gaming industry is expected to record an upturn, shifting towards a mass market, although the outlook remains uncertain. Meanwhile, consumer spending could be held back by higher financing costs, as the local currency is tied to the United States dollar.

### **Democratic People's Republic of Korea**

The Democratic People's Republic of Korea does not publish official economic statistics. In 2016, the expansion of large-scale construction and improvements in food production as a result of agricultural reforms supported the economy. On the other hand, the economy was struck by several incidents. The closure of an important industrial zone in early 2016 has hampered bilateral trade with the Republic of Korea, which will likely have a negative impact on employment. Moreover, the severe flooding in mid-2016 caused extensive damage to infrastructure and agricultural outputs, while it also displaced many residents and aggravated conditions of undernourishment. Finally, the imposition of international sanctions in late 2016 has further depressed economic activity.

The economic outlook is expected to be weak. China recently announced that it would halt its coal imports from the Democratic People's Republic of Korea for the rest of 2017. As coal exports to China are that economy's major source of foreign exchange earnings and while trade in other minerals remains subdued, overall exports are expected to be severely affected. The planned increases in infrastructure spending are also likely to face a cutback due to lower government revenue. The overall economic environment is also clouded by international sanctions and shortages of power supply.

### **Japan**

Japan's economic growth stayed at a low level of 1 per cent in 2016, down slightly from 1.2 per cent in 2015. Household consumption and fixed investment drove the expansion. The average unemployment rate was low at 3 per cent in 2016 owing in part to the shrinking working-age population, while real wage levels increased

moderately. Exports were more sluggish due to the economic slowdown in China, which accounts for a quarter of Japan's shipments, generally weak demand for capital goods in emerging economies and appreciation of the domestic currency. The devastating earthquake in April 2016 also caused temporary supply-chain disruptions that dampened production and exports. Meanwhile, despite an intensive policy effort to raise inflation to a target rate of 2 per cent, Japan faced a mild price decrease of 0.1 per cent in 2016. The monetary authorities recently introduced a negative short-term interest rate and zero long-term interest rate policy, as well as an inflation overshooting commitment in order to achieve its price stability target.

The near-term growth outlook is stable, with projected growth at 0.8-1 per cent during the period 2017-2018. Consumer spending growth is likely to remain steady, supported by fiscal stimulus measures, such as higher social security spending, a postponement of a consumption tax hike to 2019 and investments in preparation for the 2020 Olympics. Increased corporate profits and tight labour supply would also promote private consumption. A key downside risk is deterioration in market sentiments. On the domestic front, a high level of public debt, at about 230 per cent of GDP at end-2016, in addition to a significant increase in social security spending further raises concerns over the country's fiscal condition. On the external front, increased economic uncertainty in developed markets and the divergence in monetary policy directions in Japan and the United States could lead to financial volatility.

Meanwhile, Japan's overall price level is set to rise by 0.8 per cent in 2017 and 0.9 per cent in 2018. The expected return to inflation is attributable to higher global commodity prices, depreciation of the yen and continued monetary easing, although these factors are counteracted by falling rents due to a surge in apartment construction.

### **Mongolia**

Economic growth in Mongolia slowed to 1.2 per cent in 2016 from a growth rate of 2.3 per cent in 2015 and average growth of 12.3 per cent during the period of the mining boom in 2011-2014. The plunge in global commodity prices and weaker demand in China mainly accounted for lower economic growth in 2016. Domestic demand was also subdued, as private consumption and fixed investments decreased. The unemployment rate increased to almost 9 per cent at end-2016. Meanwhile, the mining sector, which had propelled the economy in the past, experienced a drastic fall in foreign direct investment due to waning confidence and investor disputes. The

decline in mining revenues pushed up government debt to nearly 90 per cent of GDP, raising concerns over debt repayments. In this regard, the Government introduced austerity measures in August 2016 and availed itself of external financing assistance. An immediate policy priority is to demonstrate a credible fiscal consolidation plan and effective macroeconomic management.

Growth is projected to pick up to 2 per cent in 2017 and 3.5 per cent in 2018. An expected increase in global prices of coal and copper, higher coal export volumes to China and the expansion of a major copper and gold mine are some of the contributing factors. In addition, railway construction under China's Belt and Road Initiative and the signing of a transit transport agreement with China and the Russian Federation are expected to facilitate cross-border trade in this landlocked country. Beyond exports, the 25 per cent minimum wage hike that became effective in January 2017 could help ease the impact of fiscal tightening and support consumer spending. To promote medium-term economic development, the Government launched an economic recovery programme for the period 2016-2020, which includes the policy aim of diversifying the country's income sources to non-mining sectors, such as tourism and agriculture.

### Republic of Korea

The economy of the Republic of Korea maintained a stable growth rate of 2.8 per cent in 2016. Relatively solid performance in key industries, such as construction of residential buildings and investment in intellectual property, drove the economy. In contrast, the shipping and shipbuilding industry is undergoing restructuring, while weak automotive production was held back even more by labour strikes. From the demand side, private consumption benefited from low inflation and interest rates, relatively low unemployment and tax reductions, although the enforcement of the country's anti-graft law dampened spending on high-value gifts. As an export-oriented economy, overall economic growth in past years has been clouded by prolonged weakness in global trade.

Forecasts are for growth to remain moderate at 2.5-2.7 per cent in 2017 and 2018. The export outlook is fragile due to increased trade protectionism and trade-related disputes with China. While consumer spending would continue to benefit from favourable job market conditions and low inflation, its strength is being restrained by high and rising household debt, the diminishing positive effect of fiscal measures and a decline in manufacturing employment. To contain household debt, measures are in place for stricter screening of loan applications and borrowers' creditworthiness in financial institutions. As with other subregional peers, a downside risk includes possible

financial volatility as a result of increasing economic uncertainty in developed markets. Prospects of a buffer for the Republic of Korea are limited by the maturing currency swap agreements with China and suspended talks with Japan.

To maintain the competitive edge of its leading industries, the Government has introduced industrial restructuring, support schemes for the participation of small and medium-sized enterprises in global supply chain and various deregulation measures. On the social front, the issue of income inequality due to labour market dualism and rising youth unemployment merits attention. Moreover, such programmes as reverse mortgages and diversified income streams for elderly citizens could support future private consumption while addressing the issue of population ageing.

### 4.2. A selected policy challenge: role of governance in clean energy innovation policies

The major economies in East and North-East Asia are at the forefront of technological advancements and play an increasingly significant role in developing energy-efficient and renewable technologies. China accounts for the highest percentage of the world's patent filings in climate change mitigation technologies, such as biofuels, solar thermal and solar photovoltaics (Helm, Tannock, and Iliev, 2014). Similarly, Japan and the Republic of Korea have a high concentration of patents in fuel cells, cleaner coal, nuclear energy and electric and hybrid technologies (National Science Board, 2016). In terms of commercial investment in clean energy, the global share of China and Japan stood at 31 per cent and 13 per cent in 2014 respectively. In leading global investment in renewable energy, with investments valued at \$102.9 billion in 2015 (Frankfurt School-UNEP Centre and BNEF, 2016), China has also stepped up its overseas investment in wind and solar energy thanks to policy and financial support promoting outbound investment in renewable energy. In going forward, China, Japan and the Republic of Korea have committed themselves to double spending on research and development for clean energy over the period 2016-2020, with the aim of making clean energy more affordable.

Innovation in support of green growth has resulted in some early gains. For example, China's energy efficiency improved by 5.6 per cent in 2015, up from an average of 3.1 per cent per year over the past decade (IEA, 2016a). Excluding China, the global energy efficiency gain was smaller at 1.4 per cent in the same year. Recent data also point to some decoupling of economic growth from energy-related GHG emissions in the subregion. In Japan,

amid zero economic growth in 2014, total primary energy supply (TPES)<sup>1</sup> and carbon dioxide emissions decreased by 3-4 per cent. In China, when the economy expanded robustly at 7.3 per cent in 2014, TPES and carbon dioxide emissions increased modestly at less than 2 per cent. Nonetheless, despite the progress, East and North-East Asia consumes almost one third of global energy, while producing about one fifth of the world's energy output. China still accounts for almost half of the world's total consumption of coal, although this proportion is set to decline as the economy continues to restructure towards less energy-intensive industries.

### Selected policy experiences for other Asia-Pacific countries

The experiences of major economies in the subregion point to at least three desirable aspects of public policies and strategies in promoting clean energy innovation. These aspects include a well-designed governance structure, balanced policy mix of incentives and regulations and an enabling financial system. The list is clearly not comprehensive as other policy aspects, such as the need to develop a large pool of educated workers and to have an open trade policy to facilitate technology transfer, are equally crucial.

The first dimension is a governance structure that features green development as an integral part of national development plans, a whole-of-government approach to implement such plans and multi-stakeholder partnerships. At the strategic level, green development<sup>2</sup> appears prominently in the subregion's national plans. Ecological innovation policies in China, Japan and the Republic of Korea go beyond promoting niche green sectors and relate to achieving concrete targets, such as reduction of carbon dioxide emissions.

As part of well-designed governance structures, China, Japan and the Republic of Korea all adopted a whole-of-government approach to promote green development. In these countries, innovation policies are coordinated directly under their respective prime ministers' offices (ESCAP, 2016e). In the Republic of Korea, various ministries worked together to prepare comprehensive green growth plans at sectoral, local and national levels (Global Green Growth Institute, 2015). Such plans are linked with other relevant areas of public policies, such as market entry, human resources development and international cooperation and collaboration with the private sector. In Japan, the Council for Science, Technology and Innovation takes the lead in the formulation of the overall government budget for science and technology. To ensure that public spending on energy technology is effective, ex-ante, interim and ex-post evaluations of energy research and development are carried out in the Republic of Korea.

Another important component of governance structure is multi-stakeholder partnerships, particularly with the business sector and international entities, those run from development to diffusion of technological innovation. In Japan, the cross-ministerial Strategic Innovation Promotion Programme functions beyond the government framework, and each project director is responsible for coordinating with industry and academic entities on end-to-end focused research and development. Similarly, Japan's open innovation hub brings together industries, academia and government to engage in research, technical evaluations and standardization efforts. In China, a large proportion of funding on science and technology was given to large State-owned institutions, a situation which has led to the establishment of innovation start-ups and university demonstration bases.

The second desirable aspect of governance structure is a policy framework in which Governments consider the use of both economic incentives and regulatory policies. Examples of incentives include taxation on pollution and favourable pricing of renewable energy products. In Japan, the tax on emissions of sulphur oxides introduced in the 1970s led firms to undertake or adopt significant technologies to reduce pollution (Matsuno and others, 2009). In 2012, Japan introduced a feed-in-tariff system in which power utilities are required to purchase electricity from renewable energy sources for a certain amount of time at a fixed price. Such schemes served as an important driver in the early deployment of solar power, which now reaches more than 1.5 million households.

On regulatory policies, a common policy example is setting minimum energy efficiency standards. For example, Japan's Top Runner Programme set as the standard the efficiency of the most efficient product in a given category. China adopted a similar mandatory energy savings programme, with efficiency benchmarks, shortened schedules to achieve the standards and other policy incentives (IEA, 2016a). Another type of regulatory policy is the increasing share of renewable energy use. In the Republic of Korea, a renewable portfolio standards programme requires power companies to steadily increase their renewable energy mix in total power generation.

Evidence suggests that a balanced mix of economic incentives, regulatory policies and technological innovation is desirable. In China, research and development on green technology is a powerful driver of efficiency improvements when interacted with increases in energy prices (Du and others, 2016). When the renewable energy law was put into effect in 2005, China created a feed-in tariff system, with a mandatory connection and purchase policy and funding mechanisms. Similarly, an experience from the Republic

of Korea suggests that financial support to develop low carbon energy technologies may not effectively deliver the targeted reduction in emissions if complementary pricing reforms are not in place (Sonnenschein and Mundaca, 2016).

The third desirable aspect of governance structure is an enabling financing system. Access to finance by firms carrying out innovation is often limited because they are capital-intensive and involve a long payback period, if not unpredictable financial returns to research and development. Meanwhile, bank lending usually requires tangible collateral and has much shorter maturity. In the case of the energy sector, research and development spending is also hampered by various potential market failures, such as indivisibility and spillovers reducing private incentives for investments, and slow diffusion of technology.

Given the constraints on conventional financing products, countries have launched an increasing number of non-traditional, green instruments, such as green bonds, credits, development funds and carbon finance. China introduced green bonds, that is, it ensures that funds are applied exclusively to finance new and existing green infrastructure projects in order to help significantly scale up the use and development of renewable energy projects. China's guidelines on establishing a green financial system, released in 2016, include a series of policy measures to support and incentivize green investment, create a national green development fund and provide a mandatory environmental information disclosure system.

Fiscal support has helped to promote ecological innovation in the subregion. For example, subsidies have been granted to local governments in the Republic of Korea to support renewable energy and energy-saving schemes since the 1990s. More recently, nearly 80 per cent of the country's fiscal stimulus in response to the 2008 global economic and financial crisis was spent on green measures and investments (Barbier, 2015), although emphasis on ensuring positive impacts on the environment required greater attention. To catalyse investments in green technologies among small and medium-sized enterprises, which often lack a track record and financial soundness, the Republic of Korea has adopted a technology appraisal system as the basis for providing guarantees and insurance for such enterprises (Moon, Song and Lee, 2016). At a broader level, cross-country evidence shows that long-term policy stability and credibility are critical to ensure financing for innovative green ventures (Crisuolo and Menon, 2014).

### **Working together to achieve green development**

Given these policy experiences, a related issue is how the major economies in East and North-East Asia could collaborate with other subregional peers and beyond to secure green development in the Asia-Pacific region. Within the subregion, several factors present opportunities for greater cooperation: (a) the existing energy supply and demand, with China being the world's largest energy consumer; (b) scarce domestic resources in Japan and the Republic of Korea; (c) the potential for renewable energy production in Mongolia; (d) technological advancements; and (e) geographical contiguity.

There has been a wide range of regional partnerships through knowledge-sharing, capacity-building and financing facilities. On technical cooperation, a recent example is the "Enevolution" initiative launched by Japan to provide developing countries with a one-stop mechanism, including technical support, for preparing energy policies. Another example is the Green Technology Center-Korea, which links the Republic of Korea's public-private cooperative green technology research projects with the demand for green technology from developing countries. Finally, a new centre is planned jointly by China's National Energy Administration and the International Energy Agency to enhance collaboration in such areas as energy data, renewable energy policy analysis and clean energy technologies. China is also increasingly engaged in global energy governance to strengthen energy cooperation as well as take the lead in discussions involving energy interconnection and collaboration in sustainable energy (IEA, 2016b).

On financing, the Republic of Korea's International Joint Energy R&D Program since 2011 has provided financial aid for energy innovation through international joint research and development activities. Japan, through its Joint Crediting Mechanism, has financed projects in Mongolia and several other developing Asia-Pacific countries to facilitate the diffusion of low carbon technologies and implement mitigation actions.

### **Domestic reforms remain key to successful ecological innovation**

The role of domestic structural reforms in pushing forward green development cannot be overemphasized. Successful ecological innovation requires policy shifts on several fronts, such as reorganization of government agencies, amendments of energy and environmental laws and policy frameworks for unconventional financial products. The overall aim is to create an enabling condition that supports the business sector to carry out more innovation in respect of clean and efficient

technologies. In China and the Republic of Korea, the share of gross domestic expenditure on research and development in GDP roughly doubled between 2000 and 2014: to 2.8 per cent in China and 4.3 per cent in the Republic of Korea. As in Japan, large research and development spending in both countries is driven by private enterprises. China's research and development spending on renewable energy technologies rose to 4 per cent in 2015, reaching as high as \$2.8 billion and matching Europe's spending (Frankfurt School-UNEP Centre and BNEF, 2016).

Some progress is being made in lagging economies. In Mongolia where energy intensity remains high, the Parliament approved the Green Development Policy in 2014 and the Mongolia Sustainable Development Vision 2030 in 2016. Among other goals, the plans are aimed at increasing the use of innovative technologies in the production sector and reducing GHG emissions by 14 per cent from the current levels. However, the journey towards ecological innovation is a long one. In the case of the Republic of Korea, the initial policy focus was on promoting learning about technology (1960s and 1970s), then developing domestic research and development capability (1980s), before developing a more advanced innovation system in the 1990s (Chung, 2011). Overall, the ecological innovation track and related policies need to be adaptive to specific country circumstances. With limited resources, developing countries may focus on innovation that make existing technologies less expensive or adapt existing technologies for new uses.

## 5. NORTH AND CENTRAL ASIA

### 5.1. Macroeconomic performance and outlook

North and Central Asian economies expanded by 0.1 per cent in 2016, following the steep decline of 2.7 per cent in 2015. As the Russian Federation accounted for about 80 per cent of the total output of the subregion, the trend for North and Central Asia largely reflected an improvement in the output trend in the country. Excluding the Russian Federation, other subregional economies posted economic expansion of 1.5 per cent in 2016, down from 2.8 per cent in 2015.

In general, growth performance in net energy-exporting economies remained relatively weak. The Russian Federation faced the second year of recession in 2016. A slight rebound in global oil prices led to a stronger domestic currency and lower inflation, but the country's growth performance was hampered by international sanctions and domestic structural impediments.

Meanwhile, Azerbaijan faced a notable economic contraction while Kazakhstan registered a decade-low economic growth rate in 2016. In both economies, sharp currency depreciation in the second half of 2015 pushed up their inflation rates to double-digit levels in 2016. Together with high inflation, the increased debt burden and fiscal consolidation undermined consumer spending. Meanwhile, unlike in other energy exporters, economic growth remained high in Turkmenistan, as long-term contracts to supply gas to China provided some cushion from low global energy prices.

Beyond net energy-exporting economies, growth performance was mixed in 2016. In Tajikistan, strong investment to enhance the country's power-generation capacity supported economic growth despite lower workers' remittances and subdued prices for main export items, such as cotton and aluminium. Growth performance was also favourable in Uzbekistan, supported by a large fiscal stimulus package introduced in 2015. In contrast, output growth fell sharply in Kyrgyzstan due to lower gold output and reduced trade with China.

The near-term growth outlook is cautiously optimistic. North and Central Asia is projected to grow by 1.4 per cent in 2017 and 1.7 per cent in 2018. Excluding the Russian Federation, the forecast growth rates for these two years are 2.9 and 3.4 per cent respectively. The positive outlook is uncertain and contingent upon such factors as a further pickup in global energy prices and steady economic growth in China, which is the subregion's growing trading partner and investor. Investment projects under China's Belt and Road Initiative would also provide some boost to foreign direct investment. If coupled with a stable geopolitical situation in the subregion, favourable developments in such external conditions would support exchange rate stability and enable easing of monetary policy. Nonetheless, while the stronger exchange rates would help lessen financial risks arising from debts denominated in United States dollars, increased debt burden in recent years will continue to weigh down consumer and investor confidence.

The subregion's medium-term growth prospects depend crucially on its ability to diversify the growth drivers. Economic diversification is especially important due to an expected prolonged period of below-trend energy and commodity prices. For example, the sharp depreciation of subregional currencies would have supported manufactured exports, which are currently lacking. More vibrant economic activities beyond the resource-based sectors would also help promote inclusive economic growth in North and Central Asia.

### Armenia

Armenia's economic growth rate slid to 0.9 per cent in 2016 from 3 per cent in 2015. Lower output in the agricultural, construction and mining sectors contributed to the slowdown. Consumer spending was subdued, as remittance inflows, mainly from workers in the Russian Federation, fell sharply. On the upside, supportive fiscal policy and higher merchandise exports to the Russian Federation, which surged after Armenia's accession to the Eurasian Economic Union in 2015, underpinned an economic expansion in 2016. Meanwhile, the overall price level decreased by 1.4 per cent in 2016 amid weak household spending, low import prices of food and energy and a price cut for retail gas. To combat deflation, the policy rate was cut eight times in 2016 for a total of 250 basis points.

The near-term outlook is projected to edge up to 2.5 per cent growth in 2017 and 3 per cent in 2018. The expected economic rebound in the Russian Federation should help revive workers' remittances, which account for about 13 per cent of Armenia's GDP. Consumer spending, particularly by low-income households, also benefits from expansion of a family benefit programme. In addition, the construction of a rail link from the Islamic Republic of Iran to the Russian Federation via Armenia and Georgia would help promote economic activity. On the other hand, fiscal support would be less strong in coming years, as the government debt-to-GDP ratio has exceeded the statutory limit of 50 per cent, which calls for fiscal tightening. Meanwhile, following deflation in 2016, overall prices are projected to rise by 1.5 per cent in 2017 and 3 per cent in 2018.

### Azerbaijan

The economy of Azerbaijan shrank by 3.8 per cent in 2016, after subdued growth of 1.1 per cent in 2015. Low oil prices dampened the economy where resource rents from the oil and gas sector account for up to 40 per cent of GDP and three quarters of government revenue. Public investment contracted as a result of ongoing fiscal consolidation. Private consumption also declined following steep price rises, higher financing costs and lower levels of credit. Inflation surged to 12.4 per cent in 2016, from 4 per cent in 2015 following currency devaluation in 2015 and an increase in utility tariffs. To curb inflation, the policy rate was raised by a total of 12 percentage points over the year 2016. The currency depreciation not only pushed up inflation but also led to a greater degree of dollarization of deposits by households and weakened banks' balance sheets as non-performing loans increased. To ensure financial stability, various macroprudential measures were also introduced, such as

deposit guarantees, tighter conditions for foreign loans and higher requirements on foreign-currency reserves.

Near-term economic growth is projected to turn positive, although rather sluggishly at 0.2 per cent, in 2017 and 1.2 per cent in 2018. Inflation is set to decline but the projected rates of 7.9 per cent in 2017 and 5.8 per cent in 2018 remain higher than the past trend. The economic rebound would be supported by a pickup in global oil prices. However, fiscal tightening, in which spending under the budget for 2017 is about 13 per cent lower than under the 2016 budget, would weigh down non-oil economic activity. In general, low levels of market development and limited macroeconomic policy flexibility continue to undermine the economy's resilience to shocks.

### Georgia

Economic growth in Georgia slid slightly to 2.7 per cent in 2016 from 2.9 per cent in 2015. Growth rates in both years were low relative to the annual average of 4.8 per cent during the period 2012-2014. Economic growth has been constrained by subdued exports and workers' remittances as a result of weak economic activity in key external partners, such as the Russian Federation. In contrast, private investment was more robust, benefiting from lower borrowing costs and a notable increase in FDI in the manufacturing and financial sectors. Public spending also increased, particularly on social benefits to support the universal health-care system.

The growth outlook is set to improve to 3-3.5 per cent during the period 2017-2018. For both years, inflation should remain relatively low at 3.2 per cent. The main contributing factors are fiscal support measures, an increase in pensions and the implementation of infrastructure projects for an oil pipeline, a deep-sea port and hydropower plants. While the key headwind is uncertainty over the economic recovery in Europe and other subregional peers, the upside is the improved business environment that should attract additional foreign investment. Meanwhile, there are risks to macroeconomic stability that need to be addressed, such as the rising public debt and interest payments, a high degree of dollarization and low foreign exchange reserves.

### Kazakhstan

Output growth in Kazakhstan dipped further in 2016 to only 1 per cent from an already low base of 1.2 per cent in 2015. Exports shrank amid subdued commodity prices and more sluggish import demand in China and the Russian Federation. Household consumption increased only slightly due to strong price pressures. The inflation



rate jumped to a multi-year high of 14.7 per cent in 2016 following significant depreciation of the local currency in late 2015. As a result, the monetary policy stance remained tight. Overall economic growth in 2016 was underpinned by public investment, as reflected in expanding construction activity. Private investment was more subdued. Corporate profitability deteriorated amid the weaker exchange rate that pushed up the debt burden.

Economic growth is projected to rebound to 2 per cent in 2017 and 2.5 per cent in 2018. A major oilfield reached its commercial production stage in late 2016 so oil output is expected to rise in coming years. An expected increase in global commodity prices would also support exports and government revenue, which would improve the Government's ability to sustain its ongoing fiscal support. To finance the fiscal shortfall, transfers from sovereign wealth funds have been raised. For medium-term economic development, the country aspires to become a hub for Eurasian trade. Higher investment in transport infrastructure and logistics is being planned.

### **Kyrgyzstan**

The economy of Kyrgyzstan shrank by 1.1 per cent in 2016 from growth rates of 3.5-3.6 per cent in the preceding two years. The slowdown was driven mainly by lower gold production. In contrast, the construction and trade sectors expanded, which was reflected in a steady increase in fixed investment and retail sales. Unlike some other subregional peers, workers' remittances continued to rise, thus supporting consumer spending. Household consumption also benefited from low inflation, which dropped to only 0.4 per cent in 2016 from 6.6 per cent in 2015, as a result of lower food prices and appreciation of the domestic currency. Such low inflation enabled monetary policy easing, for which the policy rate was cut by 6 percentage points in 2016.

Economic growth is projected to edge up to 3.5 per cent in 2017 and 3.7 per cent in 2018. The outlook assumes a moderate increase in workers' remittances due to an economic rebound in major host economies, such as Kazakhstan and the Russian Federation. Despite the low base, inflation is expected to rise only modestly to 1.3 per cent in 2017 and 3 per cent in 2018. Soft price pressure and an increase in remittance inflows should help to sustain consumer spending. Meanwhile, gold output is also expected to rebound, although global gold prices are currently projected to trend downward in coming years.

### **Russian Federation**

The economy of the Russian Federation recorded a smaller economic contraction of 0.2 per cent in 2016 after

a decline of 3.7 per cent in 2015 and a subdued 0.6 per cent growth rate in 2014. A slight rebound in global oil prices helped lessen macroeconomic instability in the country. In particular, the domestic currency appreciated by almost 20 per cent in 2016 following a cumulative depreciation of about 80 per cent in 2014 and 2015 on the back of export slumps, international sanctions and the adoption of a floating exchange rate in late 2014. The stronger exchange rate helped lower inflation to 7.1 per cent in 2016 from a decade-high rate of 15.5 per cent in 2015. Despite reduced macroeconomic volatility, still low global energy prices and international sanctions accounted mainly for the recession in 2016. Domestically, stalled progress on structural reforms and declining fixed investments also weighed down the economy. Outputs in the domestic trade and construction sectors continued to contract.

Weak economic performance and lower disposable incomes have undermined social development in recent years. For example, the national poverty rate increased by 3 percentage points to 14.2 per cent in 2015. In this regard, the Government has launched economic support measures, such as recapitalizing banks, offering guarantees for State-owned enterprises and providing pensioners with unemployment benefits and lump-sum payments. Overall fiscal support is constrained by fiscal consolidation that is focused on spending cuts, although the budget allocated to social spending has been increased. To finance the increased budget deficit, the Government issued \$3 billion in Eurobonds, withdrew resources from a reserve fund and partly privatized State-owned enterprises in the commodity sector.

The growth outlook is set to improve, with growth projected to be 1.1 per cent in 2017 and 1.4 per cent in 2018, mainly due to relatively higher oil prices. The more optimistic outlook is, however, subject to uncertainty amid volatile geopolitical tensions. The prospect is also premised on the assumption of greater exchange rate stability, which would allow more policy rate cuts and help ease inflation further. In the medium term, implementation of structural reforms, such as those on promoting market competition, addressing a declining labour force and upgrading production technologies, would help to enhance the country's growth potential.

### **Tajikistan**

Economic growth in Tajikistan increased to 6.6 per cent in 2016 from 6 per cent in 2015. An increase in public spending and fixed investment mainly drove the more rapid economic growth, which was in line with higher output levels in the construction and industrial sectors. A \$500 million investment plan by Chinese investors

was announced, and the construction of a \$200 million metals-processing plant already began in mid-2016. Meanwhile, household consumption was less upbeat, as inflows of remittances from migrant workers in the Russian Federation dropped by almost 60 per cent. Consumer spending was also held back by higher inflation, at 6 per cent in 2016 relative to 5.5 per cent in 2015, on the back of steep currency depreciation in 2016. To curb inflation, the central bank raised the policy rate by 300 basis points in 2016. The banking sector is fragile, with the non-performing loan ratio being more than 30 per cent, especially due to liabilities generated by State-owned enterprises.

Output growth is set to moderate to 5-5.2 per cent in 2017 and 2018. Fiscal policy could be less supportive than in past years, as public debt is approaching the statutory limit of 40 per cent of GDP. On the upside, global prices of key commodity export items, particularly cotton and aluminium, are projected to rise steadily in the near term. Similarly, workers' remittances should rebound somewhat as a result of the modest economic recovery in the Russian Federation. A key uncertainty is whether citizens of the Eurasian Economic Union would be given preferential treatment, which could erode Tajikistan's remittance inflows as the country's membership in the Union is still being considered. As workers' remittances account for up to 40 per cent of GDP, any changes in remittance inflows could have a significant impact on household incomes and poverty reduction.

### Turkmenistan

Economic growth in Turkmenistan softened slightly to 6.2 per cent in 2016 from 6.5 per cent in 2015 and the average annual rate of 10.5 per cent during the period 2012-2014. Despite the slowdown in recent years, Turkmenistan's growth performance remained more favourable than that of most other subregional peers. Long-term contracts to supply gas to China have provided some shelter from subdued global energy prices, although these contracts are linked to global oil prices. The slight economic slowdown in 2016 was underpinned by weaker industrial conditions as a result of sluggish external demand, while ongoing fiscal consolidation led to reduced public investment and held back construction activity. In addition to cuts in investment spending, the fiscal consolidation plan is also aimed at increasing non-hydrocarbon revenue, privatizing State-owned enterprises and increasing the effectiveness of subsidy and social programmes.

After years of slower economic growth, Turkmenistan is expected to record higher growth at 6.5 per cent in 2017 and 6.8 per cent in 2018. The positive outlook is conditional upon higher prices for gas and steady

import demand from China, which is the country's major trading partner. In the event that gas prices are more subdued than expected, fiscal consolidation would have to advance more swiftly and depress domestic demand further. The public provision of gas, water and electricity that has been a central feature of inclusive social policy is under pressure, and consideration is being given to a needs-based system of social assistance.

### Uzbekistan

The economy of Uzbekistan continued to enjoy high economic growth at 7.3 per cent in 2016, although this was the first time in a decade that growth fell below 8 per cent. The robust economic expansion was led by higher public investment as part of fiscal stimulus programmes to promote industrial modernization, infrastructure development and agricultural productivity. Private investment also expanded well, benefiting from tax relief for businesses. Meanwhile, the economic slowdown in 2016 was mainly due to weaker exports of goods and services. In particular, shipments contracted in 2016 on the back of slower import growth in China, which is Uzbekistan's largest trading partner. Workers' remittances also decreased as a result of the economic recession in the Russian Federation. As in past years, inflationary pressure was strong in 2016. The inflation rate stood at 11.5 per cent, up from 10 per cent in 2015, and was driven by upward adjustments in administered prices, robust government spending and the currency depreciation.

Growth is projected to remain high at 7.4 per cent in both 2017 and 2018. An expected economic rebound in the Russian Federation should result in higher workers' remittances, while an uptick in global oil prices would support higher hydrocarbon revenues. The Government announced in December 2016 a plan to create new economic zones, which are aimed at attracting more foreign investment and promoting product diversification, especially in the processing of mineral resources and agricultural products. Meanwhile, a key headwind to the growth outlook is weak commodity import demand in China. On the upside, the fiscal space appears sizeable, with public debt at only 15 per cent of GDP at end-2016, and that space could be used to support economic growth.

## 5.2. A selected policy challenge: deepening integration for economic diversification

Ongoing economic stagnation in North and Central Asia since the collapse of global oil prices in mid-2014 reinforces the need to diversify the subregion's economic growth engine beyond the resource-based

sectors. Economic growth performance in the subregional economies is often volatile, largely influenced by global prices for a few commodities. For example, oil and gas account for more than 90 per cent of the total export value in Azerbaijan and Turkmenistan and more than half in Kazakhstan and the Russian Federation. Similarly, more than half of Kyrgyzstan's shipments are of gold, while copper ore and aluminium account for one third of the exports from Armenia and Tajikistan respectively. A more diversified economic base in resource-based economies also would help reduce economic volatility in countries that rely on workers' remittances, such as Kyrgyzstan and Tajikistan where workers' remittances (mainly from workers in the Russian Federation) are equivalent to about a quarter of their GDP. As global commodity prices are projected to remain below trend for an extended period of time, an effort to broaden the economic base of North and Central Asian economies in order to increase their economic resilience to external adverse shocks remains an urgent task.

Lack of economic diversification also undermines progress on achieving inclusive development. Recent economic recessions have led to slower employment growth, weaker ability of the Government to provide the poor with fiscal support and higher inflation as a result of weak exchange rates. As a result, poverty has increased in such countries as the Russian Federation, with a potentially negative impact on social development in its smaller subregional neighbours. Moreover, income inequality could rise further, as temporary and low-skilled workers earning lower pay tend to lose their jobs first.

### **New multilateral initiatives provide new opportunities for economic diversification**

Two emerging multilateral initiatives on trade and connectivity provide a new window of opportunity for economic diversification of North and Central Asia: the Eurasian Economic Union (EAEU) led by the Russian Federation and China's Belt and Road Initiative.

The Union aspires to become a single market with negligible costs for internal trade among members. Established in January 2015, the pact evolved from the customs union agreed in 2009 between Belarus, Kazakhstan and the Russian Federation. Armenia and Kyrgyzstan also joined EAEU in 2015, while Tajikistan is also considering becoming a member.

Parts of the EAEU agreement include abolishing customs controls between member countries, introducing customs procedures in electronic form and harmonizing trade rules. Such trade facilitation measures are expected to help reduce transportation time and trade costs among

member countries. Under the customs union, border-crossing time for trucks leaving Kazakhstan for the Russian Federation decreased from almost eight hours in 2011 to less than three hours in 2012 (ADB, 2012).

The trade bloc is also expanding its economic ties to global markets. In October 2016, EAEU ratified its first free trade agreement with Viet Nam, which eliminated trade barriers for the majority of traded goods and enhanced cooperation in such areas as e-commerce, intellectual property protection and public procurement. Moreover, EAEU has already initiated negotiations on possible trade agreements with China, the Islamic Republic of Iran, the Republic of Korea, Singapore and Turkey, among other countries.

In addition to creating a common market in goods, EAEU is evolving into a common market in services, energy and labour. For example, the pact allows service providers registered in a member country to operate in other member countries and permits access to natural monopoly services, such as electricity transmission and energy transport. In the medium term, a common market for electricity is envisaged by 2019 and for petroleum by 2025. The EAEU treaty also provides free movement of labour by eliminating quotas and mandatory work permits and by reducing the number of documents required for migrant workers.

The second emerging multilateral initiative is the Belt and Road Initiative (BRI), which, among other objectives, is aimed at improving infrastructure connectivity between China and Europe through the Eurasian landmass. First announced by China in late 2013, the primary goal of the Initiative is to promote freer flow of economic factors, such as capital, goods, services, energy and people, across Asia and the Pacific and beyond. One core element of BRI is the Silk Road Economic Belt, which comprises land transport routes between China and the rest of Asia and Europe. Of six economic corridors that have been proposed, three pass through North and Central Asia, namely the China-Central Asia-West Asia Corridor, the China-Mongolia-Russia Corridor and the New Eurasian Land Bridge Corridor. These aspects highlight the importance of North and Central Asia in overall BRI strategies.

The efforts to realize a more connected Asia-Pacific region are not new. For example, the project to create a highway network in Asia<sup>3</sup> has been ongoing since 1992. Similarly, several large-scale infrastructure projects that are being planned are also based on facilities that predate BRI, but the Initiative goes beyond improving the network of transport infrastructure. It also seeks to enhance trade,

finance, ICT and energy links and strengthen coordination of development policies and strategies across participating countries (China, 2015). What is also striking about BRI is its sheer scale. Most studies suggest that the Initiative could cover more than 60 economies with a collective GDP equivalent to about one third of global output and 40 per cent of global trade, involving a total population of more than 4 billion people.

### **New multilateral initiatives provide impetus for governance reforms**

EAEU and BRI are expected to promote economic diversification through at least two channels. The first channel is through enhanced infrastructure connectivity and reduced trade barriers, which can facilitate access to production factors and upgrade participating country's production capacity. In particular, access to inputs that were not available locally, such as raw materials and technology, can help these economies to increase the variety of goods that they can produce. Even when production factors are already available locally, greater access means that an economy is able to produce goods at more competitive cost, allowing it to participate effectively in global supply chains.

The second channel is through incentivizing Governments to improve their economic governance and push forward policy reforms that can make their economies remain competitive after the opening up of markets. For example, BRI could encourage a race to the top in providing the soft infrastructure essential to make new hard infrastructure productive, such as an enabling business investment in terms of reduced regulatory burden, policy stability and transparent legal framework. Thus, integration would not only help optimize the benefits of economic diversification but also serve as an impetus to governance reforms, producing broader benefits for the economy as a whole.

### **The Eurasian Economic Union and Belt and Road Initiative also pose some risks**

While offering many opportunities, EAEU and BRI also present economic and governance challenges to effectively manage regional integration. For example, while EAEU creates a more integrated trade bloc among members, the initiative may hamper trade with non-members because its imposition of a common external tariff and customs code and common external commercial policies, such as anti-dumping duties, discriminates against non-members. This situation could undermine overall efforts on economic integration in the subregion. For example, the previous customs union increased the average border-crossing time for trucks entering Kazakhstan from outside the union from less than 9 hours to more than 21 hours (ADB, 2012).

Similarly, BRI also presents economic, social and environmental challenges. At a broad level, relatively easy access to large foreign loans for infrastructure projects, even if most of them tend to be on a concessional basis, could undermine macroeconomic stability in small economies with underdeveloped financial markets and less effective debt management ability. On the environment front, unless properly managed, the relocation of heavy and natural resource-based industries out of China could adversely affect air quality and cause resource degradation in recipient countries. There is thus a need for an upfront assessment of environmental safeguards. On the social front, sections of the population could be marginalized, such as workers in industries that will no longer be competitive after the opening up of markets. Dealing simultaneously on all fronts could test the capacity of most Governments.

### **Ensuring the balance among governance, economic diversification and inclusive development**

If integration is to remain beneficial for economic diversification while paying sufficient attention to sustainable development issues, then economic governance will have to be improved. However, the quality of economic governance in North and Central Asia is often perceived as being less than desirable. As resource-rich economies, the urgency of having effective economic governance in the subregion has been weak because the Governments rely on resource revenues rather than on creating a vibrant market economy that generates tax revenues. In other words, attention was often diverted from productive activities to rent-seeking activities. Indeed, economic concentration in North and Central Asia is partly due to this aspect of governance. As a result, the extent to which EAEU and BRI will be able to help enhance the quality of national economic policy design and implementation and the time frame for doing so are highly uncertain.

Greater regional integration can contribute to improving the quality of economic governance. Membership in multilateral trade initiatives helps countries accept international norms and standards in such areas as intellectual property, consumer protection and transportation. In this regard, the rise in membership of North and Central Asian countries in the World Trade Organization since 2012 is an encouraging sign, as WTO promotes the principles of transparency, evidence-based assessment of trade barriers and due process of dispute resolution.

EAEU and BRI can help promote more inclusive development. For example, EAEU agreements on labour and migration reduce the number of documents

required by migrant workers, increase the time frame for registration and the permissible period of uninterrupted stay, grant social rights to the migrant's family, especially in education, and provide migrants with guarantees about information availability. These measures are important steps in regularizing labour migration. For BRI, faster and more affordable transport networks to new markets would tend to especially benefit agricultural exporters and smaller enterprises that are currently restricted to local markets but are hoping to link into global value chains. Large commodity- and resource-based companies have already established some export channels.

## 6. SOUTH-EAST ASIA

### 6.1. Macroeconomic performance and outlook

Economic growth in South-East Asia edged up to 4.5 per cent in 2016, from a 4.4 per cent expansion in both 2014 and 2015, but remains subpar relative to the average annual growth rate of 5.3 per cent during the period 2011-2013. The slight pickup in 2016 was underpinned by stronger growth in Indonesia, the Philippines and Thailand, which together account for more than 60 per cent of the subregion's output. Domestic demand, particularly consumer spending and public investment, drove the expansion in these economies. Meanwhile, both Malaysia and Singapore recorded a multi-year low economic growth rate in 2016 owing to subdued global trade, while Brunei Darussalam and Timor-Leste faced the fourth year of output decline as oil production contracted.

As in past years, economic expansion in less developed economies in the subregion, namely Cambodia, the Lao People's Democratic Republic, Myanmar and Viet Nam, remained generally robust at 6.2-7.2 per cent in 2016. Such rapid growth was driven by robust exports of manufactures or an increase in FDI inflows into the energy sector. The rapid economic growth in these economies helps narrow the income gap within the subregion, although the broader development gap remains wide (see the next subsection for more details).

Except for Myanmar, consumer inflation was generally modest and within the official targets in 2016. The low inflation environment was made possible because of subdued global energy prices and various domestic policy changes, such as cuts in administered fuel prices and a larger food import quota in Indonesia. Soft price pressures have enabled an easy monetary policy stance in most economies in the subregion. It appears, however, that lower financing costs have not boosted private

investment in most countries, given their large excess manufacturing capacity, fragile import orders and cautious investor sentiment.

Fiscal policy has been supportive of economic growth. Various fiscal measures were aimed at supporting consumer spending, such as an increase in the tax-free threshold in Indonesia, lower income tax rates in Malaysia and soft loans for farmers and cash transfers to low-income households in Thailand. Infrastructure investment, especially in transport and energy infrastructure, also played an important role in supporting the economic rebound in Indonesia and Thailand. Overall, despite being accommodative, the strength of fiscal support in countries, such as Brunei Darussalam, Indonesia and Malaysia, was constrained by subdued commodity revenues and the need for fiscal consolidation.

The near-term economic growth outlook is expected to improve further, to 4.7 per cent in 2017 and 4.8 per cent in 2018, with higher growth rates being projected for most economies. In general, the positive prospects are supported by an expected pickup in commodity prices and supportive macroeconomic policies. A key downside risk is possible delays in public investment projects. Outside the subregion, factors such as rising trade protectionism and weaker import demand in China could undermine the expected recovery of trade flows. Despite the overall positive outlook, the subregional economies continue to face various economic imbalances and structural constraints. Examples include the need to manage wide fiscal and current account deficits in the Lao People's Democratic Republic and Myanmar and high household debt in Malaysia and Thailand. Similarly, Brunei Darussalam, Cambodia and Timor-Leste would benefit from a broader economic base.

#### Brunei Darussalam

Brunei Darussalam, which relies heavily on oil and gas exports, recorded an economic contraction for the fourth year in 2016. The output level fell by 2 per cent after a cumulative output decline of 5 per cent over the period 2013-2015. Subdued growth performance was indeed recorded before the plunge in global oil prices in mid-2014 due to maintenance work on the country's hydrocarbon facilities. Fixed investment contracted in 2016 owing to weak activity in the oil and gas sector. Private consumption was stronger as a result of lower unemployment and fiscal support. In view of the lower commodity revenues, budgeted expenditure for the fiscal year ending in March 2017 was about 12 per cent smaller than that for the preceding year. Meanwhile, the overall price level continued to decrease, at 0.7 per cent

in 2016, after small declines in 2014 and 2015. Years of deflation were driven by low global commodity prices and various price subsidies.

Output growth is projected to resume positive growth at 0.8 per cent in 2017 and 1 per cent in 2018 due to higher global energy prices. In line with an expected rebound in economic growth, modest inflation is expected in 2017 and 2018. A major policy effort will be to develop a non-energy sector in the economy. Such economic diversification will improve the economy's resilience to commodity price shocks and help broaden the sources of government revenue. In this regard, the Government has focused on promoting foreign investment in such sectors as business services, *halal* (permissible or allowed) foods and tourism.

### **Cambodia**

Economic growth in Cambodia remained solid at 7.2 per cent in 2016. The economy has enjoyed at least 7 per cent annual growth since 2011. Exports of ready-made garments, accounting for about 80 per cent of total exports, continued to expand well as a result of privileges enabling countries such as Cambodia to gain market access in developed countries. As the sector is estimated to employ more than 600,000 workers, stronger garment exports also fuelled consumer spending. Private consumption was also supported by modest inflation, at 3 per cent in 2016, and rising tourist arrivals.

As for the outlook, growth is set to remain rapid at 7.1-7.2 per cent during the period 2017-2018. Exports are set to grow further, partly aided by higher prices for key agricultural items, such as rice and rubber. Consumer spending tends to benefit from such factors as an increase in the minimum wage for workers in the garment industry, a downward trend in the household debt level and a stable price outlook. A steady increase in FDI inflows would buoy overall investment conditions, although slower credit growth could hold back domestic investments. To manage rapid credit growth and promote financial stability, the central bank raised the minimum capital requirements for banks. Meanwhile, one of the Government's policy priorities is to enhance rural incomes as part of an effort to reduce poverty, which remained high at almost 18 per cent of the total population in 2012. For example, to support rice farmers who were affected by drought during the past two years, the Government waived value-added tax on agricultural products and offered low-interest loans to millers who buy rice at predetermined prices.

### **Indonesia**

Indonesia's economic growth picked up slightly to 5 per cent in 2016, from a six-year low rate of 4.8 per cent in 2015. Consumer spending drove the rebound in 2016 amid steady job growth, softer price pressure and fiscal measures, such as an increase in the tax-free threshold and an employment scheme aimed at helping drought-affected farmers. Goods exports fell by nearly 10 per cent as a result of low global commodity prices and weak commodity demand in China. Meanwhile, consumer inflation dipped to 3.5 per cent in 2016, from 6.4 per cent in 2015, largely due to a significant cut in administered fuel prices and approval for a higher quantity of imported food items. Given modest price pressures, the policy rate was cut six times in 2016 for a total of 150 basis points. Room for fiscal support is more limited, as revenue collection has been hampered by low energy prices.

Output growth is projected to rise further to 5.2 per cent in 2017 and 5.3 per cent in 2018. Private consumption would continue to drive the economy amid modest, within-target inflation. An expected increase in energy prices should support the recovery of exports. A downside risk includes exchange rate volatility as a result of the country's twin deficits and its close link to commodity exports. The growth outlook could be more upbeat if infrastructure investments, such as those in oil refineries, toll roads and railways, gain stronger momentum than had been expected. In addition to infrastructure investment, the Government is seeking to revive economic growth by attracting more foreign investment. Various measures have been introduced to simplify approvals of large-scale infrastructure projects and business licenses and raise the cap on foreign ownership in such sectors as tourism, logistics and e-commerce.

### **Lao People's Democratic Republic**

Economic growth in the Lao People's Democratic Republic remained high at 6.9 per cent in 2016, mainly propelled by construction in the hydropower sector. The country currently has 40 operational power plants, with an installed capacity of more than 6,300 megawatts. Another 35 projects with combined capacity of 4,500 megawatts are under construction. The country's ability to sustain currently wide fiscal and current account deficits depends crucially on the future revenue stream from hydropower projects. In particular, rising mining profits would help support government revenue, while power exports and lower imports of capital goods used for construction of hydropower projects would narrow the trade deficit.

The growth outlook is set to remain buoyant at 6.8-6.9 per cent in 2017 and 2018. As in past years, power exports and construction of hydropower projects would drive the economy. Higher global prices of main commodity export items, such as copper and coffee, will also support exports. Meanwhile, private consumption should remain strong, underpinned by low inflation, solid tourist arrivals and higher workers' remittances as a result of a steady economic rebound in Thailand. In addition to hydropower projects, the medium-term outlook likely benefits from the Government's effort to promote foreign investment through several special economic zones. Ongoing construction of a high-speed railway between Vientiane and the Chinese border will enhance cross-border connectivity in this landlocked country.

### Malaysia

Malaysia's output growth moderated to a multi-year low rate of 4.2 per cent in 2016 compared with 5 per cent in 2015 and 6 per cent in 2014. Total exports contracted as a result of low commodity prices and sluggish global demand for the main export items, such as consumer electronics. Subdued external demand constrained the need for additional business investment, although progress was made on various public investment projects, which are aimed at turning Malaysia into a high-income country by 2020. The economic expansion in 2016 was largely underpinned by private consumption, which benefited from fiscal measures, such as smaller employee contributions to the retirement fund and lower income tax rates. However, household spending also faced headwinds from a drought, weaker employment and high household debt levels. To support domestic demand, the policy rate was cut by 25 basis points in mid-2016, the first reduction in seven years.

Output growth is set to rebound marginally to 4.4 per cent in 2017 and 4.5 per cent in 2018. While exports could recover somewhat, the overall economic rebound will be driven by consumer spending. Fiscal measures will also support household consumption. For example, the budget for 2017 outlined an increase in cash transfers to low-income groups, although the overall strength of fiscal support is restrained by ongoing fiscal consolidation. Meanwhile, inflation is projected to trend upward in 2017 and 2018 partly due to policy changes, such as the phasing out of the cooking oil price subsidy and upward adjustments in retail fuel prices, but the projected rate of inflation remains within the official target of 2-3 per cent.

### Myanmar

Myanmar's output growth slowed to a still high rate of 6.3 per cent in 2016 compared with 7.3 per cent

in 2015. Foreign investment, mainly in the oil and gas sector, propelled the economy. Inflation remained elevated at 7.2 per cent in 2016, underpinned by such factors as the weak exchange rate, continued albeit decreasing monetization of fiscal deficits and high transport costs. To reduce such monetization, the first auction of kyat-denominated treasury bonds was held in September 2016; it raised \$160 million.

Growth is set to rebound to 7.5-7.6 per cent during the period 2017-2018. Foreign investment in energy and infrastructure projects will continue to drive economic expansion. The removal of the remaining sanctions on Myanmar by the United States in October 2016 will support mining exports. More broadly, the business sector would benefit from various measures aimed at reducing regulatory burdens. Meanwhile, inflation is projected to remain high at 8.5 per cent in both 2017 and 2018. On medium-term economic development, the Government unveiled its 12-point economic policy in July 2016, which emphasizes development priorities, such as transparent and sustainable natural resource extraction, a competitive private sector, including reform of State-owned enterprises, effective public financial management and agricultural development. As part of economic liberalization, the Government also introduced measures to promote financial sector development, such as granting additional licenses for foreign banks and allowing private banks to supply State-owned enterprises with foreign exchange.

### Philippines

Economic growth in the Philippines sped up to 6.8 per cent in 2016 from about 6 per cent in the preceding two years. Robust private consumption drove economic expansion thanks to higher workers' remittances, stronger domestic employment and modest inflation. Fixed investment also surged in 2016 as a result of a pre-election spending cycle and a notable increase in public works projects. Unlike domestic demand, external demand was much weaker. Total exports, in which electronics components account for a large proportion of the total, declined in 2016. In an effort to further increase spending on social services, the Government recently raised the ceiling on the fiscal budget from 2 per cent of GDP to 3 per cent in the period to 2022. Years of rapid economic growth have helped reduce the poverty rate, although it remained relatively high at almost 22 per cent in 2015.

The growth outlook is optimistic, with projected growth of 6.9-7 per cent in 2017 and 2018. Higher oil prices would help boost economic activities in the Middle East, which hosts many Filipino overseas workers. In addition to higher workers' remittances, fiscal support would support

household consumption. Budgeted government spending in 2017 is more than 10 per cent higher than that in 2016, with the increase being focused on education and infrastructure development. Capital investment is expected to expand favourably, given that industrial capacity utilization is at a multi-year high level. Meanwhile, the inflation rates in 2017 and 2018 are projected to remain below the past trend.

### **Singapore**

Singapore's economic growth was largely stable at the low rate of 2 per cent in 2016. Amid weak global trade, merchandise exports, which account for about 120 per cent of GDP, shrank in 2016. Fixed investment also contracted owing to a sluggish export-oriented production sector and subdued investment in housing. Meanwhile, despite the overall price decrease and supportive macroeconomic policy, private consumption growth moderated as unemployment edged up. The monetary policy aim has switched from gradual appreciation of the nominal effective exchange rate to zero appreciation, while public spending in the fiscal year ending March 2017 is set at almost 10 per cent higher than the previous year.

The growth outlook is expected to pick up to 2.2 per cent in 2017 and 2.5 per cent in 2018, mainly conditional on a revival in global trade. Projected economic growth remains below the past trend. Domestic demand is expected to strengthen somewhat, underpinned by stable employment conditions and supportive policy measures, such as higher corporate income tax rebates for small and medium-sized enterprises. A key downside risk is heightened trade protectionism, which would especially undermine economic growth in this trade-oriented economy. Meanwhile, part of Singapore's medium-term policy effort is to enhance productivity. The Government introduced an industrial transformation programme, which promotes automation and research and development through tax allowances, financial support and loan guarantees. It also co-funds wage increases for firms that have implemented productivity enhancement.

### **Thailand**

After years of an uneven output growth record, the Thai economy gained stronger momentum in 2016. Output growth reached 3.2 per cent, after a 2.8 per cent growth rate in 2015 and 0.9 per cent in 2014. Despite relatively high household indebtedness and widespread drought that held back farm incomes, consumer spending growth rebounded in 2016 as a result of robust tourism revenue and various fiscal measures, such as higher thresholds for personal income taxes and soft loans and tax breaks for farmers. Public infrastructure projects, mainly for transport

and water management, supported the overall fixed investment conditions. While benefiting from spillovers from public investment projects and low-interest loans, large excess industrial capacity has deterred new business investments. Meanwhile, export growth was virtually flat in 2016 as a result of slack external demand.

Growth performance is forecast to remain stable at 3.3-3.4 per cent in 2017 and 2018. Private consumption will continue to be supported by modest inflation and healthy tourist arrivals. Nonetheless, counteracting these positive factors are likely sluggish prices of key agricultural products, such as rice and rubber. On capital investment, a \$25 billion national infrastructure plan for 2017 is focused on transport infrastructure projects, particularly railways. To maintain a modest fiscal shortfall, the Government enacted inheritance taxes and introduced or increased excise taxes on such items as alcohol, cigarettes and diesel. Overall, the strength of domestic demand is conditional on smooth domestic political transition that is scheduled for early 2018 and adequate progress on the implementation of infrastructure projects. Both factors would help boost market sentiments.

### **Timor-Leste**

The output level in Timor-Leste is estimated to have contracted in 2016 for the fourth year, as a result of lower oil production due to ageing fields and subdued global energy prices. Oil production accounts for up to 80 per cent of the country's output. For the non-oil sector, output growth increased slightly to 5 per cent in 2016 from 4.3 per cent in 2015, supported by higher government spending. The private sector economy remained relatively small. With regard to the outlook for the future, non-oil output growth is set to trend up to 5.5 per cent in 2017 and 6 per cent in 2018. An expected rebound in oil prices should help boost capital investment, with some positive spillover effects on the non-oil sector. Modest inflation, in part due to the pegging of the country's currency to the United States dollar, would support consumer spending. On the downside, an almost 20 per cent spending cut under the 2017 budget would restrain the strength of domestic demand.

Economic diversification is key to Timor-Leste's medium-term economic development. The financing of public capital spending has relied heavily on withdrawals from the Timor-Leste Petroleum Fund, use of which is intended for developing non-energy sectors. As oil resources are depleting, there is a need to develop other growth drivers. In this regard, some policy effort has been made, such as ongoing development of industrial clusters, infrastructure development and special economic zones.



## Viet Nam

Economic growth in Viet Nam softened slightly from a high base of 6.7 per cent in 2015 to 6.2 per cent in 2016. The slowdown was more notable in the first half of the year, as adverse weather conditions depressed agricultural output and household consumption. Fixed investment conditions were generally solid, supported by FDI in the manufacturing sector. Unlike other subregional economies which have experienced export slumps, Viet Nam's exports expanded more favourably, mainly due to various market access privileges and relatively diversified export baskets. Service receipts also rose in 2016, as tourist arrivals increased notably.

The near-term outlook is positive, with projected economic growth of 6.5-6.7 per cent over the period 2017-2018. Exports are expected to remain buoyant in the face of stronger import demand from the United States, which accounts for almost a quarter of Viet Nam's shipments. Continued relocation of businesses in search of low-cost manufacturing activities, particularly in China, would support private investment. Private consumption would benefit from higher minimum wages and strong tourist arrivals, although more modest fiscal support and higher inflation are major drags on solid consumption. Inflation is projected to increase to 4 per cent in 2017, the same level as the official limit. To restrain the rising public debt level, partial privatization of State-owned enterprises is one of the main policy priorities. The Government announced in January 2017 a list of 137 such enterprises in sectors such as banking, mining, telecommunications and oil that it is seeking to partially privatize by 2020.

### 6.2. A selected policy challenge: narrowing development gaps through better governance

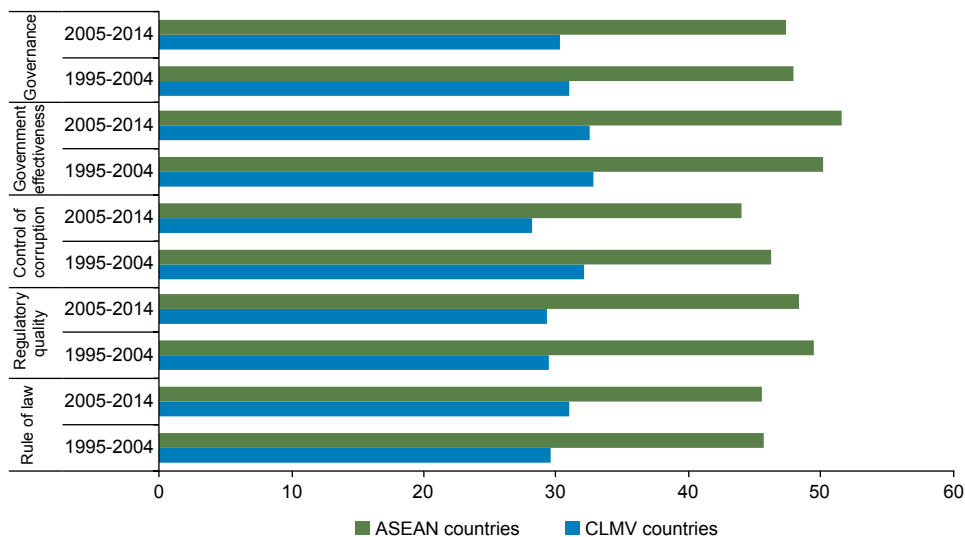
One of the key challenges for the South-East Asian subregion is narrowing the development gap within ASEAN between the later-entrant countries – Cambodia, the Lao People's Democratic Republic, Myanmar and Viet Nam (CLMV) – and those which had become members of ASEAN earlier. In income terms, the gap in the ratio of GDP per capita between the early-entrants of ASEAN and CLMV remains wide, although it has been gradually narrowing. The ratio stood at 10.6 in 2015 and 4.1 if the highest-income economy in the subregion, Singapore, is excluded. If concerted and coordinated measures are not taken to accelerate the narrowing of the income gap between the ASEAN-4 (Indonesia, Malaysia, Philippines and Thailand) and CLMV, it may take another 40 years to eliminate the gap completely.

Apart from income gaps, development gaps also exist in major socioeconomic areas. For instance, in the wake of technology-driven economic growth and the desire to integrate further into ASEAN, there is a need for CLMV countries to pay attention to their widening skills gap. Access to basic education has increased, but higher education and the quality of education remain a challenge. Similarly, while indicators of health in CLMV countries have improved significantly since 2000, the large gaps with other ASEAN countries remain. Active policy interventions will be required to ensure that higher income growth translates into lower poverty, less income inequality and better social outcomes.

Specifically, narrowing the income and development gap will require measures that increase the availability and quality of physical capital, as well as improve workers' skills and the availability of decent and productive jobs. In addition, there is a need to improve the economic fundamentals, wage and social protection systems and the effectiveness of fiscal policy. The need to narrow gaps in economic development of CLMV is particularly pressing given that deepening of subregional integration structures to fully realize the ASEAN Economic Community has already begun. Failure to close development gaps would run the risk that the economies of CLMV may be overwhelmed by more developed neighbours and may not take full advantage of the opportunities emanating from integration.

Underlying all of these policy measures, however, is the need to improve governance and institutional quality in CLMV as this is a prerequisite to undertake effective policies in the socioeconomic sphere to close the development gaps. There is a strong positive correlation between governance and institutional quality and economic growth and income levels, as is highlighted in the analysis in chapter 3 of the present publication.

Analysis of World Bank Worldwide Governance Indicators that relate to the rule of law, regulatory quality, control of corruption and government effectiveness shows that CLMV performed more poorly in all of these governance dimensions than their ASEAN peers (see figure 2.5). Moreover, for most of the indicators there has also been little improvement over the two periods 1995-2004 and 2005-2014. Indeed, control of corruption has deteriorated, whereas for other indicators performance has largely been unchanged apart from the rule of law, which has improved. In looking at the cross-country comparison of the latest period, CLMV continue to rank particularly low in control of corruption and regulatory quality, while there has been somewhat better performance in terms of the rule of law and government effectiveness.

**Figure 2.5. Governance indices in the CLMV group and ASEAN group, 1995-2004 and 2005-2014**

Source: ESCAP, based on Worldwide Governance Indicators (WGI) from Kaufmann, Kraay and Mastruzzi (2010).

Note: Worldwide Governance Indicators have been rebased to 100. High values of the indices represent a good perception of the institutional quality. The index "governance" is the average of the four indicators.

When considering the governance performance of individual countries in CLMV, there is considerable divergence. In general, Viet Nam is a better performer in the composite governance indicator and in most individual indicators, while Myanmar has the greatest deficit in both the composite and individual indicators. Whereas Cambodia shows substantially better performance in regulatory quality, Cambodia and the Lao People's Democratic Republic are in general in the intermediate position within CLMV for the composite and the individual indicators.

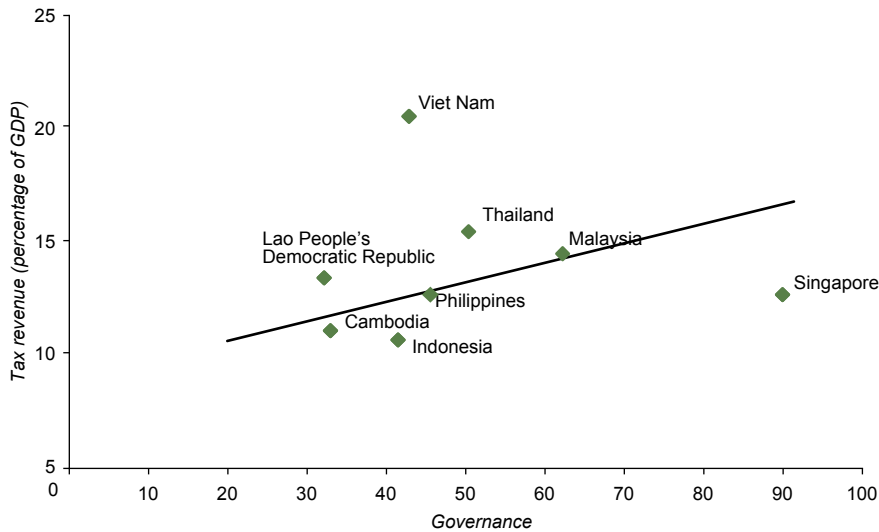
The importance of governance for socioeconomic development in CLMV can be seen by considering some of the relationships between their development indicators and governance performance. One key concern for CLMV is financing their development needs. Apart from external development assistance, this involves increasing domestic resource mobilization from both the public and private sectors. In the public sphere, governance affects the ability of these countries to raise tax revenue, owing to issues such as corruption in tax collection and low tax morale due to perceived governance deficits. The relationship between lower governance performance and low tax revenues can be seen in the examples of Cambodia and the Lao People's Democratic Republic (see figure 2.6). Governance deficits can also affect the availability of private sector credit, which is important to support development objectives. The relationship between lower governance performance and domestic credit to the private sector

can be observed in the cases of Cambodia, the Lao People's Democratic Republic and Myanmar.

Another important relationship for CLMV is between governance performance and social development, especially in the critical spheres of health and education. The efficiency of the provision of health and education services is affected by governance performance, particularly through the channels of corruption and ineffective administration. For example, the relationship between lower governance performance and health sector efficiency can be seen in the cases of Cambodia and the Lao People's Democratic Republic (see figure 2.7).

Among CLMV, the greatest governance challenge is currently being faced by Myanmar. This is not surprising as the country has been in a transition process since 2010 involving economic and political opening. Good governance is especially important for attracting investors during the economic opening of the country as it attempts to diversify from an economy based on natural resources. One of the key governance challenges is to increase bureaucratic efficiency. One way may be to increase salaries. While these have been increased rapidly in recent years, they still remain low, especially in comparison with newly available private sector jobs, including in foreign enterprises. The competition is highest in ministries with easily transferable skills, such as the Ministry of Planning and Finance and the central bank (Hendrix and Noland, 2015). Public sector reforms were

**Figure 2.6. Tax revenues and governance in ASEAN countries, 2010-2014**



Source: ESCAP, based on Worldwide Governance Indicators from Kaufmann, Kraay and Mastruzzi (2010).

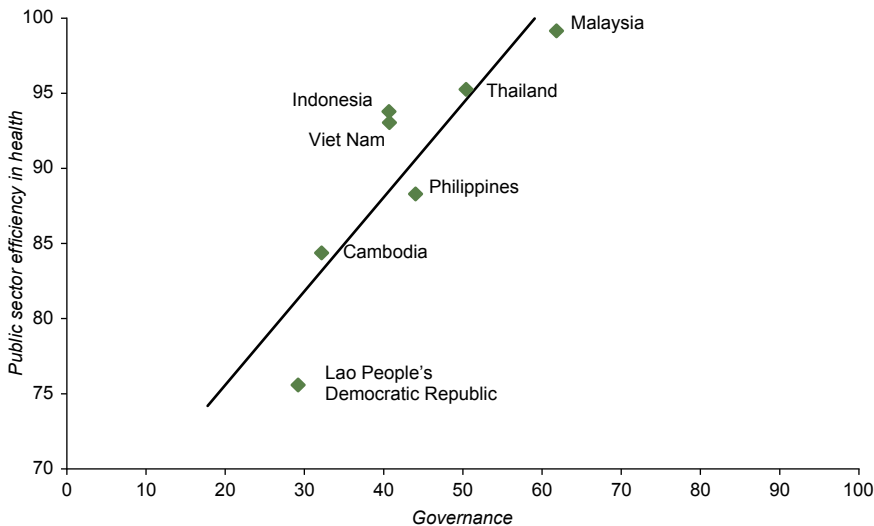
Note: Tax revenue data is the average for 2009-2013 for Viet Nam.

initiated in 2013, with the formation of interministerial committees to simplify coordination mechanisms, such as the National Energy Management Committee. However, these committees would be greatly aided in their work by having independent secretariats, as currently any policy proposals are returned to individual ministries for action. Another major challenge will also involve implementing effective decentralization of the bureaucracy. Although the 2008 constitution established state and regional governments, each with the power to levy taxes (Hook and others, 2015), bureaucrats are appointed by the national Government. This creates conflicting powers

of delegation for bureaucrats, especially with lines of delegation being further blurred by fewer line ministries at the regional level than at the national level, which results in multiple responsibilities.

The Lao People's Democratic Republic, while benefiting from good growth in recent years, remains the country with the lowest level of income per capita in the subregion. Corruption, which remains a significant barrier to accelerated development, has increased as a result of growth in the natural resources sector and an influx of foreign investment in recent years. However, the

**Figure 2.7. Public sector efficiency in health and governance, 2005-2014**



Source: ESCAP, based on Worldwide Governance Indicators from Kaufmann, Kraay and Mastruzzi (2010).

Note: Efficiency scores range between 0 and 100. An efficiency score which is equal to 100 would mean that the country is delivering the development outcomes by efficiently using the available resources.

government has been active in attempting to counter the problem through legislative action: in 2009 it ratified the United Nations Convention against Corruption<sup>4</sup> and in 2012 established an anti-corruption law. The State Inspection and Anti-Corruption Authority, which started working on investigation of corruption cases in 2014, would, however, benefit from further capacity development and specific investigative training. Currently, there is also underutilization of the criminal justice system in addressing corruption, with the authorities traditionally dealing with corruption through internal inspections but with few cases being brought to court. Some of the other challenges concern bribery and embezzlement in the private sector, which still have not been criminalized; liability of legal persons, which has not yet been introduced; and inconsistencies between the penal code and the anti-corruption law (UNODC, 2016). The country would also benefit from enhanced capacity for citizens and businesses to denounce corruption cases through advocacy, education and the improvement of the interface between citizens and the State Inspection and Anti-Corruption Authority.

Cambodia, another fast-growing country in the subregion, faces a particular challenge compared with its neighbours in terms of performance under the rule of law. Some of the key elements are judicial independence and enforcement of the law. The Government has undertaken various legal and judicial reforms, such as the “Rectangular Strategy”, which is centred on good governance and has key programmes on legal and judicial reform and fighting corruption, among others. The Government in 2010 created an anti-corruption unit in the Cambodia National Police. However, challenges remain in implementing legislation effectively. There are concerns that inefficiency, lack of training and lack of independence have had adverse impacts on the judiciary. Economic development is also affected by this situation with regard to property rights, with a key area being land acquisition (Dwyer and Sokphea, 2016). The country suffers from a lack of capacity across all sectors of the judicial system, including enforcement and the judicial, where salaries and available resources remain low. The country could also improve merit-based promotion and institute a tiered-pay system in enforcement, the police and the judiciary; eliminate the patronage system; enforce training standards; and make sure that recruits meet minimum requirements (Morrish, 2016). While the creation of the anti-corruption unit in the Cambodia National Police is a positive step, more can be done to increase the accountability of the justice system to the general public.

While Viet Nam performs better in terms of the above-mentioned governance indicators, it should undertake

more regulatory reforms to pave the way for the economy to move to upper-middle-income status. The Government has undertaken ambitious reforms recently: in 2016, Regulation 35 proposed regulatory reforms that would increase the private sector’s share of Viet Nam’s GDP from 43 per cent to 49 per cent; the Government also issued 50 decrees clarifying guidelines for enterprises and removing about 3,500 regulations, the most ambitious cutting of red tape in the country (Hoang, 2016). However, further work is required to reduce administrative burdens, overcome human resources constraints and simplify an overcomplicated, restricted and unclear licensing and regulatory environment (Vo and Nguyen, 2016). Particular actions which should be taken include improving the administrative environment through the simplification of laws and administrative procedures, reducing the scope for abuse by clarifying regulations and improving the pay of State employees and avoiding approving retroactive laws. Among specific regulations, those regarding tax should be revised in order to spur the growth of private enterprise and attract more foreign investment.

While many of the measures to alleviate these governance challenges will have to come through national policies in CLMV, policy coordination at the subregional level can also play an important role through the assistance of ASEAN. Actions that ASEAN could take include monitoring the relative governance performance of CLMV using readily available data, establishing strategic capacity-building and knowledge-sharing activities that target existing gaps and complementing national programmes. Another action includes establishing a more focused approach in capacity development programmes that target gaps in CLMV public services that are not being addressed through national programmes. CLMV could work closely with ASEAN counterparts to identify these gaps.

## 7. CONCLUDING REMARKS

For each Asia-Pacific subregion, there has been an examination in this chapter of recent macroeconomic developments and near-term prospects, and a discussion of selected issues that could be seen as case studies on how effective fiscal policy management and good economic governance can improve development outcomes.

On macroeconomic assessments, the chapter highlighted that growth prospects for the period 2017-2018 are cautiously positive across the subregions. In East and North-East Asia, Pacific island developing economies and South-East Asia, the outlook seems to be steady or improving slightly but the projected output growth in

all three subregions is below their past trends. In North and Central Asia, stronger economic recovery is expected but the prospects remain uncertain. Finally, the outlook for South and South-West Asia is more optimistic than for other subregions, although strong policy efforts are needed to tackle supply-side constraints to sustain rapid growth in the medium term. Overall, risks are tilted to the downside. Sluggish global trade would dampen the outlook for export-led East and North-East Asia and South-East Asia, while a weaker-than-expected uptick in global commodity prices would undermine economic recovery in North and Central Asia and the Pacific. At the same time, a steep rise in energy prices could bring back high inflation and widen trade deficits in South and South-West Asia.

On selected medium-term topics, the discussion highlighted the important role of effective fiscal management and economic governance in addressing social and environmental concerns and implementing structural reforms. For example, the balance between enforcing relevant laws and offering fiscal incentives is key to reducing economic informality in South and South-West Asia and promoting clean energy technology in East and North-East Asia. Experience also highlights the importance of careful design and implementation of fiscal measures, such as by reorienting public health spending towards preventive care in Pacific island developing economies, conducting independent evaluation of public research and development spending in East and North-East Asia and de-linking the provision of social assistance from employee contributions in South and South-West Asia. In these three subregions, partnerships also matter, whether these are with international development partners in the cases of South and South-West Asia and the Pacific islands, given their limited fiscal space, or with the business sector in the case of East and North-East Asia.

In the chapter, it has also been highlighted that, to cope with structural shifts in the external environment, Governments themselves would benefit from institutional rearrangements and greater capacity. In North and Central Asia, a policy effort to diversify the drivers of economic growth would be aided by new initiatives on regional economic integration, but actual economic gains would depend on the extent to which closer cooperation drives the Governments to cut red tape and improve the conduct of national economic policies. Similarly, in the less developed economies of South-East Asia, civil service reforms that lead to reduced corruption and improved cross-ministry coordination would enhance bureaucratic quality, which is a key component for any successful domestic structural reform.

## ENDNOTES

- <sup>1</sup> TPES is calculated as the sum of production, net trade and stock changes of fuels, such as coal and gas. Fuels are subsequently transformed into other energy forms, such as electricity.
- <sup>2</sup> Green development implies policies that either reduce resource use per unit of value added incrementally (relative decoupling) or keep resource use and environmental impacts stable or declining while the overall economy is growing (absolute decoupling). Absolute decoupling is essential for achieving sustainable development.
- <sup>3</sup> See the Intergovernmental Agreement on the Asian Highway Network (United Nations, Treaty Series, vol. 2323, No. 41607).
- <sup>4</sup> General Assembly resolution 58/4, annex.