



CHAPTER

2



PERSPECTIVES FROM SUBREGIONS

The Asia-Pacific region is vast, varied and rich in development experiences. Some countries are very large and some very small in terms of size of population, economy and geography. The economies of some are growing at a high rate; those of others have barely started to gather speed while some even remain static. Some offer world-class physical and financial infrastructure and, driven by high productivity, have become manufacturing and trade hubs in the global economy. Yet, some are quite poor, relying primarily on agriculture or a few commodities, and possess less-than-adequate connectivity with the rest of the world.

Consequently, the development challenges faced by the region are quite diverse. While some economies are struggling to cope with low commodity prices, others are reaping the benefits from such prices. Female labour force participation is high and adequate in some economies, but lags behind considerably in others. Differences in population dynamics and vulnerability to natural disasters are other examples. Even the aspects of economic stability, such as macroeconomic balances, financial markets, debt positions and inflation, along with associated policies, vary substantially across countries.

The purpose of this chapter is to share a glimpse of the mosaic that is the Asia-Pacific region. By being focused on subregional challenges and country-level developments, this chapter offers a better and deeper understanding of economic prospects, structural issues and the development potential of various subregions in Asia and the Pacific. This strategy allows for a better appreciation of the range of required policies and demonstrates that a one-size-fits-all approach to development cannot and should not be followed. Rather, the specific conditions of each country or at least different subregions should be evaluated separately keeping in view their respective historical context, social and political traditions and aspirations.

In **East and North-East Asia**, moderation in economic expansion in China and the Republic of Korea together with Japan's weak growth path and stubborn deflationary pressure depressed the subregion's economic expansion in 2015. The near-term economic prospects for this export-oriented subregion are not bright either, as global trade is set to expand only sluggishly in coming years. The Republic of Korea is the only economy in the subregion where growth is set to trend upward steadily over 2016 and 2017 amid revived domestic demand. Key uncertainties are whether China's medium-term growth will settle around 6.5% and whether the Japanese economy would return to a recession if its consumption tax increases in 2017, as planned. The upside is that in most economies in the subregion there is adequate room for fiscal and monetary policy support.

Moderating economic growth in China is partly policy-induced. This transition is indeed positive as long as progress that has been made on social development is not reversed. A more challenging situation could arise in such neighbouring countries as Mongolia, which has relied on China's demand for minerals to fuel its economic expansion in past years. As macroeconomic policy space to cope with China's slowdown is limited, slower growth in Mongolia is perhaps inevitable and could hold back the pace of poverty reduction in that country. More broadly, decelerating growth in China has recently been accompanied by growing concerns and heightened economic uncertainty, as reflected in global stock market selloffs in mid-2015 and again in early 2016. An immediate challenge is how to manage the transition in China without causing too many negative spillovers into the global economy.

Given that economic deceleration in China is already in its sixth year, subregional economies have been seeking to increase the role of domestic demand in

driving future economic growth. Despite some concrete policy efforts and examples of success, the adjustment has not been sufficiently rapid. This is largely because the transition is constrained by structural factors that evolve only slowly, such as a shrinking population in Japan, high retention of corporate and personal savings in China and neglect of non-export activities in the Republic of Korea.

The issue of an ageing population poses a serious threat to the economic and social development of the subregion. The size of the working-age population in all major subregional economies is projected to shrink after 2020 to the extent that older persons could account for up to one third of the total population by 2035. The impact of rapid population ageing on fiscal sustainability could be substantial as population ageing pushes up public spending on old-age pension schemes and health-care services, while it constrains revenue collection as a result of a smaller workforce. Although the subregion appears to exhibit adequate fiscal resources now, fiscal risks are rising. The issue of an ageing population can, however, be turned into an opportunity if adequately addressed. For example, the expectation of a longer life can increase the savings rate, which in turn would create a greater stimulus for investments and could lead to a "second demographic dividend".

In **North and Central Asia**, the subregional economies faced a marked deterioration in economic growth performance and heightened macroeconomic instability in 2015. In most countries, a deep plunge in global prices of oil, gas and minerals slashed export earnings and fiscal revenues, weakened terms of trade and resulted in steep currency depreciations and multi-year high inflation. International sanctions and stalled progress to tackle structural weaknesses also drove the recession in the Russian Federation. As the Russian labour market employs numerous migrant workers from its neighbouring economies, the recession dampened economic growth in non-oil, remittance-dependent subregional economies.

Although some analysts suggest that the economic turmoil may have bottomed out, the outlook is highly uncertain and would depend on oil prices and developments on the geopolitical front. Moreover, risks are clearly tilted to the downside. As a large share of bank credit is denominated in foreign currencies, debt burdens and overdue loans have surged due to exchange rate depreciation, thereby placing financial stability at risk. A key concern is that oil prices are expected to remain at low levels. Thus, the pressure that deterred economic growth in 2015 will persist,

with relatively less room being available for policy response as fiscal positions have weakened due to earlier fiscal stimulus measures and subpar energy revenue. Moreover, a dilemma arises in terms of monetary policy in the face of subdued economic growth, high inflation and the risk of further currency depreciation. Poverty has recently increased in the Russian Federation and could rise further amid a prolonged period of economic downturn.

The current economic turmoil serves as a striking reminder that the subregion needs to diversify its growth engine beyond resource-based sectors. Although infrastructure connectivity has improved in recent years, reforms to create vibrant business support services to complement a high value-added manufacturing sector are needed. Economic diversification calls for liberalization in both input and product markets. The policy challenge is to push forward deregulation, such as easing the process of market entry, while having in place strong regulatory bodies that protect consumer interests and ensure fair competition. Questions also remain regarding the desirable size and role of public enterprises in driving future economic growth in these economies where the role of the State has historically been dominant.

In the **Pacific** subregion, overall economic growth in 2015 was largely driven by higher production of liquefied natural gas in Papua New Guinea, which accounts for 60% of output in Pacific island developing economies. This situation masks much slower economic expansion and even contraction in other countries. Economic growth has traditionally been volatile, as economic activity has often been driven by movements in global prices of primary commodities, tourism receipts that are highly sensitive to economic conditions in source economies and one-off developments, such as natural disasters and subsequent reconstruction activities. The near-term growth outlook is set to weaken as capital inflows into Papua New Guinea's mineral sector have passed their peak levels, while dry conditions brought about by the El Niño weather phenomenon will constrain subsistence agriculture.

Given their small population size and land area and remote geographic location, Pacific island developing countries are highly exposed to natural hazards and meteorological extremes, such as cyclones, tsunamis, droughts and floods. The likelihood that a natural disaster will take place in one of the Pacific island developing countries each year is about one in five, which is greater than that faced by any other small States in the world. Because of their magnitude,

natural disasters seriously threaten the livelihood of people in the Pacific. For example, damage and losses caused by Cyclone Pam in March 2015, one of the worst natural disasters to affect Vanuatu in its history, were estimated to be equivalent to about 60% of the country's gross domestic output. The impact on the poor was even greater, given that they live in more disaster-prone areas of Vanuatu with less protected shelters.

As exposure to natural catastrophes is determined largely by geographic conditions, public policies have been focused on enhancing a country's ability to cope with natural disasters. In this regard, many countries have established large fiscal buffers to deal with the after-effects of such phenomena, while at the subregional level a natural disaster-linked insurance scheme was launched. Other initiatives are also under way, such as the construction of natural disaster-resilient transport infrastructure and a national budgeting process in which the cross-cutting nature of natural disasters is recognized. Nonetheless, the sheer scale of weather-related extremes calls for closer and perhaps more innovative partnerships between the Pacific islands and international development community.

In **South and South-West Asia**, India's economy is gaining growth momentum, underpinned by its steady, albeit uneven, progress on policy reforms to attract foreign investment and revive stalled infrastructure projects. The positive spillovers of stronger growth in India into other major economies in the subregion are below their potential in view of the limited trade and financial linkages that exist. For the near-term, optimistic prospects assume that structural reforms would move forward at a pace that keeps up with business expectations and improves market sentiments. As recent interest rate reductions have not translated into higher fixed investment, further reforms are needed to improve the business environment. The role of policy reforms in supporting future economic growth is particularly important for this subregion as room for countercyclical policies is somewhat limited.

There are signs of improvement in the subregion with respect to three persistent interconnected macroeconomic imbalances, namely large fiscal deficits, high inflation and wide current account shortfalls. Lower oil prices have resulted in a decline in inflation and have allowed fuel subsidy rationalization, leading to a positive effect on fiscal positions. Nonetheless, reforms to ease supply-side constraints, such as severe energy shortages and infrastructure deficits, are critical in reducing production costs and

promoting export competitiveness. Over the medium term, such reforms would help to relieve cost-push inflation and narrow current account shortfalls, thus promoting persistently greater macroeconomic stability in the subregion.

Despite a recent pickup, the subregion's economic growth remains below its high potential, which is supported by a young population and surplus labour in the agricultural sector. One option to close the output gap is by increasing the female workforce participation rate, which is one of the lowest rates in the world. Policy efforts have been made to overcome core barriers to women's work, such as enhancing the availability of and access to good-quality education and providing safe public transport to work in rural areas. Other policies are designed to offset disincentives for women to work, such as offering adequate parental and child-related benefits and taxation frameworks that reduce the net tax liability of working mothers. However, the key question is whether such policies are bold enough to alter deep cultural roots and social norms that discourage or even prohibit a role for women outside the household sector.

In **South-East Asia**, economic growth was stable at a low level in 2015. Merchandise exports declined amid China's growth moderation, but household spending in major economies was also held back by domestic factors, such as slower job creation in Indonesia and high household debt levels in Malaysia and Thailand. The near-term growth prospects would benefit from accommodative monetary policy stances and fiscal stimuli recently launched in larger economies. Countries with lower income levels would continue to enjoy relatively robust economic expansion, thus narrowing the development gaps between frontier economies and emerging economies in the subregion.

The ASEAN Economic Community, which became effective at the end of 2015, has as its major goal the promotion of a single market and production base in member countries, all of which are in the subregion. Lower import tariffs and less restrictive non-tariff barriers should provide a good opportunity for such countries as Cambodia, the Lao People's Democratic Republic and Myanmar to diversify their growth engines, although reforms to enhance the business environment are also needed to attract more foreign direct investment (FDI). While foreign investment helps to create more jobs, it may not necessarily benefit government revenue to the extent expected due to various tax exemptions and reductions that are in place. Such tax privileges also complicate tax administration and result in lower levels of compliance.

Such competition across countries in the subregion and beyond to attract more foreign investment by offering generous tax benefits is not always welfare-enhancing and should be addressed through stronger regional cooperation on tax matters.

More broadly, tax reforms are needed amid changing economic landscapes. For example, greater regional economic integration means that revenue from trade taxes tends to decrease, while capital becomes more mobile and difficult to tax. Moreover, as countries move up the income ladder, there will be more demand for better public social services and urban infrastructure amid a growing middle-class population and rapid urbanization. Critical to successful tax reform is the need to have more effective coordination among relevant agencies, such as departments within ministries of finance, foreign investment promotion agencies and local governments. Greater use of information technology in tax administration also matters, especially its capacity to help increase tax compliance through risk-based auditing and third-party information sharing.

1. EAST AND NORTH-EAST ASIA

1.1. Macroeconomic performance and outlook

China's growth moderation and Japan's stubborn deflationary pressure are constraining output growth in East and North-East Asia

East and North-East Asia experienced a largely stable economic growth rate of 3.3% in 2015. However, excluding Japan, growth slowed from 6.2% in 2014 to 5.7% in 2015, mainly due to declining merchandise exports as a result of an economic growth moderation in China and tepid global demand. The Japanese economy recovered marginally from the negative impacts of the consumption tax increase in 2014. Amid sluggish international trade, economies in the subregion have sought to rely more on household spending for sustaining economic growth. Private consumption was the largest contributor of output growth in all of the economies in the subregion, except in Mongolia where mining exports continued to propel the economy.

For the subregion as a whole, economic growth is expected to increase slightly to 3.4% in 2016. The key factor is the expected modest recovery in Japan, which will partially compensate the growth moderation in China. Economic growth performance is unlikely

to improve further in 2017 due to weak prospects in China and Japan, as the global trade outlook remains anaemic and Japan is scheduled to put into effect the second round of sales tax increases in 2017. Consistent with the growth outlook, inflation is projected to remain broadly stable and below 2% for the subregion as a whole in 2016 and 2017. Mongolia is an exception, where near-term inflation may approach 7% in 2017.

An increasing concern for the export-dependent economies in East and North-East Asia is the drastic deceleration in global trade in recent years. In 2015, global trade volume growth dipped below the 3.3% pace projected by the World Trade Organization (WTO) in early 2015. While continued weakness in global trade is a reflection of sluggish recovery in import demand in developed countries, an economic growth moderation in China also dampened exports in other subregional economies. From double-digit growth prior to the global financial and economic crises, China's imports shrank by 14.2% in 2015 relative to that of 2014. While that decline was partly due to tumbling commodity prices, import volume also contracted. In China, Japan and the Republic of Korea, their weaker currencies against the United States dollar do not appear to have helped boost exports.

While economies in East and North-East Asia recognize the need to shift to a more consumption-led growth path, structural impediments have made the transition difficult. In particular, efforts to raise productivity and income levels have faced several challenges. In China, while some progress has been made in terms of increasing the share of private consumption in total output, the savings rate is still close to half of GDP. Such a high savings rate is driven by the high retention rate of corporate earnings, low accessibility of affordable credits to households and inadequate social safety nets. These issues are being addressed by the Government, which is improving access to financial services for smaller enterprises and rural households and strengthening social safety nets, but it will take time for the reforms to have an impact on household and corporate behaviour. In Japan, productivity gains are difficult to achieve due to ageing and declining population size. In the Republic of Korea, relatively low productivity in non-manufacturing sectors is a result of the favourable treatment given to the export-oriented manufacturing sector, and this situation has yet to be adequately resolved.

At the same time, to overcome the sluggish recovery in global demand, East and North-East Asian economies increasingly turn to bilateral and multilateral

free trade agreements to boost trade. Following the sixth trilateral summit between China, Japan and the Republic of Korea, which took place in Seoul on 1 November 2015 after a three-year break, negotiations on a trilateral trade agreement are expected to gain momentum. In particular, the three countries agreed to kick-start the process of removing barriers to cross-border electronic trade.

China

Economic growth in China continued the moderating trend that started in 2010. The economy expanded by 6.9% in 2015 relative to the 7.3% growth rate in 2014. Exports shrank by almost 3%, while fixed investment, especially on equipment and machinery, was subdued. As a result, consumption was the largest contributor to output growth, supported by stable employment conditions, higher disposable income and low inflation. Consumer spending also benefited from a supportive macroeconomic policy stance. Fiscal spending increased, while the policy interest rate was cut twice in 2015. Lower interest rates and the easing of restrictions on home purchases that were put into place in 2013 to curb overheating in the property market underpinned the recovery of the housing market during the second half of 2015.

The financial sector experienced heightened volatility in recent years. After a 150% gain between June 2014 and June 2015, China's main stock market index underwent substantial corrections in mid-2015 and early 2016 on concerns over slower economic growth and devaluation of the currency, the renminbi. The impact of stock market volatility on consumption and investment is, however, expected to be modest, as equities still account for only a small portion of household and corporate assets. Capital outflow, sparked by speculative selling of the currency and the interest rate hike in the United States, resulted in record high net sales of \$466 billion in foreign exchange by banks in 2015. To stem speculative attacks, the central bank responded by intervening in the foreign exchange market and tightening controls on currency trade. A new 20% reserve requirement was imposed on all currency forward positions.

As economic rebalancing is moved forward, economic growth is projected to moderate further to 6.5% in 2016 and 6.3% in 2017. These projections are still largely in line with a minimum target for an economic growth rate of 6.5% during the country's 13th five-year plan (2016-2020). The plan places emphasis on the quality of growth. Under the plan, green

initiatives are to be better integrated into economic policies, particularly to address the growing problem of air pollution, through such measures as tougher emissions standards and more support for the use of non-fossil fuels.

Meanwhile, financial reforms to move the economy towards a more market-based system are expected to continue, including interest rate deregulation and increasing the flexibility of the exchange rate. These reforms are expected to help reduce transaction costs and benefit all other subregional economies which have deep and wide linkages with China. However, they may also increase the risk of short-term volatility with widespread spillover effects on a global scale, as was demonstrated by the recent turmoil in the Chinese stock and currency markets. Managing planned financial reforms towards a more open market system in the light of increased volatility is a pressing challenge for the Government.

Hong Kong, China

In the Special Administrative Region of Hong Kong, China, economic growth was largely stable at 2.4% in 2015. Overall expansion was underpinned by relatively solid private consumption on the back of strong labour market conditions, including a low unemployment rate of 3.3%, increases in household income and low inflation. In contrast, the export of goods contracted by 2.2% as a result of weak demand in China and developed markets. Exports of services also decreased marginally due to the decline in inbound tourists from mainland China and smaller receipts from transportation services. The lower level of tourist arrivals dampened retail sales, which have registered weak growth in recent years. Meanwhile, fixed investment conditions are mixed, with growth in construction investment being robust but slackening in machinery and equipment investment.

While economic growth is expected to slow to 2% in 2016 and pick up slightly to 2.3% in 2017, the export outlook remains anaemic. Domestic demand should benefit from recent measures, including tax relief, credit guarantee schemes for small and medium-sized enterprises and additional income support for the elderly and low-income households. The budget surplus maintained in recent years will provide a healthy buffer for accommodative fiscal policy. In contrast, the monetary policy stance will tighten, as monetary policy conduct in Hong Kong, China is effectively tied to that of the United States. The growth outlook will depend on how consumption and investment react to higher financing costs.

Macao, China

The economy of Macao, China contracted by about 20% in 2015 following drastic declines in tourism-related earnings and gaming sector revenues. The contraction started in 2014 after China's anti-corruption drive made it difficult to attract high-end tourists from China, the single largest growth engine of the economy of Macao, China. Despite the economic slump, fixed investment appeared buoyant in mid-2015, mainly owing to large-scale investment projects in tourism that had been planned. As a result, the unemployment rate was low at 1.8% in mid-year, while labour earnings also increased. Inflation was moderate at 4.6% in 2015.

The economy is projected to contract further by 2.7% in 2016. The increased supply of gaming facilities in recent years and greater competition in the tourism sector in the Asia-Pacific region are likely to put pressure on corporate profits and overall economic growth. A freeze on government spending in response to falling tax revenue will also hold back output growth. Meanwhile, economic growth is set to rebound to 4.6% in 2017, assuming that the adjustment cycle comes to an end. Investments on non-gaming entertainment facilities that have been made in recent years should also help to attract a more diversified range of tourists and improve the economy's medium-term outlook for growth.

Democratic People's Republic of Korea

While official economic data are limited, available data suggest that the economy of the Democratic People's Republic of Korea has grown more rapidly in the past few years¹ than in the more distant past, supported by rising mineral exports to China and higher production at the Kaesung Industrial Zone. The agricultural sector is less robust, as a poor harvest was reported for the second consecutive year. According to the Food and Agriculture Organization of the United Nations (FAO), drought and flooding caused a 12% reduction in rice production, leading to a drastic reduction in food rations for households, when most households were already estimated to have borderline and poor food consumption rates.²

The Government continues to increase its efforts to attract FDI into the country. In 2015, a special economic zone was developed in North Hamkyung Province, making it the twentieth special economic zone to be set up since 2013. The operation of these special zones is, however, contingent on fragile

relations with the Republic of Korea. For example, the Republic of Korea suspended production in the Kaesung Industrial Zone in February 2016 to protest nuclear testing by the Democratic People's Republic of Korea. On the outlook for the future, the economy is likely to experience a slowdown in 2016, mainly due to China's lower demand for minerals.

Japan

The economy of Japan resumed positive output growth in 2015, expanding by 0.5% from zero growth in 2014. Growth performance was, nonetheless, weaker than expected amid the economic slowdown in China which constrained business investment and exports. Although the currency depreciated by 20% in 2015 relative to the United States dollar, partly as a result of expansionary monetary policy, exports did not appear to benefit from the weaker exchange rate. Meanwhile, the economy continues to face deflationary pressure. After a rise in inflation to 2.7% in 2014, which was driven by the consumption tax hike, inflation decreased to 0.8% in 2015 on the back of sluggish economic activity and lower commodity and food prices. Monetary easing would continue until the inflation target of 2% is met.

Economic growth is projected to increase to 1.1% in 2016. Solid employment conditions, with an unemployment rate of about 3% at end-2015 and increases in real wages would support consumer spending. Growth is, however, expected to be slightly restrained, to 0.7% in 2017, due to the impact of the scheduled sales tax increase in April that year. Overall, the near-term growth outlook is clouded by more modest fiscal support at a time when fiscal consolidation is needed. The Government is trying to consolidate fiscal debt levels which reached 245% of GDP in 2015, and achieve a primary budget surplus by 2020.

Mongolia

Mongolia's economic growth slowed significantly to 2.3% in 2015 compared with an average annual growth rate of 10.6% in the preceding three years. The slump was underpinned by sharp declines in mining sector investments, weaker external demand for coal and copper, particularly from China, and deteriorating terms of trade. Fixed investment decreased in 2015 due to a notable decline in FDI as investments relating to the first phase of the Oyu Tolgoi mine project came to an end.³

Amid concerns over rising public debt which more than doubled from approximately 40% of GDP in 2010

to nearly 90% in 2015, the Government cut spending in 2015 by about 4.2%. The Fiscal Stability Law was amended in early 2015; it set the new fiscal deficit ceiling at 5% of GDP and will decrease it further to 2% of GDP by 2018. Moreover, off-balance sheet spending through a development bank, which uses proceeds from selling government-backed bonds to finance public investment projects, will be reined in. Despite fiscal tightening, public debt increased as the Government made up for the shortfall in FDI by mobilizing external financing. Meanwhile, monetary policy was also tightened by phasing out the price stabilization programme which provides low-interest rate credit to suppliers of oil and food and contributed to the rapid growth in credit in recent years.

Economic growth is likely to weaken further in 2016 to 0.5%, before recovering slightly to 1% in 2017. Production in the Oyu Tolgoi mines would be sluggish, while global commodity prices are set to remain subdued. Fiscal and monetary policy support will also be modest. On the positive side, an agreement was reached on the second phase of the Oyu Tolgoi mine project, which is estimated to cost \$5.4 billion, and that should help revive the inflow of FDI.

Republic of Korea

The Republic of Korea registered weaker-than-expected output growth of 2.6% in 2015, down from 3.3% in 2014. Falling exports, particularly heavy-industry goods, such as machinery and shipping vessels, mainly explain the slowdown. Consumer spending and tourist arrivals were dampened by the outbreak of the Middle East respiratory syndrome-coronavirus in mid-2015. In response, the Government introduced a \$9 billion supplementary budget, and the fiscal deficit for 2015 increased slightly to 3% of GDP. The country's monetary policy stance also eased to support economic growth amid low inflation. The benchmark interest rate was cut to a record low of 1.5% in June 2015. Together with public policies to support home ownership, low financing costs helped to revive the housing market and the construction sector. Meanwhile, the labour market was relatively stable. Wage levels increased by about 3% in 2015. The unemployment rate was also low, although youth unemployment and informal employment are reported to have increased.

The growth outlook is projected to improve slightly, to 2.9% in 2016 and 3.1% in 2017. Recovery in consumer spending is expected to be the main driver of growth, although its strength would be held back by high and rising levels of household debt.

A possible rise in interest rates is a downside risk, which could undermine the recent rebound in real estate investment. As in past years, the downturn in global trade will limit overall economic growth in this export-oriented economy.

1.2. A selected policy challenge: population ageing and fiscal sustainability

The working-age population in all major subregional economies is expected to shrink after 2020

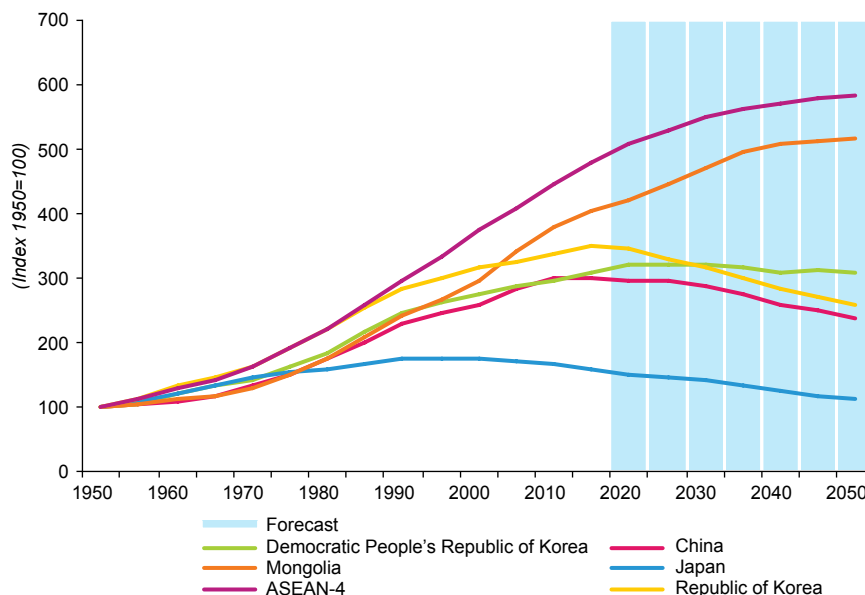
East and North-East Asia is experiencing unprecedented population ageing. The combined population of the subregion in 2015 accounted for about 22% of the world's total population, while the population aged 65 or older in the subregion constituted 29% of older persons worldwide. It is estimated that, by 2035, the share of the older population in the subregion would increase to 31% of the total for East and North-East Asia (United Nations, 2015). Japan has the highest proportion of people aged over 65 in the world, and the country's population size is already shrinking. Similarly, the pace of population ageing

is rapid in China. The proportion of people aged 65 or older in the total population is projected to increase from 6.7% in 2000 to 12.1% in 2020 and 27.6% in 2050. As shown in figure 2.1, all major economies in the subregion, except Mongolia, are likely to face a declining working-age population after 2020. In comparison, the working-age population in the ASEAN-4 countries (Indonesia, Malaysia, the Philippines and Thailand) will continue to grow and reach a plateau only after 2050.

Population projections are based on current levels of fertility and longevity, which change only slowly over time. Adjustments to demographic shifts through net migration could take place more swiftly. However, the subregion's net migration levels have been low, mainly due to the importance placed on homogeneity and national identity. Furthermore, the sheer magnitude of the migration levels required to mitigate the impact of population ageing would make doing so an ambitious strategy. It is estimated that Japan would need to accept more than 600,000 immigrants a year until 2050 in order to keep the size of its working-age population constant at the 1995 level (United Nations, 2001).

Figure 2.1

Working-age population, 1950-2050



Sources: United Nations, Department of Economic and Social Affairs. Available from <http://esa.un.org/unpd/wpp/Download/Standard/Population/>

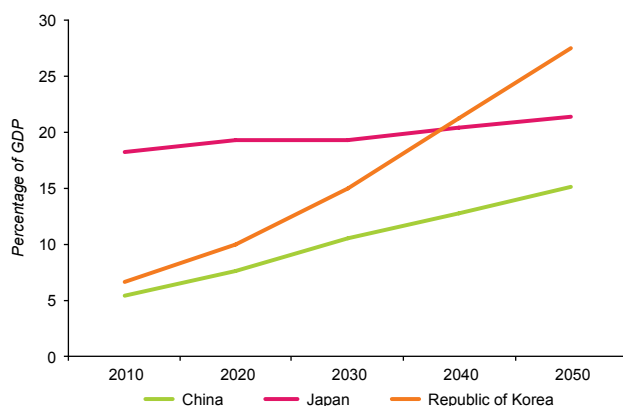
Broad-based policy reforms would help to maintain fiscal sustainability amid rapid population ageing

The impact of rapid population ageing is enormous and multifaceted. Of particular concern here is the impact on fiscal sustainability. On the expenditure side, population ageing is increasing the fiscal burden of old-age pension schemes and health-care services. On the revenue side, a smaller workforce constrains a country's potential for economic growth and undermines the collection of government revenues. A key question is whether fiscal positions in East and North-East Asian economies will be strong enough to cope with future rises in spending and potential declines in revenue.

Figure 2.2 depicts the projections of age-related government spending, comprising pension, health care, long-term care and unemployment benefits in China, Japan and the Republic of Korea during the period 2010-2050. It shows that all three countries are likely to experience considerable increases in public expenditure to support their ageing populations. The greatest increase in age-related spending is expected in the Republic of Korea, to nearly 30% of GDP in 2050, because the potential support ratio, or the ratio of persons aged 20-64 to persons aged 65 and older, is projected to decrease rapidly in the coming decades. In particular, this ratio for the Republic of Korea is projected to fall from 16.1 in 1980 to only 1.5 in 2050. These ratios are 13.2 and 2.1 in China, and 7.5 and 1.4 for Japan, respectively, during the same time period.

Figure 2.2

Total age-related spending as a share of GDP, 2010-2050



Sources: ESCAP, based on Standard and Poors, "Global aging 2013: rising to the challenge", *RatingsDirect*, 20 March 2013.

In terms of the fiscal space needed to tackle an ageing population, three economies in the subregion, namely China; Hong Kong, China; and the Republic of Korea, still have relatively low levels of public debt and have room to cushion future increases in expenditure. In Mongolia, while public debt levels are higher and have raised concerns in recent years, population ageing is progressing at a much slower pace than in other subregional peers. On the other hand, Japan has been facing fiscal pressures at a time when population ageing is already at an advanced stage. Nevertheless, while fiscal consolidation is certainly needed in Japan, public debt is viewed as stable as the Government holds large amounts of assets; net public debt was approximately 90% of GDP in 2013. Also, the central bank holds nearly one third of all outstanding government debt. These factors have enabled government bond yields to remain low despite the high levels of debt.

In the light of the projected demographic changes and growing age-related spending, the subregional economies have implemented various policy reforms to improve the well-being of older persons while keeping government debt at manageable levels.⁴ In 2015, the Government of China abolished the one-child policy and removed the dual-track urban pension system under which government employees were exempted from making pension contributions. In Japan, recent measures included extending employees' pension insurance to more part-time workers, shortening the period needed to be eligible for the national pension from 25 to 10 years and setting up a new pension service to reduce the operating cost of public pension schemes. Finally, the Republic of Korea undertook extensive pension reforms, extended mandatory severance-pay plans to firms with five or fewer workers, increased childcare benefits and a lump-sum grant on birth and set up an electronic information system for collecting social security contributions.

A number of European economies with ageing populations, such as Spain and Greece, have undergone painful pension reforms in the recent past. They experienced growing intergenerational tensions as the pay-as-you-go schemes relied on current pensions being supported by current workers who would then receive a lower pension due to the shortfall in contributions when they reached retirement age. This experience suggests that it is critical to start early to implement and sustain reforms in order to avoid abrupt adjustments and massive build-ups of debt. Doing so would help to ensure orderly payments of ageing-related expenditures, such as health-care costs.

An urgent priority for East and North-East Asian economies is therefore to maintain fiscal sustainability through tax reforms. In a recent study, it was found that, given a currently low tax-to-GDP ratio, there is significant room to raise taxes without causing major economic distortions in China, Japan and the Republic of Korea (Poesoro, 2015). Recent efforts to increase tax revenues in the subregion include the sales tax increase in Japan in 2014; the Republic of Korea is considering adding another income tax bracket at the top end of the pay scale. Beyond maintaining fiscal sustainability, there is need to provide a social protection floor, increase female labour force participation, raise the retirement age, and use other untapped labour potential, such as persons with disabilities.

2. NORTH AND CENTRAL ASIA

2.1. Macroeconomic performance and outlook

Declining global commodity prices and stalled progress in policy reform in the Russian Federation have resulted in recessions in North and Central Asia

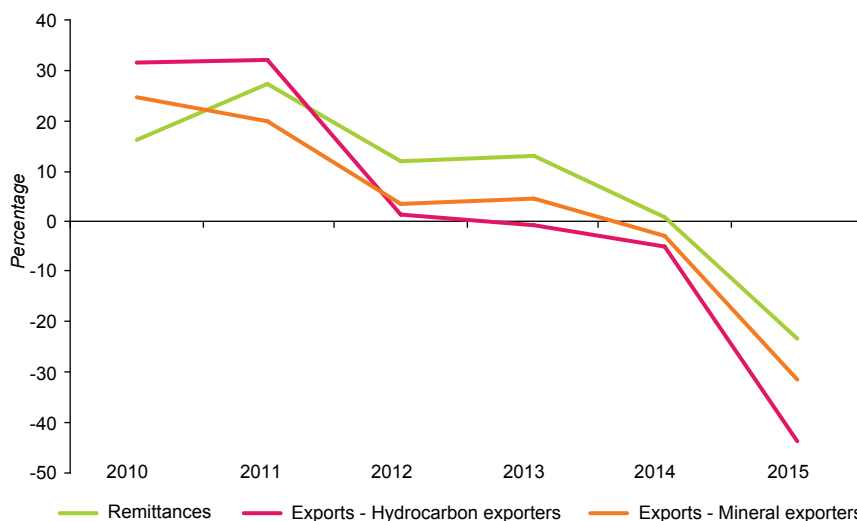
The North and Central Asian subregion is facing difficult macroeconomic conditions. After a subdued 1.4% economic growth rate in 2014, subregional output

contracted by 2.6% in 2015 amid a deep recession in the Russian Federation. Excluding the Russian Federation, which accounts for about 80% of output in the subregion, other economies did experience some expansion. However, at an average economic growth rate of 3.1% in 2015, this is a notable moderation from the 5.4% growth rate recorded in 2014. Sluggish growth was mainly due to low global prices for oil, gas and minerals, which led to steep declines in commodity exports from the subregion (see figure 2.3). In Azerbaijan, Kazakhstan, the Russian Federation and Turkmenistan, oil and gas account for more than 70% of total exports.

Meanwhile, the economic contraction in the Russian Federation was also driven by international sanctions and persistent structural weaknesses. Migrant workers form a large proportion of the labour force in the Russian Federation. Economic contraction, combined with policies that made it more difficult for migrant workers to obtain patents and work permits, contributed to the return or unemployment of many migrant workers, which led to reduced remittance flows from the Russian Federation. Remittances in 2015 are estimated to have decreased by almost half in United States dollar terms, or more than \$10 billion (United Nations, 2016). As a result, non-oil economies that rely heavily on worker's remittances, such as Armenia, Kyrgyzstan and Tajikistan, were also affected by the recession.

Figure 2.3

Annual changes in workers' remittances and exports, 2010-2015



Sources: ESCAP based on data from World Development Indicators database of the World Bank, Interactive database of the United Nations Conference on Trade and Development, and CEIC Data. Available from www.ceicdata.com.

Note: The mineral-exporting countries depicted by the green line are Armenia, Georgia, Kyrgyzstan and Tajikistan. The hydrocarbon-exporting countries depicted by the red line are Azerbaijan, Kazakhstan, the Russian Federation, Turkmenistan and Uzbekistan.

Plunges in commodity exports and deteriorating terms of trade exerted a significant depreciation pressure on the subregional currencies. After the float of the ruble in November 2014, the Russian Federation's currency depreciated by 66% for the whole year and by another 13% in 2015 (see figure 2.4). Dramatic depreciations were also recorded in 2015 in Azerbaijan and Kazakhstan. Available data would indicate that some interventions were made to reduce exchange rate volatility. For example, foreign exchange reserves in the Russian Federation declined by almost 25% in 2014 and another 10% in 2015. In Kazakhstan, reserves are reported to have declined by more than 10% in 2015. The main risk associated with steep currency depreciations is the surge in debt servicing costs, as up to 20-65% of total loans are denominated in foreign currency (United Nations, 2016). The increased debt burden weighed down already fragile consumer and investor confidence. Rebuilding corporate and household balance sheets will also take time.

Other economies sought to maintain exchange rate stability by imposing foreign exchange controls. While such measures often offer short-term palliative benefits, they incur other economic costs and thus should be removed when stability returns. For example, controls have led to the burgeoning of unofficial markets in which exchange rates are reported to exceed the official rates by a factor of two.

Rising exchange rate and financial instabilities came at a time when monetary policy is facing complex

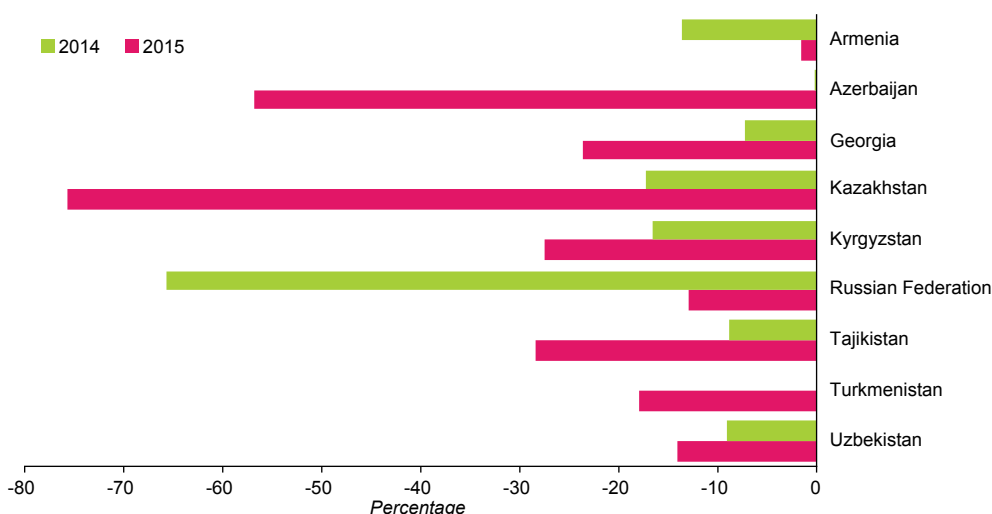
trade-offs: inflation is rising; the process of currency depreciation may not be at its end; and economic growth is anaemic while the highly dollarized financial sector is under stress. Consequently, while tighter monetary policy will send credible signals on containing inflationary pressures, excess tightening may depress business-led revival of economic growth. In some countries in the subregion, higher interest rates may signal an overt attempt at defending the domestic currency. The pace of taking a credible path thus is a difficult balancing act that will rest on the level of credibility of central banks.

The near-term economic outlook is not too bright, despite the expectation that recession in the Russian Federation will bottom out in 2016, and economic growth in all other economies may show a slight improvement. This cautionary assessment takes into account that the distribution of risks remains skewed to the downside. Key downside risks include slower-than-expected economic growth in China which is the subregion's growing investor and trading partner, a drawn-out period of low oil prices and further currency depreciations that will further push up foreign liabilities among corporate debtors.

Medium-term growth prospects depend crucially on more substantial structural reforms. The North and Central Asian subregion needs to diversify its economic structure in order to achieve inclusive economic growth, especially amid an expected prolonged period of low energy and commodity prices. The subregion has the potential to diversify from coal, oil and

Figure 2.4

Percentage change in currency values between January and December against the United States dollar, 2014 and 2015



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

gas into renewable energy sources. Diversification into other economic activities by tapping into global value chains is also more feasible given recent improvements in transport and electricity infrastructure. Investments in hard infrastructure projects, such as the Turkmenistan-Afghanistan-Pakistan-India natural gas pipeline, have for the first time in more than a decade produced tangible progress in cross-border connectivity. Meanwhile, with Kazakhstan's accession to WTO in 2015 and Azerbaijan's accession under way, only Turkmenistan and Uzbekistan in the subregion remain outside WTO. These developments augur well for improved and deeper economic integration in the subregion over the medium term.

Armenia

Economic growth in Armenia moderated to 3% in 2015 from 3.5% in 2014. The decline in remittances from migrant workers in the Russian Federation and tight monetary policy constrained consumer spending. Overall growth was supported by the opening of a new copper mine and higher agricultural output owing to favourable weather. Increased government expenditures, especially on public health, education and initiatives to promote the country's transition towards a knowledge-based economy, also underpinned the economic expansion. Together with declining revenues from value-added tax and import tariffs, higher government spending resulted in the fiscal deficit of 2.3% of GDP in 2015 compared with a surplus in 2014. To shore up underperforming revenue, the Government issued a \$500 million, 10-year Eurobond in March 2015. Meanwhile, tight monetary policy and subdued private consumption helped to keep inflation slightly below the 4% official target.

Output growth is projected to soften further to 2.5% in 2016, before picking up slightly to 2.8% in 2017. The outlook for 2016 is weighed down by expected economic contraction in the Russian Federation that would further dampen workers' remittances, which account for about 13% of GDP. Other key headwinds are lower government spending amid fiscal consolidation and weak exports due to low prices for metals and minerals.

Despite relatively sluggish economic growth in past years, the medium-term economic prospects could be boosted by Armenia's accession to the Eurasian Economic Union that became effective in January 2015. Membership in the Union tends to benefit the country concerned through lower import prices for energy, enhanced access for exports amid lower tariffs and reduced non-tariff barriers, and mobilization

of external financing in infrastructure connectivity projects. Migrant workers are also expected to benefit from more secure working conditions in the Russian Federation. Moreover, the Government's increased focus on innovation as a strategy for sustainable development coupled with an educated workforce is expected to bring new sources of growth and diversification.

Azerbaijan

Azerbaijan's economic growth moderated to 1.1% in 2015 from 2.8% in 2014. Low oil prices dampened the economy where resource rents from the oil and gas sector account for up to 40% of GDP and three quarters of government revenue. Despite a sharp decline in revenue, public capital expenditure, especially in the non-hydrocarbon sector, increased and that supported economic growth. As a result, the country's consolidated fiscal balance, which includes the State oil fund, shifted from a surplus of 3.4% of GDP in 2014 to a deficit of 5.3% of GDP in 2015.

As in other economies in the subregion, plummeting oil and gas revenues have put depreciating pressure on the domestic currency. The central bank devalued the manat currency by 33.5% in February 2015. However, as the pressure continued and foreign exchange reserves plunged, the manat was floated in December 2015. For the whole year, the currency depreciated by almost 60%. The steep depreciation pushed up imported inflation, and overall price increases rose to 4% in 2015 from 1.5% in 2014.

Near-term growth prospects are weak, with the projected pace being 0.3% in 2016 and 1.2% in 2017. The expansion is likely to be driven by non-resource sectors, as oil prices are anticipated to remain at low levels. The Government announced spending cuts of 10% in the 2016 budget so fiscal support would be more modest. Meanwhile, bank lending conditions could be stricter, especially for foreign-denominated loans, as overdue loans increased by more than 25% in 2015. Tighter credit conditions and higher inflation would undermine consumer spending. Over the medium term, structural reforms, such as enabling policies for the development of a diversified business sector, improved competition and transparency, and enhanced regional integration, will remain critical for reducing vulnerabilities and supporting the potential for growth.

Georgia

Economic growth in Georgia slowed from 4.6% in 2014 to 2.8% in 2015. As a non-oil economy, the

deceleration was attributable largely to subdued economic activity in the subregion and in the European Union. Manufacturing output and exports dipped, especially shipments of automobiles, the country's largest export item. Workers' remittances, which account for 11% of GDP, also declined amid an economic contraction in the Russian Federation. The economic expansion in 2015 was driven mainly by the construction and financial sectors.

Despite weakening demand, benign food prices and a tight monetary policy stance, the weaker exchange rate pushed up the inflation rate from 3.1% in 2014 to 4% in 2015. The central bank, which has adopted an inflation-targeting regime, raised the policy interest rate five times in 2015 for total increase of 400 basis points. Fiscal support was moderate, and the budget deficit was maintained at around the targeted 3% of GDP, despite emergency spending after floods in June 2015 and higher-than-estimated health-care expenditures.

The growth outlook is projected to be largely stable at 2.7% in 2016 and 3% in 2017. The key headwinds are a fragile economic recovery in the European Union and expected sluggish import demand in the subregion. In addition to lower remittances, an increase in debt servicing of foreign-currency loans would weigh on consumer spending. On the upside, low oil prices would help keep inflation at levels lower than in most other subregional economies, although this would be conditional on a stable exchange rate. Over the medium term, for a non-oil small economy such as Georgia, private sector development that promotes export diversification and higher quality of education to boost productivity are some of the key reforms needed for building resilience to volatilities in the external environment.

Kazakhstan

Economic growth in Kazakhstan dropped to a six-year low of 1.2% in 2015 compared with 4.3% in 2014. Merchandise exports fell amid lower global commodity prices and deep currency depreciation in the Russian Federation, which restricted the demand for Kazakhstan's exports. The trade deficit thus widened and put depreciating pressure on the domestic currency. After interventions to maintain the soft peg between the tenge and the United States dollar, the central bank abandoned the peg in August 2015, which is also in line with its transition towards an inflation-targeting monetary framework. As a result, the currency depreciated by about 75% and pushed up inflation in the latter part of the year. To keep inflation at a manageable level, the policy rate

hike of 10.5 percentage points took place between September and December 2015.

To cope with slower economic growth, the Government increased spending on social programmes and schemes to support the non-oil sector, such as small-scale businesses and relief for homeowners whose mortgages are dollar-denominated. Given sharp declines in revenue, capital expenditures have been reprioritized, while the budget is being partly supported by \$2 billion in loans from multilateral development banks, the issuance of Eurobonds worth \$4 billion and the use of additional resources from the sovereign funds.

Economic growth is projected to soften further to 0.5% in 2016 before recovering modestly to 1.5% in 2017. Subdued oil prices and exports, fiscal tightening and higher inflation are the main drivers of the sluggish near-term economic outlook. On the upside, the construction sector would benefit from preparations for Astana Expo-2017. Recent policy reforms, such as privatization of public assets and amendments to the labour law designed to attract foreign investments, should also help to revive market sentiment. More generally, the recently announced structural reform agenda that is focused on introducing more liberal policies, strengthening market competitiveness and enhancing economic diversification would help support Kazakhstan's medium-term growth outlook.

Kyrgyzstan

Economic growth in Kyrgyzstan was largely stable at 3.5% in 2015. Higher production and exports of gold boosted the economy in the first half of the year. Non-tax revenues from the gold sector enabled the Government to maintain the fiscal deficit at about 5% of GDP in 2015, despite higher spending on social programmes, public sector wages and capital expenditure in the months before the October elections. Growth performance, however, deteriorated in the second half of 2015 amid declining workers' remittances and a slowdown in gold exports, which weakened consumer spending and domestic investments. Meanwhile, despite depreciation of the currency by 28% in 2015, inflation softened to 6.6%, as price increases were constrained by weak household spending while monetary policy remained tight.

Economic growth is projected to moderate to 2.5% in 2016, as gold production will remain weak. A rebound by 4% in 2017 is expected, contingent upon stabilization in global commodity prices and revived economic activity in the subregion. Similar to the

case of Armenia, the accession of Kyrgyzstan to the Eurasian Economic Union in May 2015 is expected to help boost the country's economic development through higher workers' remittances. The economic gains would, nonetheless, be limited until Kazakhstan and the Russian Federation, the two major member countries of the bloc, resume stronger growth momentum.

Russian Federation

The economy of the Russian Federation shrank by 3.7% in 2015, after having recorded a subdued growth rate of 0.6% in 2014. The steep declines in the prices for crude oil and natural gas and the intensification of international sanctions accounted in the main for the country's economic contraction. Domestically, stalled progress on structural reforms and weak fixed investments also weighed down the economy. Outputs in the manufacturing, trade and construction sectors were characterized by notable decreases. Amid export declines and sanctions, the domestic currency depreciated by 66% in 2014 and another 13% in 2015. Such steep depreciation contributed to a decade-high inflation rate of 15.5% in 2015, which, together with anaemic economic activity, led to an almost 10% decline in real wages, according to the official estimate. Low- and middle-income households were the most adversely affected; the national poverty rate is estimated to have increased by 3 percentage points to 14.2% in 2015. The number of people living in poverty is currently more than 20 million.

The currency depreciation and high inflation rate resulted in an increase in the dollarization of household deposits, while dollar-denominated corporate debts also increased. The amount of overdue claims rose by 54% in 2015, representing almost 4% of GDP. These developments could undermine financial stability, especially since international sanctions already limit the country's access to global financial markets. To ensure financial stability, the central bank accelerated reforms that would facilitate a move towards a free-floating exchange rate regime, increased foreign exchange liquidity, tightened banking supervision and doubled the level of insured deposits.

On the fiscal front, the Government launched an anti-crisis plan, which is aimed at recapitalizing banks; providing guarantees for State-owned companies in the agricultural, manufacturing and transport sectors; and supporting social programmes, such as unemployment benefits. To finance the plan amid lower-than-expected revenue collection, the Government temporarily suspended a budget rule that caps spending, cut

spending in some programmes by 10%, introduced a partial indexation of public wages to inflation and froze government pension contributions for a third consecutive year.

The economy is projected to contract further by 1.5% in 2016, before registering zero growth in 2017. These projections are subject to considerable uncertainty, however, due to volatile geopolitical tensions and future energy prices. Consumption and investment would remain weak in 2016, while fiscal consolidation is expected to move forward. The outlook in 2017 is premised on the assumption of greater exchange rate stability, which would ease inflationary pressure, and the country's monetary policy stance. If oil prices rebound more quickly than expected, a recovery in fixed investment could be rapid as several investment projects had been postponed in previous years. A key challenge facing the Russian Federation is the need for a credible medium-term fiscal consolidation programme that is adjusted to lower oil prices. Implementation of delayed structural reforms would help to enhance the country's growth potential.

Tajikistan

Economic growth in Tajikistan slowed from 6.8% in 2014 to 6% in 2015. As a result of a recession and tighter restrictions on immigration, remittances from workers in the Russian Federation are estimated to have decreased by 60% during the first half of 2015. As remittances account for up to 44% of GDP, making Tajikistan one of the most remittance-dependent countries in the world, the decline in remittances placed considerable pressure on consumer spending and the economy in general. The expansion of the economy in 2015 was supported by higher agricultural output. Construction activity benefited from foreign investment projects that had been agreed in previous years but were recorded only in 2015.

Slower economic growth appeared to have weakened the country's fiscal position. The scheduled increases in public sector salaries, student aid, pensions and other benefits in September 2015 were postponed. Meanwhile, currency depreciation of almost 30% in 2015 raised import prices of essential food items, such as wheat and sugar, although the tight monetary policy stance helped to keep inflation stable.

Growth is set to moderate further to 5% in 2016 and 5.2% in 2017. Workers' remittances and near-term economic growth prospects would continue to be dampened by weak economic activity in the Russian Federation. Similarly, commodity exports are projected

to remain anaemic as a result of low commodity prices and sluggish import demand in the subregion. A downside risk includes a relatively low level of foreign exchange reserves, which fell from \$173 million in January 2015 to \$84 million in December. This buffer may be needed if external economic conditions deteriorate. An upside is potential investment inflows from China in the energy, infrastructure, textiles and gold-mining sectors.

Turkmenistan

Compared with other subregional economies, growth in Turkmenistan was relatively solid at 6.7% in 2015. The expansion was underpinned by large-scale investment projects from China and increases in domestic public and private investments that buoyed construction activities. The pace is, however, slower than the 10.3% growth rate recorded in 2014, as the volume of gas exports to China and the Russian Federation decreased. Meanwhile, inflation stepped up to 7% in 2015, partly pushed up by a currency devaluation of 18% in the early part of the year.

Economic growth is projected to trend down to 5.4% in 2016 before rebounding to 6.5% in 2017. Gas exports are expected to remain weak. The main headwind in 2016 is the projected higher inflation that is partly driven by higher custom duties on food items, as the country recently adopted an import-substitution policy. Meanwhile, after a long delay, the construction of Turkmenistan's portion of the \$10 billion Turkmenistan-Afghanistan-Pakistan-India gas pipeline began in late 2015. The project is expected to help create a large number of jobs and generate a steady revenue stream from exports to the energy-deficient South and South-West Asian subregion. A recent deal with Japan involving investment in the energy and chemical sectors should also support medium-term growth.

Uzbekistan

Economic growth remained strong at 8% in 2015, making Uzbekistan the fastest-growing economy in the subregion. Higher government spending helped to mitigate the adverse impact of the deteriorating external environment, which resulted in falling oil exports and declining workers' remittances. The Government continued to allocate more than half of its spending on social programmes. In September 2015, salaries for public sector employees, student grants, pensions and other State benefits were increased by 10% on average. Public investment also increased. As a result of fiscal stimulus and currency depreciation, inflation increased to 10% in 2015.

Growth is projected to remain high at 7.8% in 2016 and 8% in 2017. Domestic demand would continue to support expansion, as merchandise exports and remittance inflows are likely to be weak amid low global prices for oil, gold and cotton as well as subdued economic activity in other subregional economies. Prudent macroeconomic management in past years, as reflected in favourable fiscal positions and large external buffers, helped to enhance the country's ability to respond to external shocks. Nonetheless, further efforts are needed to accelerate privatization and promote a more diversified, private sector-led economy that can generate productive jobs and sustain inclusive growth. Greater exchange rate flexibility to address rising pressures on the current account may also be needed, if the crisis is drawn out.

2.2. A selected policy challenge: services sector development for economic diversification and integration

To diversify its growth engine, North and Central Asia needs to create vibrant business support services to complement high value-added production

A key medium-term policy challenge faced by North and Central Asian economies is to gain competitiveness beyond the export of primary commodities. Doing so would require improving the business services component of the production process, which in turn would facilitate structural diversification and enhance regional economic integration. These services, also known as backbone infrastructure services or producer services, have direct consequences for adding value in production processes.

More than two decades after the end of the central planning system, the role of services in the subregion remains limited. While the share of services in GDP increased in most subregional economies between 1993 and 2013, services activities often involve small-scale trading rather than the business services that are required in a modern economy or by those intending to participate in global value chains. Furthermore, lack of adequate data in terms of measuring business services significantly reduces understanding of the role of the services sector in the subregion as well as its capacity for evidence-based policymaking.

The absence of a modern services sector is largely due to the underdeveloped state of the market economy and consequent lack of demand. Improvement in backbone services is a precondition for such demand to emerge. For example, the benefits of services

reform are verified only when reforms in both essential backbone services and complementary services occur (Fernandes, 2007). Similarly, in another study that examined the impact of better infrastructure services on economic growth, it is estimated that the Tashguzar-Boysun-Kumkurgon railway line in Uzbekistan raised subregional output by about 2% through enhanced connectivity effects. This development appears to have been driven by value-added increases in industry and services of about 5% and 7%, respectively (Yoshino and Abidhadjaev, 2015).

Economic diversification requires balance between deregulation and strong regulatory frameworks

Services reforms are complex because they involve a balanced mix of liberalization through deregulation and reregulation. In particular, deregulation refers to the dismantling of regulatory barriers to market entry and the promotion of competition, while reregulation includes the establishment of a transparent, predictable and enforceable legal environment, with strengthened and independent regulatory agencies. For countries that emerged from centralized planning systems, the policy challenge is even more complex as there are more regulatory barriers to dismantle and no benchmarks for effective regulation. In other words, the subregion is faced with the need to enhance competitiveness by increasing the contestability of markets through the entry of new domestic and foreign service providers. At the same time, they need to implement effective regulatory supervision of both domestic and foreign operators due to the asymmetric nature of information in such systems.

Furthermore, reforms may – and often do – include privatization because State-owned enterprises still account for a large share of producer services in the subregion. Privatization is, however, not an essential condition. The incumbent service provider can remain State owned, as long as the regulator permits entry of new providers in the market in a non-discriminatory way that promotes competition. In this regard, FDI is an important channel through which foreign providers can contest infrastructure and other service markets as greenfield investments, joint ventures between public-private enterprises or other forms of privatization.

In this context, a key policy consideration is to identify what services the Government needs to provide and what can be left to private initiative. Kyrgyzstan's nascent value chains in clothing and beans are an example. Suppliers of specialized services have

emerged in response to demand. The Government's essential role was limited to providing transport and communications infrastructure services and to facilitating international trade.

Government support can also involve positive externalities. For example, there is a proposal to convert the city of Almaty into a subregional services hub through development of transport, tourism and financial services (see box 2.1). Such developments could also stimulate modern firms to participate in global value chains because many initiatives on the proposed hubs, such as effective Internet connectivity and courier services, are also prerequisites for value-chain participation. The act of internationalization of a city could itself spur new service activities as people bring in new ideas of how to remove bottlenecks or increase efficiency. An important spin-off benefit could include improved public support for provision of education and health services. While Kazakhstan, as is the case for other countries in the subregion, inherited high literacy rates and basic health services from the centrally planned economy, it has been a long and difficult task to maintain past achievements while creating education and health services better attuned to a modern market-based economy.

Recent policy reforms have shown some early results. According to the World Bank's ease of doing business index,⁵ notable improvements were made in the overall business environment between 2014 and 2015. Of the 10 components that make up the index, the improvements are attributable to the "ease of trading across borders" component in Armenia, Azerbaijan and 4 Central Asian countries for which data are available. Georgia maintained its position above the median, while the other countries remained below the median, despite the improvements made in cross-border trading. Another relevant indicator is the services reform index of the European Bank for Reconstruction and Development, which is used to measure progress in policy reform in the services sector. That index reflects the average of three sub-indices, namely banking, non-banking and infrastructure reforms.⁶ For recent WTO entrants, the index shows a slight improvement in Tajikistan, primarily due to improvements in the non-banking sectors prior to the country's WTO accession in 2013. For the other two WTO entrants, Kazakhstan and the Russian Federation, although at higher levels than Tajikistan, the index shows a more stable trend, and thus suggests slow progress over the past decade.

In looking forward, it is not unreasonable to expect positive developments in the reform agenda to

Box
2.1

2020 General Plan of Almaty Development

The city of Almaty, as the capital and largest economic centre of Kazakhstan, is positioning itself as an emerging Eurasian business hub through the development of key services sectors. In utilizing its existing infrastructure and leveraging on its future status as a world-class transportation and logistics hub, the so-called Almaty-2020 Development Plan is aimed at the development of an innovation cluster, known as the “Park of Innovative Technologies”. Efforts in this regard will be focused on the information technology, education and health-care sectors; the involvement of international staff and major international companies, including financial institutions, is being focused on building production capacity in innovative services.

Importantly, the Plan involves developing Almaty into an international transport and logistics hub through construction of a world-class airport, new road junctions and main transport routes, including “BAKAD” (big Almaty ring road) which will connect with the main Western China-to-Europe route, as well as the development of accompanying logistics services. In turn, these steps will stimulate the development of tourism as well as attract major international sporting events, such as the 2017 international multi-sport event known as Universiade, in addition to international exhibitions and festivals. With the necessary backbone services in place, numerous ancillary services, providing thousands of new job opportunities, especially for the city’s youthful population, will sprout in the areas of website development, tour operators, interpreters, language schools and creation of information maps, among others.

Under the Plan, emphasis is also being placed on the ease of doing business. The aim is to increase by 2020 the share of foreign investments to fixed assets by 50%; that measure will be used as an indicator of the city’s ability to independently attract foreign investors, including multinational companies, in the work of the city. Towards this end, Almaty is opening a “one-stop” business service for investors that will streamline and shorten the time spent between application, approval and start of implementation of investment projects.

As a major metropolis in North and Central Asia, Almaty has embarked on an ambitious plan that positions the city as a hub of Eurasian business, innovation and culture, and affords greater importance to the development of state-of-the-art services, which will have direct consequences for adding value and contributing a range of services to economic growth, sustainability and inclusiveness. Through the balanced integration of these three pillars, Almaty may be on the path towards becoming a model of sustainable development.

emerge over the next five years, as the economic slowdown continues to expose the weaknesses of an undiversified economic structure. In this regard, service sector commitments under the General Agreement on Trade in Services can serve as a means of locking in and reinforcing domestic policy reforms that will promote an economic structure that is more resilient to global economic volatility.

The time is opportune for conducting in-depth studies that are adapted to the realities and idiosyncratic challenges of the subregion. There is a need for policy advice that identifies and sequences priority sectors for a services liberalization agenda. More research is needed to identify precisely which service inputs are important for enhancing the competitiveness of exports and to determine how countries in the subregion can bolster these inputs. This could involve policies for promoting and facilitating FDI in strategic sectors, subcontracting arrangements and investments in social services that would build a skilled workforce, among

other things. Policy advice is also needed concerning measures that would tackle regulatory barriers while introducing new regulations that would enhance the conditions for competition so that a higher content of services in the downstream economy could be realized for economic diversification.

3. PACIFIC

3.1. Macroeconomic performance and outlook

Growth outlook is dimmed by smaller capital inflows into Papua New Guinea and dry conditions brought about by the El Niño phenomenon

Pacific island developing economies as a whole grew by 6.5% in 2015, down from the 8.7% growth in 2014. The expansion was uneven across economies. In Papua New Guinea, which accounts for close to

60% of total output of the group of countries, growth was robust at almost 10%, driven by production of mineral resources. In contrast, economic contractions were registered in economies such as Vanuatu due to the devastating impact of Cyclone Pam, and Cook Islands due to shortages in tourism facilities. For most other economies, growth remained below 4% in 2015.

Pacific island developing economies as a whole are projected to experience an economic slowdown in coming years, with growth rates moderating to 3.4% in 2016 and 2.7% in 2017. Soft prices for mineral exports weigh down the growth forecast in Papua New Guinea, a situation which will drag down overall growth for the group of island economies. In most countries, ongoing effects from El Niño also induce drought conditions and constrain agricultural and fisheries production (see box 2.2). The modest growth outlook is supported by expected steady economic expansion among key trading partners, such as Australia and New Zealand, lower energy import bills, higher tourism receipts and continued infrastructure upgrades and post-cyclone reconstruction efforts in some economies. The key downside factor is an increased risk of cyclones, which could significantly damage productive infrastructure and tourism facilities.

The subregion's ability to sustain high economic growth has been hampered by various factors. On the domestic front, inadequate transport and communications connectivity, notable energy and infrastructure gaps and limited skilled workforce and institutional capacity remain key constraints to growth. These factors have constrained the role of the private sector in supporting the economy, with the result that the public sector remains the largest employer in many economies in the subregion. On the external front, heavy reliance on global economic conditions has resulted in volatile inflows of FDI, foreign aid, tourism and export receipts and workers' remittances, and has undermined macroeconomic stability.

Pacific island developing economies

Fiji

Economic growth in Fiji moderated to a still high rate of 4% in 2015 compared with 5.3% in 2014. Dry conditions relating to the El Niño event resulted in a decline in the production of sugar, while much lower global prices for gold and sugar weighed down exports. The services industry, especially the transport, accommodation and restaurants sectors, dominated economic activity in 2015, supported by buoyant tourism demand. Visitor arrivals increased

by 9% in 2015 compared with 2014, driven by a greater number of tourists from traditional markets, such as Australia and New Zealand, which account for three quarters of the total number of visitors. Both public and private investment buoyed the construction sector and created employment. Eased consumer credit conditions and low inflation also supported consumer spending.

The economy is projected to slow to a 2.2% growth rate in 2016 before rebounding to 3.1% in 2017. Cyclone Winston affected Fiji in February 2016, causing damage to agricultural output and tourism services in some parts of the country. The prolonged drought conditions are also expected to adversely affect production of sugarcane and other crops. The projected expansion in 2016 is supported by post-cyclone reconstruction efforts, increased foreign aid, and higher remittances sent from families abroad. Inflation is expected to rise in the first half of 2016 due to reduced food supply, although low oil prices and the reduction in the value-added tax rate from 15% to 9% would help to keep price rises at manageable levels. The major drivers of economic growth in 2017 will be the tourism-linked sectors, particularly additional investment in hotel rooms, and projects to upgrade road and airport infrastructure and air carriage capacity. Exports of sugar would, however, be constrained by the end of preferential access of Fiji's sugar to the European Union scheduled to take place in 2017.

Sustaining strong medium-term growth will depend on effective implementation of reforms to improve the business climate, particularly in areas that facilitate new business start-ups and the grant of construction permits. To promote business investment, the Government improved access to land for investment by providing an opportunity for indigenous landowners to deposit their land and benefit from lease payments for the use of such land. Meanwhile, civil service reforms are currently under way, which would help to enhance productivity and the efficiency of public service delivery.

Papua New Guinea

Output growth in Papua New Guinea decreased to 9.9% in 2015 from 13.3% in 2014, owing to temporary closure of a large copper and gold mine. The still high economic growth rate in 2015 benefited from higher production of liquefied natural gas (LNG). Non-resource output is likely to grow more moderately as a result of drought conditions that affected agricultural output and lower government spending that held back construction activity. Meanwhile, the inflation rate was largely stable at 5.1% in 2015, as the effects of lower

Box 2.2

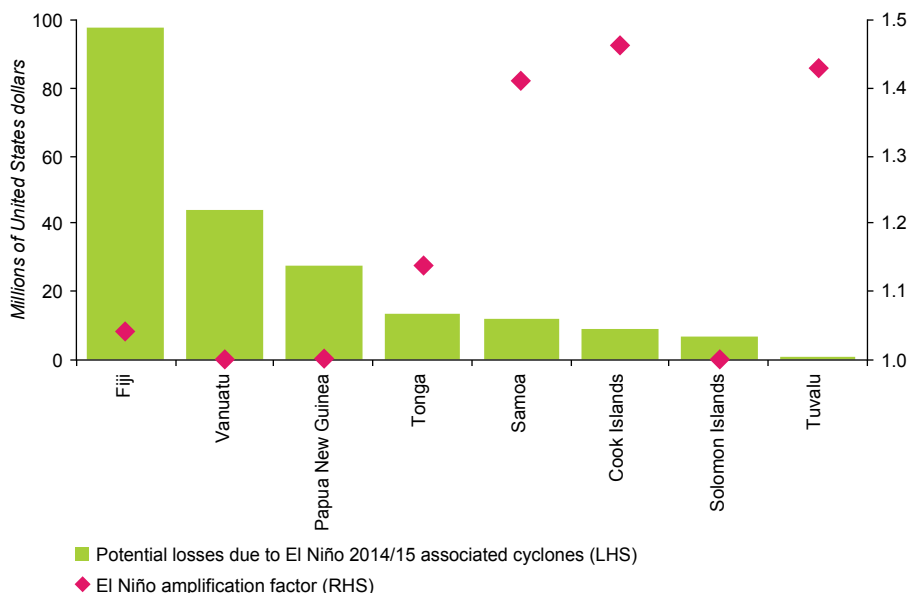
Current El Niño impacts

Pacific island developing countries are currently facing El Niño, which is associated with irregular rainfall, increased tropical cyclone frequency and abnormal sea level conditions. Historically, the adverse impact of El Niño has been sizeable, largely because reduced wet season rainfall significantly lowers output of subsistence agriculture. For example, droughts due to El Niño 1997/98 caused failure of staple food crops, such as taro and yam, and forced people to rely on bush crops and food aid. In Fiji, drought related to El Niño 1997/98 led to a 26% decline in sugarcane production and \$7 million in losses from livestock death.

The potential impact of El Niño 2014/15 in Pacific island developing countries is likely to be uneven and sector-specific. For example, an El Niño event extends the skipjack tuna habitat, the main fishery resource in the subregion, towards the east (such as near Kiribati), and the later part of an El Niño event increases primary tuna productivity in the west (such as near Papua New Guinea and Solomon Islands).

El Niño events are expected to increase the magnitude of risk associated with tropical cyclone activity. The figure below shows the potential losses due to cyclones that are associated with El Niño 2014/15. These estimated losses are derived by multiplying a country’s average annual loss due to cyclones by a corresponding amplification factor. Among other considerations, the average annual losses take into account exposure information, damage estimation and hazard assessment that is based on the experience of 2,400 cyclones in 15 Pacific island developing countries over a 60-year period.^a The amplification factor is based on historical El Niño events that exhibited similar atmospheric and oceanic conditions to that of the 2014/15 El Niño.^b Overall, the figure shows that potential losses in Cook Islands, Samoa and Tuvalu are estimated to be 41-46% greater than during normal years.

Potential losses due to 2014/15 El Niño associated cyclones



Source: United Nations, Economic and Social Commission for Asia and the Pacific (ESCAP), *Economic and Social Survey of Asia and the Pacific 2014: Regional Connectivity for Shared Prosperity* (Sales No. E.14.II.F.4) and ESCAP and Regional Integrated Multi-Hazard Early Warning System for Africa and Asia, “El Niño 2014/2015: impact outlook and policy implications for the Pacific islands”, Science and Policy Knowledge Series, Advisory Note, November 2014.

Note: LHS = left-hand side; RHS = right-hand side

^a Pacific Catastrophe Risk Assessment and Financing Initiative, *Catastrophe Risk Assessment Methodology: Risk Assessment – summary report* (Washington, D.C., World Bank, 2013). Available from http://siteresources.worldbank.org/EXTDISASTER/Resources/8308420-1342531265657/PCRAFI_REPORT_WEB_Final.pdf.

^b See New Zealand National Institute of Water and Atmospheric Research, “Seasonal climate outlook: December 2014 – February 2015”. Available from www.niwa.co.nz/climate/sco/seasonal-climate-outlook-december-2014-february-2015.

oil and commodity prices were offset by a currency depreciation of 14% in 2015.

Near-term economic growth is projected to decline notably, to 4.3% in 2016 and 2.4% in 2017. Capital inflows relating to LNG projects have passed their peak levels, while unfavourable weather conditions are anticipated to further dampen the agricultural sector. Fiscal support would also be more modest amid an expected decrease in government spending. On the upside, construction activities in preparation for hosting the eighth Summit of African, Caribbean and Pacific Heads of State and Government in 2016 and the Asia-Pacific Economic Cooperation Leaders' Summit in 2018 are expected to support the economy. The key downside risks are lower-than-expected prices for key commodity export items, such as copper and gold, and lower external demand for minerals. Such phenomena could weaken public revenue performance, necessitating further consolidation of expenditures.

The immediate policy challenge is to manage headwinds from severe government revenue shortfalls, which could amount to nearly 5% of GDP according to an official estimate, due to lower-than-expected revenues from the minerals sector. A supplementary budget for 2015 introduced budget cuts of about 2.7% of GDP, mainly for projects that were behind schedule on implementation and for idle funds that had not been disbursed. These steps would help keep the public debt level within the statutory limit of 35% of GDP. In the medium term, fiscal consolidation is needed to abate risks due to further declines in commodity prices. Given the smaller fiscal space, spending on necessary public services, such as health and infrastructure, has to be well targeted to support more inclusive growth. A revival of agriculture and a strengthening of small businesses supported by greater financial inclusion will also be vital for improving the livelihood of the majority of the population.

Samoa

Economic growth in Samoa in 2015 edged up to 1.5% from 1.2% in 2014. Improved growth was attributed mainly to higher earnings from tourism, the post-disaster reconstruction programme and construction of a new airport terminal and similar work relating to the hosting of the Commonwealth Youth Games in September 2015. Visitor arrivals rose by 5.4% during the first three quarters of 2015. Workers' remittances, which account for about one fifth of GDP, also grew during the year mainly due to higher inflows from Australia and New Zealand. Lower fuel prices contributed to a benign inflation rate of 1.9% in 2015.

Near-term growth is projected to remain relatively low, at 2.2% in 2016 and 0.7% in 2017. While moderate expansion of agriculture and tourism are expected to support the economy, a narrow economic base and absence of high-value-added industries pose a significant constraint. The country's largest employer in the manufacturing sector, Yazaki EDS Samoa Ltd., is expected to close its operations, which will displace a significant number of workers. In this regard, government policies are critical to facilitate opportunities in commercial agriculture and further boost tourism.

Solomon Islands

Economic growth in Solomon Islands is estimated to have rebounded to 3.2% in 2015 following the 2% growth in 2014, which was held back by destructive floods. The recovery was broad-based. In addition to reconstruction projects, economic growth was underpinned by expansion in agriculture, manufacturing and wholesale and retail trade, which offset the suspension of production at the country's main gold mine, Gold Ridge, that had been contributing about one fifth of GDP. The overall price level decreased by 0.3% in 2015, mainly due to lower global prices for food and oil.

In 2016 and 2017, economic growth is expected to be 3% and 2.8%, respectively. Stronger performance in the mining and logging sectors are upside possibilities, although diversification of growth drivers away from resource-based sectors remains essential. Greater engagement of subsistence farmers in market activities could further boost growth. Similarly, improvement in the business environment is necessary to optimize returns from planned infrastructure investment, including a proposed submarine cable to provide high-speed Internet access.

Vanuatu

Vanuatu's economy is estimated to have contracted by 1% in 2015. Cyclone Pam devastated parts of the country in March 2015, severely damaging housing, infrastructure, agriculture and tourism facilities. Overall, the damage and losses to the economy are estimated to have exceeded 60% of GDP. Reconstruction and infrastructure upgrades in the months that followed helped to reduce the magnitude of economic contraction for the whole year, although there have been delays in some construction projects. Meanwhile, post-cyclone supply shortages and higher demand from reconstruction activity pushed up inflation to 2.5% in 2015. A temporary exemption on the value-

added tax on construction materials and lower oil prices provided some cushion.

“Strengthening ni-Vanuatu Resilience” – the new national recovery and economic strengthening programme plan which is focused on strengthening resilience in housing and settlement communities (specifically infrastructure reconstruction, restoring social services and boosting tourism and agriculture-related livelihoods) – is expected to support economic growth in the near term. In 2016 and 2017, such growth is expected to recover to 2.5% and 3.8% respectively, but there is also risk of delays on infrastructure projects due to capacity constraints and external funding gaps. Similarly, the recovery of agricultural output is contingent on favourable climatic conditions. Reduced policy uncertainty and swift decision-making by the new Government formed in early 2016 could enable timely implementation of infrastructure projects and boost business confidence in general.

Smaller Pacific island developing economies

The economy of **Cook Islands** remains weak, with the second successive year of contraction estimated at 0.5% in 2015, following the decline of 1.2% in the preceding year. Despite increased budget appropriations for capital projects, delayed implementation amid capacity constraints hampered growth performance. Tourism activity is constrained by shortages in accommodation, particularly during the peak season.

In **Kiribati**, steady growth of 3% is estimated for 2015, following infrastructure development-led growth of 3.8% in 2014. Donor-funded public infrastructure programmes, such as major road, water, sanitation and airport projects, and higher returns from fisheries are expected to remain key drivers of growth. Inflation is also estimated to have remained low at 1.4% in 2015 on the back of low oil prices and a stable currency. In looking forward, output growth in 2016 and 2017 is projected to be about 1.8-2%. Public infrastructure works are expected to continue to support growth. One key policy challenge is to address youth unemployment, which is at the highest rate in Asia and the Pacific region.

In **Marshall Islands**, the economy contracted by 0.5% in 2015. Construction activities had shrunk in recent years, as major infrastructure projects were completed in 2013. The economy is projected to resume expansion in 2016, supported by higher fishery output and new donor-funded infrastructure projects. The outlook is, however, weighed down by limited

private sector expansion and the scheduled reduction in grants under the United States Compact, which account for about two thirds of government revenue, resulting in lower development spending.

The economy of **Micronesia** is estimated to have contracted by 1.5% in 2015, an improvement relative to the 3.4% contraction in 2014. Several devastating typhoons affected the economy in 2015, which damaged food crops and led to a decline in household consumption. Construction activities also contracted, as post-typhoon reconstruction efforts are constrained by limited capacity. The output growth is projected at 2.5-3.5% in 2016 and 2017, underpinned by higher revenue from fishing licenses and infrastructure grants.

In **Nauru**, output growth is estimated to have contracted by 10% in 2015 from a decade-high of 17.5% in 2014. The ongoing demand created through operations of Australia’s Regional Processing Centre for asylum seekers, the second largest employer after the Government, continues to support growth. Mining delays have limited secondary mining of phosphate. Limited domestic supply and rising consumption pushed up inflation to 11.4% in 2015 from 3% in 2014. Growth is projected to recover at 3% in 2016.

In **Palau**, economic growth accelerated to 6.7% in 2015 from 4.7% in 2014. Strong tourist arrivals, mainly from China, drove the robust expansion in the tourism sector, which contributes up to 70% of GDP. Higher public capital expenditure also supported growth. The outlook for 2016 is rather positive, with projected growth at 3% on the back of higher tourist arrivals and ongoing infrastructure projects.

Tonga is estimated to have grown by 3.4% in 2015, up slightly from 2% in 2014, supported by reconstruction works after Cyclone Ian in 2014 and the coronation of the King of Tonga which boosted tourism and government and consumer spending. Growth momentum of about 2.7-2.8% is expected in 2016 and 2017, mainly due to construction activity in preparation for the 2019 Pacific Games. Inflation is expected to remain low in the near term, reflecting weak global commodity prices.

Output growth in **Tuvalu** was stable at 2% in 2015. As in Vanuatu, Cyclone Pam affected the country in March 2015. The stable growth was supported by recovery of tourist arrivals in the months that followed, as well as donor-funded construction work and exports of coconut oil. Growth is projected at 3-3.5% in 2016 and 2017, supported mainly by ongoing infrastructure upgrades.

Australia and New Zealand

Australia

The Australian economy recorded a stable growth rate of 2.5% in 2015. Exports of iron ore were relatively robust, while service receipts, particularly in tourism, education and business services, benefited from the weaker exchange rate. Lower inflation and unexpectedly strong employment growth in late 2015 helped to support consumer spending. In contrast, mining investments dropped sharply as several large-scale projects were completed. The below-target inflation rate of 1.5% in 2015, underpinned by lower fuel prices and input costs and regulatory changes in utility prices, allowed easing of monetary policy. The official cash rate was cut by a total of 50 basis points in 2015.

Growth is expected to trend up to 2.7% in 2016 and 3% in 2017. The economy gradually transitioned from resource-led growth to more broad-based growth, as reflected in strong employment growth in the services sector. As in 2015, the weaker currency would continue to buoy service receipts in key sectors, while private consumption would benefit from continued employment growth and the wealth effects due to high prices for housing. Export prospects are mixed. Exports of liquefied natural gas are expected to gain more momentum as new projects begin production in the coming years, although the outlook for shipments of iron ore and coal is less upbeat. Inflation is set to rise slightly due to stronger domestic demand and an increase in the tobacco tax in 2016.

The positive economic outlook is clouded by uncertainties. The pace of growth moderation in China will have important implications for commodity demand and prices and Australia's terms of trade. Domestically, the strength of private consumption is contingent upon solid conditions in the job market. Modest wage growth is, however, expected in the coming years, as firms continue to face spare capacity and the composition of employment shifts away from the high-paying mining sector. Sustained consumer spending is also conditional on maintaining wealth effects derived from the housing market. In this regard, an increase in mortgage rates and the introduction of differential loan pricing between investors and owner-occupiers would help to cool the housing market. Finally, fixed investment conditions will depend on whether non-mining business investments would step up to offset sluggish mining investments amid falling commodity prices. An official survey suggests, however, that investment intentions and non-residential

building approvals remain at low levels (Australia, Bureau of Statistics, 2016).

New Zealand

Economic growth in New Zealand continued its steady upward trend that started in 2011. Output grew by 3.4% in 2015, supported by strong tourism and construction activities and high net migration. Together with a lower unemployment rate and higher wage levels, a multi-year low inflation rate of 0.3% in 2015 and an accommodative monetary stance supported household spending. External sector performance was weaker. A substantial decline in export prices of dairy products, which make up almost 30% of total exports, weighed down economic growth, especially in the first half of 2015.

Growth is projected to edge up to 3.5% in 2016 and 3.6% in 2017. The economy is likely to be driven by private consumption on the back of favourable labour market conditions, immigration and increased wealth from high property prices. High net in-migration and low financing rates would continue to push up housing demand and construction, despite a tapering in reconstruction following the 2011 Christchurch earthquake. Prices of dairy products would remain low. The key downside risk is the sharper-than-expected growth moderation in China, which would further depress commodity prices. While there is room for further monetary easing if needed, macroprudential measures may be required if asset prices rise rapidly. Fiscal support could be modest, as one of the Government's priorities is to maintain a fiscal surplus in the coming years.

3.2. A selected policy challenge: coping with natural disasters

A natural disaster is more likely to take place in the Pacific island developing countries than in any other of the world's small States

Pacific island developing countries are generally characterized by small population size and limited land area, remote geographic location and exposure to natural hazards and weather-related extremes, such as cyclones, tsunamis, droughts and floods. Based on historical frequency, the probability of a natural disaster occurring in Pacific island developing countries is estimated to be more than 20% per year, which is higher than that of small States in other regions of the world (Cabezon and others, 2015). The absolute number of people affected by natural disasters may be small, but they still represent

a substantial proportion of their island populations (ESCAP, 2015e). Lack of economic diversification and constrained macroeconomic policy space in Pacific island developing countries also limit their ability to absorb the impact of adverse shocks. According to an index that measures a country's exposure and ability to cope with natural hazards in 171 countries, Papua New Guinea, Solomon Islands, Tonga and Vanuatu rank among the top 15 countries (United Nations University, 2014). In this context, climate change is often seen as the most significant threat to the livelihood and well-being of people in the subregion.

In addition to their devastating human cost, natural disasters often severely damage housing, transport infrastructure, agricultural output and tourism facilities. Owing to their economy-wide impact, natural disasters can result in very extensive damage and large losses. For example, damage and losses from Cyclone Pam that affected Tuvalu and Vanuatu in March 2015 are estimated at about 34% and 61% of GDP, respectively. Similarly, in Samoa, the estimated damage and losses from a tsunami in 2009 and Cyclone Evan in 2012 are 25% and 30% of GDP, respectively. As the poor and other vulnerable groups of island populations tend to live in more hazard-prone areas, the impacts on them could be disproportionately large, with significant implications for poverty reduction.

The long-run impact of natural disasters on economic development is substantial. It has been estimated that damage and losses due to natural disasters reduced GDP growth rate in Pacific island developing countries by 0.7 percentage points per year during the period 1980-2014 (Cabezón and others, 2015). Thus, the aggregate output level in 2014 would have been close to 30% higher than the actual level had there been no natural disasters. Another estimate from the same study suggests that, for damage and losses that are equivalent to 1% of GDP, the fiscal balance would deteriorate by 0.5% of GDP in the year after the disaster, as spending on reconstruction rises while tax revenue falls. The fiscal position would weaken more notably without large inflows of foreign aid and grants that typically follow natural disasters.

The sheer scale of natural disasters calls for a stronger partnership with international development community

Policies that seek to enhance macroeconomic fundamentals, particularly the Governments' financial position, will help to increase the subregion's resilience to natural disasters. To fully meet the fiscal costs of natural disasters, Pacific island developing economies

need to: (a) strengthen domestic fiscal buffers, including contingency funds and cash reserves; (b) expand the use of risk transfer instruments, such as insurance and other hedging instruments; and (c) maintain financial support from donors and multilateral institutions.

Several Pacific island developing economies have made progress in building fiscal buffers, as reflected in lower public debt levels and more favourable fiscal balances. Competing demands for scarce fiscal resources, however, also mean high opportunity costs for building buffers. To supplement the limited national sources of government revenue, donor funding remains a necessary part of efforts to increase resilience. While higher flows of external funds for climate change adaptation are expected in the Pacific subregion, red tape has resulted in slow access and high transaction costs among recipient countries. To improve access to such funds, some economies have benefited from direct budget support from donors, while other countries require improved public financial systems to enable the use of national systems for the delivery of financial assistance for dealing with natural disasters and the effects of climate change.

Fiscal planning can enhance economic resilience to natural disasters by building more natural disaster-resistant public infrastructure and by having in place post-disaster budgetary procedures to support emergency relief, economic recovery and reconstruction without sacrificing debt sustainability. There is a need to recognize the cross-cutting nature of disaster risk issues when formulating sectoral planning and government budgets in order to enable the implementation of appropriate risk-mitigation strategies. In view of the diverse characteristics of Pacific island developing economies and the varied country-specific implications of natural disasters, tailored policy measures are required.

At the subregional level, a risk-sharing mechanism, such as the Pacific catastrophe risk insurance pilot programme of the World Bank, provides limited insurance cover for five Pacific islands.⁷ For the 2015 season, aggregate cover against cyclones and earthquakes, including tsunamis, amounted to \$43 million. Tonga received \$1.27 million in response to a cyclone in 2014, and \$1.9 million was paid to Vanuatu following Cyclone Pam in early 2015. Both payments helped fund the early response and assessments carried out shortly after the disasters.

A road map has been adopted towards an integrated Pacific regional strategy for disaster risk management and climate change adaptation and mitigation.⁸ The objective of the strategy is to support better

preparedness and resilient development planning. Activities include sharing best practice country case studies on disaster risk management and climate change adaptation and strengthening information management systems, such as the creation of databases on hazards, exposure, vulnerabilities and risk assessments. There is also a need to strengthen drought monitoring and early warning systems, enhance the use of space applications and promote risk-sensitive development strategies.

4. SOUTH AND SOUTH-WEST ASIA

4.1. Macroeconomic performance and outlook

The optimistic prospects are conditional on the progress of structural reforms that keep up with business expectations

The South and South-West Asian subregion continued its recovery from a recent post-crisis downturn. In 2015, the average economic growth rate was largely stable at 5.7%, compared with 5.6% in 2014, led by India's 7.6% growth, which made that country the fastest-growing major economy in the world in 2015. Although low oil prices have helped, the subregion's relative growth resilience is noteworthy in the context of widespread slowdown in the emerging markets. The gradual improvement in the subregion's growth outlook is projected to inch up to 5.9% in 2016 and 6.3% in 2017, supported by the lifting of sanctions on the Islamic Republic of Iran and Nepal's rebuilding of its earthquake-ravaged infrastructure, and by the boost to Pakistan's economic outlook as the China-Pakistan Economic Corridor gathers momentum.

This positive outlook is premised on continued policy reforms that are critical for enhancing FDI inflows and raising investment rates, especially as most economies in the subregion still exhibit limited room for countercyclical fiscal policy responses when faced with adverse shocks. Despite recent declines, the inflationary environment is somewhat vulnerable. Towards the end of 2015 consumer prices showed signs of edging up, and additional feed-in from currency depreciations could occur if capital outflows from the subregion increase significantly amid global economic volatility and uncertainty. Inflationary pressures could also be stoked by another subdued monsoon season, given the dominance of monsoon-dependent agriculture in the subregion.

As a net importer of hydrocarbons, South and South-West Asia will continue to benefit in the short to

medium term from the sharp decline in oil prices that has helped to bring down consumer prices and relieved fiscal pressures. Lower inflation in the subregion has enabled central banks to reduce policy rates, sometimes aggressively, as in the case of Pakistan, while Sri Lanka recently increased its rate in early 2016 after it had reached historic lows.

Lower policy rates, however, have not resulted in a significant rise in investment rates, which are held back by the uncertain global economic environment. For most countries in the subregion, private consumption continues to propel growth, which is expected to be boosted further by the forthcoming implementation of government salary revisions in India and Sri Lanka. Meanwhile, fragile global economic conditions pushed export growth into negative territory for most countries in 2015, although there were signs towards the end of the year that the downward spiral may be ebbing. However, as imports also declined, the current account balances have narrowed and remained within manageable limits.

Focusing on fiscal consolidation and addressing energy and infrastructure deficits remain important medium-term objectives in most economies in the subregion. At the same time, boosting public investment in sustainable infrastructure to close the existing gaps could help to revive the investment cycle and pay rich dividends. Some countries, by leveraging the increased policy space from fuel subsidy reductions, have already pivoted their strategic policy direction towards fostering a more sustainable energy infrastructure. India, for instance, plans to have 175 gigawatts of renewable energy capacity by 2022, including 100 gigawatts of solar energy. Nepal is seeking to harness its huge hydroelectric potential through regional cooperation strategies pioneered by Bhutan. Afghanistan and Pakistan are erecting cross-country transmission lines for power trade with other countries in North and Central Asia under the CASA-1000 project. Similar opportunities for regional cooperation are presented by the Turkmenistan-Afghanistan-Pakistan-India gas pipeline and the Islamic Republic of Iran-Pakistan-India hydrocarbons pipeline projects. The \$46 billion China-Pakistan Economic Corridor that got under way recently also covers energy and transport connectivity projects.

In the context of a difficult global economic environment, exploiting the potential of regional economic integration within South and South-West Asia and beyond assumes new criticality. An estimate shows that only a third of intrasubregional export potential, which is projected to grow to \$173 billion by 2020, is currently being

exploited (ESCAP, 2016). The high cost of trade in the subregion is a key barrier to formation of regional value chains, but the cost could be brought down by strengthening regional transport connectivity, including through implementing the ESCAP Asian Highway and Trans-Asian railway routes and facilitation tools.

The issue of turning the youth bulge into a demographic dividend by stepping up investment in education and health and creating decent and productive job opportunities for young people also needs policy attention. These policy actions would help sustain productivity improvement, as discussed in chapter 3. Policies need to be put into place urgently before the share of the working-age population starts to decline after 2030, a process that has already begun in Sri Lanka. Implementing such policies designed with a gender-perspective would directly boost women's labour market participation rates in the subregion, which could add more than \$3 trillion to subregional output by 2025, as discussed in the next section.

At the nineteenth SAARC Summit to be held in Pakistan in late 2016, consideration should be given to taking concrete steps to unlock the potential of subregional economic integration in South and South-West Asia for fostering shared and sustainable prosperity for all.

Afghanistan

Economic growth in Afghanistan picked up slightly in 2015, to 2% from 1.3% in 2014, driven by government services and the construction and telecommunications sectors. Overall agricultural growth was muted however.⁹ Domestic business sentiment deteriorated due to security concerns, as reflected in a 30% decline in FDI in the first half of the year.¹⁰ Similarly, merchandise exports dropped by 15% in the first half of the year, pushing up the trade deficit to about 42% of GDP for the whole of 2015. Meanwhile, despite the 15% currency depreciation and the heavy reliance on imported goods to meet domestic demand, the overall price level decreased by 1.3% in 2015 owing to lower global food and fuel prices.

Growth is expected to edge up further: to 3% in 2016 and to 4% in 2017. The delayed withdrawal of foreign troops would help to sustain an important role for foreign aid, although that would also reflect continued unrest. The positive outlook is conditional on an improved security situation and progress on structural reforms. The Government's reform agenda is focused on maintaining internal security, revitalizing economic development, fighting corruption and strengthening regional cooperation.

Although the fiscal situation improved in 2015, with an increase in revenue on the back of a revival in economic activity and better domestic tax and customs compliance, the financing of basic public services continues to rely heavily on foreign aid. Foreign aid accounted for 23% of GNI in 2014 and helped Afghanistan to repay the arrears created in 2014. Continued donor support, stronger revenue collection and prioritization of expenditures are necessary to help the Government meet fiscal and external funding gaps. To increase revenues, the Government recently increased the business tax rate and fuel fee, introduced a 10% telecommunications tax and planned to introduce a value-added tax. Developing extractive mining industries, which requires an appropriate legislative framework and infrastructure investment, is also a significant potential source of government revenue.

Bangladesh

Bangladesh has sustained a robust and resilient economic growth rate of more than 6% in the past several years. In 2015, output grew by 6.5%, up from 6.1% in 2014, despite political turmoil in the third quarter. Although the share of private consumption in GDP has trended downwards in recent years, household spending continued to propel the economy in 2015, supported by lower inflation, higher workers' remittances and farm incomes, and rising public sector wages and transfer payments. Garment exports, accounting for more than 80% of total exports, were sluggish on subdued orders from Europe and lower cotton prices. Despite favourable workers' remittances, strong import demand and tepid export of goods pushed the current account balance into a deficit of 0.8% of GDP in 2015, the first shortfall in three years. Meanwhile, inflation dropped slightly to 6.4% in 2015 amid a vigilant monetary policy and a stable exchange rate that enabled pass-through of lower global food prices.

The outlook for growth remains optimistic, with growth being projected at 6.8% in 2016 and 7% in 2017. Apart from strong household spending supported by steady employment growth, economic growth should also benefit from a supportive macroeconomic policy stance, including a 50-basis point reduction in the policy rate in January 2016 and the planned, larger fiscal deficit of 5% of GDP for the fiscal year 2016. On the downside, high non-performing loans could constrain the growth of bank loans.

Despite strong growth performance in past years, several medium-term development challenges remain. These include, among others, the need to reduce infrastructure and energy shortages, broaden the

export base beyond garments and ensure decent work conditions and labour rights. To promote economic diversification, a skills development programme for the ship building industry has been introduced. The Government also plans to increase the tobacco tax and introduce a uniform 15% value-added tax rate and a 5% supplementary duty on mobile telephone usage to shore up fiscal resources. With regard to social development, the Government is scaling up school feeding programmes, its maternal health voucher scheme and an integrated microcredit programme.

Bhutan

Economic growth in Bhutan accelerated to 5.9% in 2015 compared with 3.8% in 2014, boosted by the commissioning of the \$195 million Dagachhu hydropower project. The hotel and restaurant sector also expanded favourably in line with higher tourist arrivals. A special agreement with Thailand that eases visa restrictions and lower daily costs helped to support the arrivals, although the tourism sector was dampened following the Nepal earthquakes in April 2015 as tourists tend to visit Bhutan and Nepal in a combined package. Meanwhile, inflation moderated to a still high level of 6.6% in 2015. Softer price pressure was largely attributable to lower inflation in India, the source of the bulk of consumer and capital goods consumed in Bhutan.

Growth in 2016 and 2017 is projected to increase further to 6.5% and 6.6%, respectively, as commissioning of new hydropower projects and high-value tourism growth would continue to drive the economy. Private consumption would benefit from relaxation of credit controls, while a higher revenue stream from completed hydropower projects and grants from India should help buoy government consumption. At about 30% of GDP in 2015, the current account deficit is expected to remain elevated over the medium term, as an increase in hydro-exports is offset by rising non-hydro imports.

Steady growth in output in past years has kept the overall unemployment rate at a low level, but youth unemployment remained close to 10% and informal employment accounts for more than three quarters of total employment. As a result, the Government has focused on developing a skilled workforce with the aim of energizing the business sector. For example, a national workforce plan has been developed to identify labour demand in various sectors. Another development challenge is the country's heavy reliance on foreign grants to finance its capital expenditure, more than 70% of which comes from India. Policy

reforms in this area have sought to expand the tax base, collect more revenue from corporate income tax and dividends from hydropower projects and restrain expenditure on public sector salaries.

India

Economic growth in India edged up to 7.6% in 2015 compared with 7.3% in 2014, making India the fastest-growing large economy in the world. Private consumption growth continued to be the main growth driver, as reflected in robust services activities relating to trade, finance, transport and communications, and real estate. However, strong household consumption was not broad-based; rural demand was weaker due to muted agricultural activity and slower rural wage growth resulting from subpar monsoon seasons in recent years. Meanwhile, stalled large-scale infrastructure projects and somewhat cautious investor sentiment resulted in sluggish fixed investment growth. On the external front, merchandise exports declined on weak orders in advanced economies and lower prices of refined petroleum products, which accounted for more than 13% of India's total exports. However, as imports also shrank and services exports remained in surplus, the current account deficit narrowed to about 1% of GDP in 2015.

Despite a spatially uneven monsoon and some seasonal spikes in food prices, consumer inflation moderated to 5% in 2015 from 6.7% in 2014. Lower inflation was driven by low global commodity prices, a downward adjustment in administered fuel prices and government measures, such as price checks, anti-hoarding and suspension of futures trading of select pulses. Moderate inflation enabled the Reserve Bank of India to cut policy rates by a total of 125 basis points in 2015.

The near-term growth outlook is positive, with the projected growth being 7.6% in 2016 and 7.8% in 2017. Urban household spending is expected to drive economic growth amid steady employment growth and relatively low inflation. Fixed investment conditions would benefit from lower borrowing costs and a more enabling business environment, as reflected in India's better ranking in the World Bank's ease of doing business index. Nonetheless, high levels of stressed bank assets and fragile business confidence could constrain investment growth. The overall strength of domestic demand will depend on progress made in implementing structural reforms and how rapidly large-scale stalled infrastructure projects are unlocked. Some progress has been made in reforming fiscal policy, such as the rationalization of fuel price subsidies,

but the implementation of the goods and services tax remains an important reform that is being held up due to political deadlock.

The Government recently launched several initiatives to promote inclusive and sustainable development. These measures include programmes to support small and medium-sized enterprises through enhanced credit under the Micro Units Development and Refinance Agency bank loan scheme; foster financial inclusion through the *Jan Dhan* programme under which 250 million people have gained access to modern banking services; create a skilled workforce under the Skill India initiative; make India a manufacturing base; and promote entrepreneurship under the Start up India Stand up India initiative. On the social front, a scheme to enhance access to improved sanitation through the introduction of a 0.5% cess on all taxable services was introduced. The Government is also placing emphasis on developing sustainable cities under the 100 Smart Cities mission, and harnessing solar and wind energy, with the target being to attain 175 gigawatts of renewable generation capacity by 2022.

Islamic Republic of Iran

Economic growth in the Islamic Republic of Iran decelerated to only 0.8% in 2015, from 4.3% in 2014 and the economic contractions recorded in 2012 and 2013. The slowdown was primarily due to international sanctions and lower oil prices, which constrained private consumption, held back foreign investment and dampened exports. Falling oil prices also widened the fiscal deficit in 2015, as oil revenues account for nearly 40% of total revenue. Meanwhile, inflation remained high at 13.6% in 2015, although it was much lower than the annual average of 28% in the preceding three years, as access to goods and services were constrained by the sanctions.

Growth is expected to rebound from a low base to 4.4% in 2016 and 5.1% in 2017, mainly due to the lifting of the sanctions, which became effective in January 2016. Oil export revenues should help to increase government revenue and the current account surplus, even though oil prices remain low. Foreign investment is also expected to pick up strongly in the near term, especially in infrastructure projects, but the country's medium-term growth is limited by significant domestic bottlenecks and restrictive business conditions. Inflation is likely to exceed the central bank's single-digit target due to supply-side bottlenecks and pent-up consumption demand released by renewed access to global markets.

Part of the policy effort to revive economic growth has been focused on improving financial intermediation through reducing non-performing loans and loosening financial bottlenecks. Examples of such measures include reductions in the bank reserve ratio and the interbank rate, \$200 million in deposits in the export promotion bank to support non-oil exports and a plan to develop a public debt market. The role of fiscal policy would be constrained by low oil prices. It has been estimated that a decline by \$10 per barrel in the global oil price would worsen the country's fiscal balance by 1% of GDP (IMF, 2016b). To improve its fiscal position, the Government is seeking to strengthen compliance measures, remove tax exemptions and continue its subsidy reforms.

Maldives

Economic growth in Maldives slowed sharply to 4.8% in 2015 from 8.5% in 2014 due to sluggish performance in the tourism sector, which accounts for about 40% of GDP. Tourist arrivals grew by only 1.3% in 2015 on the back of a 37% decline in visitors from the Russian Federation. The average duration of stays also decreased slightly. As was the case with service exports, merchandise exports were also subdued as shipments of canned fish products fell. On the supply side, construction activity was strong, benefiting from an increase in housing projects and public construction programmes. Meanwhile, consumer inflation moderated to 1.4% in 2015, underpinned by the decrease in fish prices and slower growth in housing rents. The minimum reserve requirement was lowered from 20% to 10% in August 2015 in order to support economic activity although the policy rates were left unchanged at 4%.

The near-term growth outlook is set to improve to 6% in 2016 and 7.1% in 2017. The construction sector would benefit from large-scale infrastructure projects planned over the next few years, although the tourism sector tends to remain anaemic. While rising public spending helps to support the economy amid tepid tourism activities and increased political uncertainty, large public debt poses a significant macroeconomic challenge. The fiscal deficit is estimated at close to 7% of GDP in 2015 due to lower-than-expected revenue collection. In this regard, the Government is focusing on reining in current expenditure and better targeting subsidies, and it introduced a green tourism tax of \$6 per day. To achieve sustained economic growth, there is a need to diversify the economy beyond tourism. Recent initiatives to promote domestic investment, for example through special economic zones and loan schemes for small and medium-sized enterprises, are thus encouraging.

Nepal

Economic growth in Nepal fell from 5.4% in 2014 to 3.4% in 2015. Catastrophic earthquakes in April 2015, causing losses estimated at one third of GDP, and a subpar monsoon season that resulted in weak agricultural output mainly accounted for the slowdown. Continued political unrest over the new constitution resulted in strikes and disruptions of trade routes in certain parts of the country. The unrest pushed up prices of fuel and other essential commodities and widened the difference in inflation rates between Nepal and India, a situation which could undermine the country's competitiveness in view of the exchange rate peg to the Indian rupee. The unrest also limited the supply of construction materials and held back the implementation of public projects on post-earthquake reconstruction. As a result, government expenditure declined in the second half of 2015.

Growth in output is expected to soften further to 2.2% in 2016, before rebounding to 4.5% in 2017. Consumer spending may be constrained by relatively high inflation and weak agricultural production. In the medium term, a trade agreement with the United States, which grants duty-free treatment to certain textile and apparel articles from Nepal, should help to attract greater investment flows. Similarly, an agreement with India to develop two large-scale hydropower projects could help exploit Nepal's immense hydropower potential and address the issue of power shortages.

The official estimate suggests that the April 2015 earthquake may have pushed at least 700,000 more people into poverty in 2016, undermining the country's target of reducing the poverty rate to 18% by 2016 from 25% in 2011. To strengthen the role of fiscal policy in supporting social and economic development, there is a need to address persistent underdisbursement of allocated budgets, which is mainly due to poor project management and bureaucratic hurdles. Similarly, tax administration and compliance could be improved. In this regard, the Government announced the issuance of a reconstruction bond to enhance the ownership and participation of the general public in the reconstruction works.

Pakistan

Economic growth in Pakistan increased slightly to 4.2% in 2015 compared to 4% in 2014, underpinned by a pickup in the services sector and a modest recovery in agriculture. Consumption continues to anchor the economy amid a decade-low inflation rate of 4.6% in 2015 that enabled a significant easing of monetary

policy. Despite lower borrowing costs, subdued private investment conditions have kept overall investment stagnant at about 15% of GDP for the whole year. Meanwhile, the trade deficit widened in 2015 as exports declined, mainly due to lower cotton prices. Nonetheless, favourable workers' remittances helped narrow the current account deficit, and foreign exchange reserve rose to an all-time high of \$20.8 billion at end-2015.

Growth is expected to increase further in the near term, to 4.5% in 2016 and 4.8% in 2017, on the back of continued policy reform efforts, including privatization of loss-making State-owned enterprises. Downside risk includes slower growth of workers' remittances as economies in the Middle East, the major destination of Pakistani migrant workers, continue to face lower oil revenue and subdued economic activity. Despite a more favourable economic outlook, Pakistan continues to face significant vulnerabilities from domestic security issues, critical energy shortages and domestic financing of public debt, which constrains private sector development. These less enabling macroeconomic environments have resulted in a sluggish inflow of FDI.

Pakistan's energy demand is expected to exceed domestic supply in the medium term as a result of low investment, distribution challenges and circular debt flow problems among energy companies.¹¹ The sector uses only 70% of installed capacity, a situation that leads to blackouts lasting for 6-8 hours a day throughout the country. To address energy shortages, the Government introduced new surcharges on power tariffs and inaugurated a solar park in 2015. Pakistan will also benefit from energy transmission from Central Asian countries under the CASA-1000 project going on-steam shortly. The China-Pakistan Economic Corridor is likely to add 10 gigawatts of power capacity by 2018.

Sri Lanka

Economic growth in Sri Lanka was stable at 4.9% in 2015, although this rate remained much lower than the average growth rate of 8.5% during the period 2010-2012. The expansion was largely broad-based. A revival in agricultural output benefited from favourable weather conditions. Manufacturing activities expanded, while real estate, finance and trade drove accelerated growth in the services sector. On the demand side, growth was driven mainly by private consumption. Relatively soft price pressure, partly a result of much lower administered fuel prices, enabled the policy rate cut of 50 basis points in April 2015. Nonetheless, the policy rate was raised by a similar

magnitude in early 2016 to address rapid credit growth. On the external front, the current account deficit in 2015 widened despite strong tourist arrivals. Shipments of tea, seafood and garments decreased due to weak demand and the import bans imposed by the European Union. Workers' remittances, the country's largest source of foreign exchange, were held back by a decline in income inflows from the Middle East. The Government resorted to borrowing from the International Monetary Fund (IMF) to beef up foreign exchange reserves against the backdrop of sharp depreciation in the exchange rate.

Growth is projected to gain further momentum, at 5.4% in 2016 and 5.9% in 2017. Private consumption will likely remain the key growth driver amid greater urbanization and rising demand for housing. One immediate policy challenge is to ensure a strong fiscal position and debt sustainability. Public debt reached 72% of GDP in 2014. The 2016 budget suggests that the fiscal deficit would remain large at 5.9% of GDP. The fiscal shortfall is due to both limited revenue collection, with the tax revenue-to-GDP ratio having been only 10.2% in 2014, and the country's large expenditure burden. Unless tax reforms and expenditure rationalization are implemented, fiscal conditions are unlikely to improve significantly.

One of the medium-term challenges is to transform Sri Lanka into a competitive export-led economy. To achieve this, the Government has fostered public-private partnerships and promoted liberalization of the services sector. The need to enhance labour skills, diversify export markets, restructure loss-making State-owned enterprises and reduce infrastructure deficiencies will remain important. Development in these areas would help the country to attract more FDI and employment. Youth employment in Sri Lanka is 10 times higher than overall employment, the largest difference in the Asia-Pacific region.

Turkey

Output growth in Turkey increased to 4% in 2015 from 2.9% in 2014, driven by moderate expansion in industrial production and more favourable market confidence in the final part of the year. Exports to Europe increased, although overall shipments were held back by tensions with the Russian Federation. Tight monetary policy and lower oil and fuel prices helped to lessen inflation to 7.7% in 2015 from 8.9% in 2014. Low commodity prices also helped reduce energy import bills and the current account deficit. Meanwhile, the fiscal deficit was estimated at 1.2% of GDP in 2015. An increase in revenue outpaced

the rise in expenditure in line with revived economic activity.

Growth is expected to moderate to 3% in 2016, before picking up to 3.7% in 2017. Exports should increase amid a gradual economic recovery in Europe. Consumer spending is likely to benefit from a 30% rise in the minimum wage level. The outlook is nonetheless clouded by a volatile political environment due to continuing unrest in Syria, which has resulted in Turkey becoming host to approximately 1.5 million refugees and an origin and transit country for migrant smuggling to Europe. A key downside risk is the deteriorating economic relations with the Russian Federation, which could impose economic costs of between \$7 billion and \$12 billion.¹² Although the upcoming election may imply additional expenditure commitments in the medium term, the Government has targeted a budget surplus in 2016 assuming that there will be a steady increase in government revenues and that the downside risk on tensions with the Russian Federation does not materialize.

4.2. A selected policy challenge: boosting women's labour force participation

Increasing female workforce participation could help South and South-West Asia reach its high potential for output growth

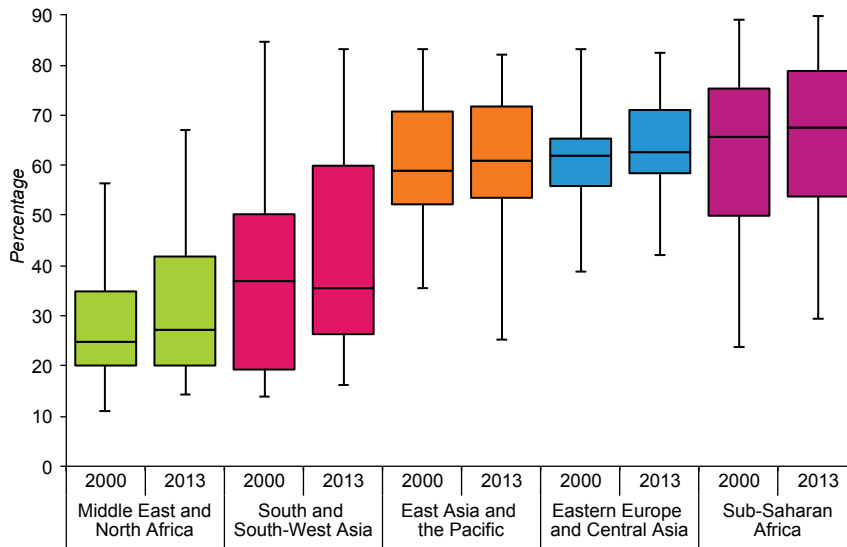
South and South-West Asian countries perform poorly in ensuring economic opportunities for women. Based on an index of women's economic participation, which captures female labour force participation, gender wage equality and the presence of female professional workers in 145 economies, Bhutan, the best-performing country in the subregion, is ranked at ninetieth (World Economic Forum, 2015). India, the Islamic Republic of Iran and Pakistan are ranked among the bottom six countries in the index.

The median female labour force participation rate in South and South-West Asia, at 35.5% in 2013, is lower than that of all other regions of the world except the Middle East and North Africa (see figure 2.5). South and South-West Asia is also the only region in the world where female labour force participation decreased between 2000 and 2013.

At the country level, female labour force participation is diverse in this subregion. The participation rate in 2013 was below 30% in Afghanistan, India, the Islamic Republic of Iran and Pakistan (see panel A in figure 2.6). In Bangladesh and Maldives, the participation rate was much higher (see panel B),

Figure 2.5

Female workforce participation in South and South-West Asia: low and decreasing, 2000 and 2013



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

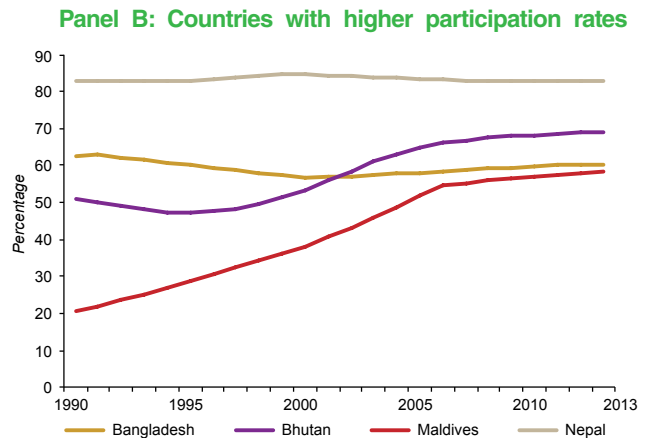
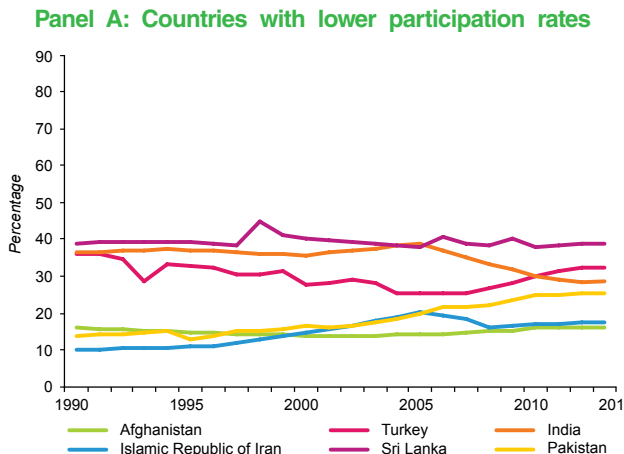
Note: The upper and lower limits of the enclosed boxes correspond to the 75th and 25th percentiles respectively, while the horizontal lines within the boxes depict the median. The vertical lines show the range where the uppermost (lowermost) points reflect the maximum (minimum) values. These box plots are based on data from 152 countries: 20 in the Middle East and North Africa; 10 in South and South-West Asia; 29 in East Asia and the Pacific; 47 in Eastern Europe and Central Asia; and 46 in sub-Saharan Africa.

although at about 60%, this is just on par with the global average. Only Bhutan and Nepal seemed to have active female participation in the labour markets compared with other countries in the world, mainly owing to many female workers in agriculture, especially

in Nepal. In terms of changes over time, one striking trend is the steep decline in the participation rate in India since 2005, which is driven mainly by the lower labour market participation rate among rural women.¹³ In contrast, the participation rate surged by

Figure 2.6

Female labour force participation diverse in South and South-West Asia



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

18 and 38 percentage points in Bhutan and Maldives during the period 1990-2013, respectively. Box 2.3 contains a discussion of why the female workforce participation rates in the subregion are rather diverse and generally low.

Concrete policy actions to boost the female workforce participation rate would promote economic growth in the subregion. In one simulation for India, raising the female labour force participation rate to the same level as that of males would increase GDP by

Box 2.3

Explaining the low female workforce participation rate in South and South-West Asia

Conceptually, labour market participation for women and men depends upon a combination of individual and household factors, matched with job characteristics and demands, and facilitated by economic and social infrastructure. While common factors help determine labour market participation for both women and men, women often face a far more restrictive range of such factors compared with men. Household and social norms in the subregion assume that women take the vast majority of responsibility for domestic work and caregiving and are sometimes restricted from labour market participation altogether if household income levels are sufficiently high. Labour market segmentation and economic decision-making norms restrict the range of possible jobs in which women can participate. Low incomes and high informality in segmented occupations and economic activity create significant gender gaps in participation in premium-level formal employment.

In Bhutan and Nepal, where the participation rates are higher, there are generally fewer social restrictions on women to work, while poverty also drives the need to work in Nepal. The emergence of labour-intensive, export-oriented sectors, such as the ready-made garment sector in Bangladesh and tourism in Maldives, have boosted women's labour market participation, as social norms identify many occupations in these sectors as women-centric. Such sectors are still relatively small in India and Pakistan where female participation is limited. Available evidence also shows that the expansion of microfinance schemes in Bangladesh has helped to increase job availability in rural areas of the country.^a

The role of social norms in affecting female workforce participation in the subregion is strong. Working women can be perceived as lowering their household's social status. In one survey in Pakistan, 35% of women respondents reported that they were not working due to a lack of permission from a man, usually the husband or father, to work outside home and instead they needed to carry out domestic responsibilities.^b Similarly, the World Values Surveys during the period 2010-2014 reveal that only one third of the respondents in India and Pakistan agreed that having a job was the best way for a woman to be independent. This view compares to more than half (54%) of respondents worldwide and places India and Pakistan in the bottom 3 countries out of the 60 countries surveyed.

The impact of education on female labour force participation is sizeable and non-linear. In India, it is estimated that one additional year of women's education increases the female participation rate by 0.6 percentage points.^c In Sri Lanka, women with a secondary education are more likely to stay outside the workforce than those with other education levels.^d Women with a primary education as their highest level of schooling are often from poorer households where participation in work is a subsistence-level necessity, while those with a tertiary education often work due to the greater opportunity costs of forgoing high expected wages.

Gender pay gaps, which arise when women with similar skills are paid less than men for doing the same job, also discourage women from working. In India, it is estimated that women are paid 10-15% less than men after accounting for education and work experience.^e Similarly, OECD data show that the gap between median earnings of women relative to median earnings of men was about 20% in Turkey relative to an average of 14% in 24 European economies.

^a Rushidan Rahman and Rizwanul Islam, "Female labour force participation in Bangladesh: trends, drivers and barriers", ILO Asia-Pacific Working Paper Series (New Delhi, International Labour Organization, 2013).

^b R. Pande, D. Ford and E.K. Fletcher, "Female labor force participation in Asia: constraints and challenges" (synthesis report) (Manila, Asian Development Bank, forthcoming).

^c Surjit Bhalla and Ravinder Kaur, "Labour force participation of women in India: some facts, some queries", Asia Research Centre Working Paper 40 (London, London School of Economics and Political Science, 2011).

^d World Bank, "Low female labor-force participation in Sri Lanka: contributory factors, challenges and policy implications", Report No. 68, Discussion Paper Series, South Asia Region Human Development Sector, January 2013.

60% in 2025 compared with the baseline scenario (McKinsey Global Institute, 2015). Similarly, as a group, such an output gain is estimated at 48% above the baseline scenario in Bangladesh, Nepal, Pakistan and Sri Lanka. In another study, a policy package that includes reforms to reduce gender bias in the labour market and higher public spending in social areas is estimated to raise annual output growth in India by two percentage points above its steady-state rate (Agénor, Mares and Sorsa, 2015).

Bold policies are needed to alter deep cultural roots that discourage a role for women outside the household sector

Government policies to promote female labour force participation could focus on overcoming core barriers and offsetting disincentives for women to work. Policies that overcome the core barriers would enhance the availability of and access to good-quality education, offer skill development programmes, including women's entrepreneurship, and provide a conducive infrastructure and safe public transport to work, especially in rural areas. For example, in Bhutan, Bangladesh, Pakistan and Sri Lanka, electrification and improved access to water increased women's time available for market work (World Bank, 2011). Policies should also ensure equal decision-making, including access to finance and such productive assets as land and capital, and improve the flow of information on the job market. A quota for women in wage employment could also be introduced, at least in sectors where women do not traditionally participate. Finally, there is a need to address discriminatory laws, such as labour laws that limit the maximum amount of part-time work and family laws that limit decision-making power and/or the land rights of female family members.

Policies that offset disincentives to women's work would reduce the cost of joining the job market. An example includes adequate parental and child-related benefits, such as parental leave that is fully funded by the Government¹⁴ and for which a component must be used by male parents. Another example is taxation frameworks that encourage mothers to work by reducing the net tax liability, such as taxing individual income rather than family income and tax-deductible childcare payments (Elborgh-Woytek and others, 2013). New laws or stronger enforcement of existing laws and regulations are also needed to: (a) allow more flexible work arrangements, such as part-time jobs and work during non-traditional working hours; (b) increase female workers' bargaining power

to reduce gender pay gaps; (c) ensure a safe work environment that reflects social values but removes traditional practices that may be gender discriminatory; and (d) strengthen labour market flexibility, such as easing the entry and exit of workers.

Governments in the subregion have already pursued some of these policy options. Some recent reforms include those relating to women's representation, such as the requirement in India that at least one board member of every firm listed on the stock exchange is a woman and the provision in Pakistan that introduced a 22% quota for women in local governments (World Bank, 2016b). Other reforms provide greater social benefits, such as longer maternity leave; in the Islamic Republic of Iran, paid paternity leave has been introduced and in Turkey free preschool education. Finally, in Nepal, changes in legislation entitle unmarried daughters to an inheritance irrespective of their age; previously they had to be older than 35 years.

Successful policy reforms to boost female labour force participation need to be bold and broad-based. The policy package needs to be bold in order to mobilize millions of women into the workforce, partly because influencing social norms, which have deep cultural roots, is a challenging task.¹⁵ The reform also needs to be broad-based, as it requires government action on various fronts, such as increasing public spending, amending laws and regulations and mainstreaming gender equality into policy design, budgeting, and monitoring and evaluation. An example of policy design is India's rural employment guarantee scheme, which ensures that at least one third of participating workers are women and have access to childcare facilities at worksites. On budgeting, Bangladesh has since 2005 incorporated gender issues into the national budget and produced gender budget reports.

5. SOUTH-EAST ASIA

5.1. Macroeconomic performance and outlook

More rapid output growth in subregional economies with lower income levels helps narrow the development gaps within South-East Asia

South-East Asia consists of countries at various stages of economic development that are increasingly integrating with each other in terms of trade, investment and finance. The launch of the ASEAN Economic Community in late 2015 is expected to bring the 10 ASEAN countries closer to a single market and

production base. At the same time, Governments are increasingly concerned about inclusive growth and innovation. Income inequality has widened during past decades of rapid economic growth, leaving behind the rural poor and those in vulnerable employment.¹⁶ Meanwhile, countries that previously had not sufficiently diversified and upgraded their industries are facing renewed pressure. For instance, the Indonesian economy has been significantly constrained by falling global commodity prices, while Cambodia's garment sector has been adversely affected by increased cost competition following Myanmar's liberalization and Viet Nam's free trade agreement with the European Union.

On average, South-East Asian economies grew by 4.3% in 2015, similar to the pace in 2014 but lower than the average of 5% during the period 2011-2013. Exports were sluggish, while private domestic demand moderated. Currency depreciation against the United States dollar did not boost exports much, due in part to stable or appreciating real effective exchange rates and offsetting effects on companies with high dollar debt.¹⁷ At the same time, consumer spending moderated in some countries on the back of slower job creation, high household debt and weak rural incomes. Mild inflation and low interest rates were unable to stimulate domestic demand as much as in the past. Given the subpar demand in both external and domestic markets, private investment was not robust either. Fiscal policy was generally supportive, such as strong growth in social spending and capital expenditures in Indonesia, the Philippines and Thailand. Except for the Lao People's Democratic Republic and Malaysia, subregional countries still have relatively low levels of public debt and external debt.

Economic growth is projected to pick up gradually to 4.5% in 2016 and 4.8% in 2017, supported by stronger government spending and a modest recovery in domestic private demand. In particular, consumer spending and investment are expected to steadily strengthen in Indonesia and Thailand – the two largest economies in South-East Asia – benefiting from economic stimulus and reform measures introduced in late 2015. The projection also assumes that robust growth of 6-8% will be sustained in Cambodia, the Lao People's Democratic Republic, Myanmar, the Philippines and Viet Nam where domestic demand is generally buoyant on the back of rapid real income and credit growth and foreign investment. Downside risks include negative trade and financial spillover effects from China, slow progress on economic stimulus and reform measures and adverse weather conditions. While downside risks dominate, upside risks include

stronger-than-expected growth in investment from the ASEAN Economic Community, the Trans-Pacific Partnership trade agreement and bilateral free trade agreements in the respective member countries.

Inflation is expected to edge down from 2.5% in 2015 to 2.4% in 2016, primarily due to a decline in Indonesia, before rising to 2.8% in 2017. However, this trajectory is subject to various factors, such as global oil prices, fuel subsidy reforms, tax reforms and currency movements. The exchange rate stabilized somewhat in the early months of 2016 following sharp depreciations in 2015. However, there may be renewed volatility from the impact of currency devaluation in China as well as the further expected increases in interest rates in the United States. The monetary policy space in some countries would be constrained by capital outflow pressures and the need to ensure financial stability.

Current account surpluses among major exporters are much smaller compared with those in the 2000s, reflecting the relative strength of domestic demand to external demand. Commodity prices are having a significant but mixed impact, as import bills have fallen in most countries but export revenues have declined sharply among oil exporters. Countries such as Myanmar and Viet Nam are also witnessing strong capital imports driven by foreign investment.

Brunei Darussalam

Economic contraction in Brunei Darussalam continued in 2015, although at 1.2% this was more modest than the declines of 2.3% in 2014 and 1.8% in 2013. Increased petroleum production offset the impact of lower global oil prices. Stronger government spending, including in the construction sector, also supported the economy. In contrast, private consumption was held back slightly by regulatory caps on household borrowing. As the energy sector accounts for two thirds of the economy, both fiscal and current account balances recorded a rare deficit in 2015.

Economic growth is projected to return to positive growth, at 2% and 3% in 2016 and 2017, thanks to increased petroleum production. Fiscal support, backed by substantial savings under the national wealth fund, will also continue to buoy the economy and provide employment. Nonetheless, the likely persistently low prices of oil and gas pose considerable challenges for the country in coming years. In the medium term, it is critical to accelerate economic diversification to reduce reliance on the energy sector. Aside from improving the business environment, the Government

could actively support the development of small and medium-sized enterprises, including through public procurement and enhanced access to finance. The ASEAN Economic Community and the Trans-Pacific Partnership trade agreement may also open up more opportunities to attract investment into non-energy sectors, such as agro-processing, eco-tourism and financial services. Plans to establish a stock market and create an Islamic bond market to boost *sharia*-compliant financial services are already in place.

Cambodia

Economic growth remained high at 6.9% in 2015, although this rate moderated slightly relative to that in past years. The strong growth was fuelled by robust consumer spending on the back of rapid expansion in real income and credit, while investment in equipment and structure benefited from strong FDI inflows, including from China. Strong domestic demand and improvements in revenue administration resulted in stronger-than-targeted revenue growth, which helped lower the fiscal deficit (excluding grants) to 3.7% of GDP in 2015. Nonetheless, the healthy economic expansion in 2015 was not broad-based. Tourist arrivals decreased, while agricultural activity, which accounts for two thirds of employment and a third of GDP, grew by only 1%. Exports of major items, such as garments and rice, also softened amid increased competition driven by Myanmar's liberalization and Viet Nam's engagement in free trade agreements.

Driven by strong domestic demand, economic growth is projected to remain high at 7-7.1% in 2016 and 2017. Reduction of tariff and non-tariff barriers under the ASEAN Economic Community should be used as an opportunity to accelerate economic diversification, especially because the role of garment exports in driving the economy may not be as strong as in the past. In August 2015, the Government launched a new industrial development policy that is aimed at expanding the industrial base beyond garments and food processing to such areas as machinery and electrical equipment assembly and agro-industrial production. To realize such a development, it will be important to attract FDI into higher value-added sectors and channel more credit to upgrade the industrial sector.

Indonesia

As South-East Asia's largest economy, Indonesia experienced a broad-based slowdown in 2015 as

consumer spending and business investment slowed, while exports remained subdued. The economy grew by 4.8%, well below its average growth rate of 6% in the preceding five years. Both exports and imports reached their lowest levels since 2010. Weak corporate performance, especially in commodity-based sectors, and excess production capacity acted as a drag on private investment. Consumer spending in 2015 was adversely affected by relatively high inflation and unemployment rates of 6.4% and 6.2%, respectively. Fewer than 200,000 new jobs were created between August 2014 and August 2015 compared with an average 2.6 million new jobs created yearly between 2006 and 2012 (World Bank, 2015a). Slower job growth has undermined social outcomes, with the poverty rate rising to 11.1% after a steady decline in the past decade.

Economic growth is projected to rebound to 5.3% in 2016 and 5.5% in 2017. Consumer spending should benefit from lower inflation and accommodative monetary policy. The policy interest rate was cut by 25 basis points in January 2016 following further easing of inflation in late 2015. After tackling price and currency stability in 2015, monetary policy is expected to be more growth-oriented in 2016. Meanwhile, investment is expected to benefit from higher budgeted public investment and recent announcements on regulatory and structural reforms. These measures include plans to simplify investment regulations and procedures and to enhance the finance of small and medium-sized enterprises by reducing financing costs and improving access to collateral through land titles.

Macroeconomic policy management is challenging amid slower economic growth and greater pressure on capital outflows. Low oil revenue, sluggish economic activity and high disbursement of public infrastructure outlays resulted in a widening of the fiscal deficit to 2.8% of GDP in 2015, which was above the target of 1.9% of GDP and close to the statutory limit of 3% of GDP. To pre-finance the 2016 budget, which calls for further shifting of resources from energy subsidies to infrastructure and social assistance, the Government raised \$3.5 billion in an international bond sale in December 2015. On the monetary policy front, the central bank focused on stabilizing the domestic currency amid capital outflow pressures in 2015. Measures introduced in the second half of the year included foreign exchange interventions in the forward market, issuance of Bank Indonesia Certificates in foreign currency and renewing the bilateral currency swap agreement with China.

Lao People's Democratic Republic

In the Lao People's Democratic Republic, economic growth moderated to a still high rate of 6.4% in 2015 compared with almost 8% per year in the preceding five years. The economic expansion was driven by the operation of a new hydropower plant and increased mining output. Monetary and fiscal policies were tightened to secure macroeconomic and financial stability in 2015; the country's booming construction and real estate sectors had for years been underpinned by rapid increases in money supply and credit as well as steady growth in government spending. Credit growth fell to about 15% in 2015 from more than 30% in the previous few years. At the same time, the Government restrained public wage increases and rationalized off-budget capital expenditures.

Economic growth is expected to pick up to about 7% in 2016 and 2017, broadly in line with the official medium-term target. Hydropower and mining will continue to drive growth, despite some concerns over economic performance in major export markets, such as China and Thailand. The construction of a high-speed railway from Vientiane to the Chinese border and the upgrade of the main airport will also support the economy. Meanwhile, after abating due to lower oil prices and moderate money supply and credit expansion, inflation is expected to rise from 1.3% in 2015 to 2% in 2016 and 2.3% in 2017.

Economic diversification remains a priority, as the resource sector has limited capacity to absorb labour. The agricultural sector employs about two thirds of those employed, and overall labour productivity is low. Development of tourism and labour-intensive manufacturing, such as garments, will help expand employment opportunities. Lack of diversification in the past has also meant that high economic growth did not sufficiently translate into poverty reduction. Targeted social expenditures are needed to narrow the gap between rich and poor households in terms of access to education and health services.

Malaysia

Malaysia's economy expanded by 5% in 2015, down from 6% in 2014. Private consumption slowed amid low prices for rubber and crude palm oil; the introduction of a goods and services tax in April 2015 resulted in a temporary elevation in inflation. Tighter macroprudential measures also held back household credit, especially in riskier segments such as credit cards. Fiscal support was also modest. Despite lower

oil revenue, the fiscal deficit narrowed due to fuel price subsidy rationalization and the introduction of the goods and services tax. Meanwhile, fixed investment remained robust with the continuation of infrastructure projects initiated under the Economic Transformation Programme. On the external front, continued weakness in commodity exports, in particular petroleum products, was partly offset by solid performance of electrical and electronics exports. The decline in the import of intermediate goods also implied a growing value-added contribution of the electrical and electronics sector (World Bank, 2015b).

Economic growth is expected to ease to 4.4% in 2016 on the back of low commodity prices and fiscal consolidation, before rebounding to 4.8% in 2017. Private consumption could be constrained by expected slower growth in inflation-adjusted earnings as price pressures build up slowly in coming years. On the other hand, accommodative monetary policy would continue to support consumption, with the policy interest rate being left unchanged and the reserve requirement ratio having been reduced by 50 basis points in January 2016. Meanwhile, public investment should remain robust on the back of the construction of new underground train lines and other infrastructure investments under the new five-year plan. Steady business investment is also anticipated, although low energy prices and further currency depreciation may exert downward pressure on machinery investment. Export growth is likely to remain sluggish, resulting in narrowing of the current account surplus. The upside risk is from potential trade and investment impacts related to the Trans-Pacific Partnership trade agreement.

Myanmar

The economy in Myanmar expanded rapidly at a growth rate of 8.5% in 2015, the same pace as that in 2014, on the back of robust growth in the manufacturing, construction, tourism and natural gas sectors. In contrast, agricultural activity slowed, as severe floods in mid-2015 submerged more than 400,000 hectares of farmland and dampened farm output and rural incomes. Together with the floods, strong domestic demand and continued monetization of the fiscal deficit drove up inflation to 10.7% in 2015 from 5.9% in 2014. On the external front, exports of natural gas increased, but imports grew more rapidly, resulting in a wider current account deficit of 9% in 2015. Meanwhile, government spending grew rapidly in the lead up to the general election in November 2015. Recurrent spending, such as public sector wage bills, went up and led to the wider fiscal deficit of

5% of GDP in 2015. The shortfall would have been much higher if one-off receipts from telecom and gas companies had been excluded.

Growth is expected to be high at 8-8.5% in 2016 and 2017. Myanmar stands to benefit from an expected relocation of foreign investment projects in the manufacturing sector around the region in search of lower labour costs. Nonetheless, monetary and fiscal policies are expected to be tightened slightly, given high inflation and growing external imbalances. The domestic currency has been under depreciation pressure, which resulted in the realignment of the reference exchange rate and the parallel market rate in July 2015, after efforts to ease depreciation pressure, for example by limiting cash withdrawal in the United States dollar, did not appear effective. The adoption of the financial sector law in January 2016, under which banks now face more stringent rules on reserve requirements, would also contribute to slower credit growth. The downside risk to the economic outlook is low natural gas prices, which would reduce export revenues and potentially lead to lower-than-expected foreign investment inflows in the energy sector.

In the medium term, power shortages remain a key constraint on business activities. However, the 2015/16 budget outlines cuts in capital expenditures, which is somewhat in contrast to the priority given to infrastructure development in the country's medium-term plan. To enhance fiscal resources, there is room to improve the revenue potential of the extractive industry, for instance through centralizing the collection of gas-related revenue and increasing transparency. Tax administration can be strengthened, building on recent progress, including the operation of a large taxpayer office.

Philippines

Economic growth moderated slightly to 5.8% in the Philippines in 2015, from an average of 6.7% in the preceding three years. Exports contracted by almost 6% compared with 2014 owing to subdued shipments of manufactured, agro-based and mineral items. Workers' remittances, which are equivalent to 10% of GDP, also grew at a slower pace. Nonetheless, the current account surplus of 3% of GDP was maintained, as weak exports and remittances were partly offset by lower fuel imports and continued strong performance of business process outsourcing. Domestic demand was more buoyant. Private consumption benefited from low inflation, at 1.4% in 2015, and favourable labour market conditions. Adequate domestic financial

liquidity also supported credit growth for consumers despite some moderation in loan growth in the real estate sector due to macroprudential measures.

Economic growth is projected to rebound to 6% in 2016 and 6.2% in 2017 largely driven by strong domestic demand. Monetary policy remains accommodative, with the policy interest rate kept unchanged at 4%, while an expansionary 2016 national budget contains significant social and infrastructure spending. As in 2015, consumer spending would continue to benefit from mild price rises and a low jobless rate. Strong investment growth is also expected, as private participation in infrastructure increases and FDI inflows strengthen, albeit from a low base. However, part of business investment may be held back in the election year as investors wait to see what would be the new administration's policies.

The year 2016 will mark the last year of the current five-year Philippines Development Plan 2011-2016, in which inclusive growth and acceleration of infrastructure development are emphasized. Given the rapid growth of the country's labour force, a priority is to ensure strong job creation of the productive and remunerative kind that will lead to poverty reduction. A concern is that employment generation has been concentrated on services and construction rather than manufacturing. Also, while the unemployment rate has declined, underemployment and youth employment remain a challenge. The Government has launched several initiatives to tackle workers' skill deficiencies, such as programmes under the Technical Education and Skills Development Authority. While increasing public infrastructure outlays, the Government could also further mainstream productive employment into industry road maps.

Singapore

The economy of Singapore is heavily dependent on trade flows, with exports accounting for about 190% of GDP. Given subdued demand in advanced economies and China, economic growth slowed to 2% in 2015. The export-oriented manufacturing sector contracted even as construction and services saw some improvements towards the end of the year. Economic growth is projected to be stable at 2% in 2016 before rebounding to 2.5% in 2017. In respect of the 2015/16 budget, the Government announced plans for public transport upgrades and higher health-care spending over the next five years. The downside is that financing costs may rise as local interest rates tend to follow the United States federal fund rate, given the country's main lever of monetary policy is

the nominal effective exchange rate. In December 2015, the Singapore interbank rate rose to its highest level in more than seven years.

Thailand

Thailand's economy experienced a mild recovery in 2015 with growth rising to 2.8% from a low base of 0.8% in 2014. Consumer spending on non-durables expanded moderately, benefiting from two interest rate cuts in the first half of 2015 and soft loans for farmers and small-scale entrepreneurs. Purchases of durable goods remained low, however, in part due to high household debt and weak rural incomes. Meanwhile, private investment continued to contract partly owing to large excess capacity in the manufacturing sector. New investments were limited to some sectors, such as telecommunications and alternative energy. Public investment showed signs of improvement, growing by an estimated 22% in 2015 after having contracted in the previous two years. Exports remained weak as shipments of agricultural commodities, electronics and petrochemicals were disappointing. Trade in services was a bright spot, however, with tourism revenues reaching nearly a tenth of GDP, despite the bombing incident that occurred in Bangkok in August 2015.

Economic growth is projected to increase gradually to 3.2% in 2016 and 3.5% in 2017. Consumer spending is expected to recover further, benefiting from relatively mild inflation, low interest rates and stimulus measures introduced in late 2015, although high household debt and weak rural incomes will continue to act as a drag on spending on durable goods. Private investment is set to return to positive growth in 2016 on the back of economic stimulus programmes and strong public investment. The Government announced measures to support small and medium-sized enterprises and the real estate sector, a number of tax incentives and initiatives to expedite investment promoted by the Board of Investment. Meanwhile, several public infrastructure projects were recently begun, and the Government plans to spend \$83 billion over seven years on new railways, roads and customs ports. A \$3.5 billion fund was also approved as part of an effort to attract more private participation in infrastructure.

One immediate policy challenge is to tackle high household indebtedness. The household debt-to-GDP ratio has almost doubled in the past decade to about 80% in 2015, with a higher debt service ratio among low-income groups. Given that the debt problem is linked to poverty and inequality issues, efforts are needed to strengthen rural incomes which have been affected by drought and lower agricultural

commodity prices. Social protection could also be strengthened. A positive step was the launch of the National Savings Fund in August 2015, which will provide social insurance for the self-employed, such as farmers, vendors, taxi drivers and daily wage earners. The fund will be co-financed by the Government. To increase its fiscal resources, the Government reduced fuel subsidies and implemented new inheritance and gift taxes.

Timor-Leste

Economic growth in Timor-Leste is estimated to have contracted since 2013 owing to declining petroleum production.¹⁸ The economy is heavily dependent on oil, with oil revenues accounting for about 80% of GDP. For 2015, economic growth in non-oil sectors moderated to 4.3% from 5.5% in 2014 due to weaker government spending and delays in several large-scale private investment projects. Inflation remained low at about 1% in 2015 amid lower global commodity prices and appreciation of the United States dollar, which is used as the national currency, against the majority of the country's trading partners. The current account surplus is estimated to have shrunk notably to 4.3% of GDP in 2015 from almost 25% of GDP in 2014 due to declining oil and gas receipts, lower investment returns and higher imports driven by public works.

For the whole economy, a further contraction is still expected in the near term. The decline in global oil prices has resulted in a 56% reduction in forecast petroleum revenues for the period 2016-2022 and a 15% reduction in the country's estimated total petroleum wealth. The position of the Timor-Leste Petroleum Fund recently deteriorated from nearly \$17 billion in 2014 to \$16.4 billion in September 2015, and more withdrawals are needed to finance planned expenditures in coming years. Meanwhile, growth of non-oil sectors is set to pick up to 5-5.6% in 2016 and 2017 on the back of sustained government spending and higher foreign investment.

The country plans to achieve upper-middle income status with a well-educated and healthy population by 2030. The Government's strategy is to frontload spending to build the required infrastructure to attract foreign investment in agriculture, mining and tourism. Business-friendly legal and regulatory frameworks have also been put into place. As hydrocarbon reserves are expected to be depleted in about a decade, there is a need to increase revenue collection. Targeted social spending would help to reduce the poverty rate; currently half the total population is considered poor.

Viet Nam

The economy of Viet Nam expanded by a robust 6.7% in 2015 compared with 6% in the previous year. Recovery in domestic demand gained momentum. Favourable consumer sentiments were underpinned by low inflation, which dropped to only 0.6% in 2015 from 4.1% in 2014 and more than 11% on average in the preceding three years. Total investment grew by 9% amid robust FDI inflows and rising government expenditures marking completion of the country's five-year planning cycle. Exports of foreign-invested, higher-value sectors, such as mobile telephones and electronics, continued to expand rapidly, while commodity exports were more subdued. In addition to diversification into higher-value products,¹⁹ a competitive exchange rate helped to boost the export of manufactures. The central bank devalued the currency three times in 2015 by a cumulative 3% and widened the trading band in an effort to preserve stability in the currency market.

Economic growth is projected to edge up further to 6.8-6.9% in 2016 and 2017 mainly owing to continued strong performance in domestic private demand. Consumer spending would be supported by increases in real incomes and credits. Investment should benefit from government measures to enhance the business environment, including the March 2015 resolution on improving the ease of paying taxes and border clearance procedures. The Trans-Pacific Partnership trade agreement is also expected to attract more foreign investment to build up export capacity, although more stringent environmental and labour requirements may raise production costs in the short run. The conclusion of the free trade agreement with the European Union, which accounts for one fifth of total exports, would provide a boost to the economy.

Despite strong growth performance in recent years, macroeconomic policy management remains a challenge. On the monetary front, reported non-performing loans have declined to about 3% of total loans; this improvement is due in part to transfers of default credits to the country's asset management company, which had purchased roughly \$10 billion in bad debts as of October 2015. The resolution of these bad debts, however, has been slow in the absence of an adequate legal framework. On the fiscal front, countercyclical fiscal policy during the past few years has weakened the country's fiscal position. The budget deficit reached 6.6% of GDP in 2015, while public debt edged up to 61% of GDP. Declining oil revenue and a further cut in corporate income tax rates constrained revenue collection. Meanwhile, amid

increasingly limited access to concessional external finance, the Government has relied mainly on domestic debt, which involves higher borrowing costs and results in shorter maturity of the public debt profile.

5.2. A selected policy challenge: improving tax policy and administration

Competition across countries to attract more foreign investment by offering generous tax benefits is not always welfare-enhancing

An important function of Government is to collect taxes for the provision of public goods, such as education, health care and infrastructure. For South-East Asia, total tax revenues as a share of GDP ranged between 12.4% in Indonesia and 19.6% in Thailand in 2013.²⁰ While the "optimum" tax-to-GDP ratio would depend on a number of factors – such as a country's preference for public goods, the availability of non-tax revenues and the structural characteristics of the economy – by all accounts, there seems to be room for increasing tax revenues in a number of countries. For instance, it was found in a study that Indonesia's potential tax-to-GDP ratio is approximately 4-5 percentage points higher than the actual level (ESCAP, 2014a).

Intuitively, tax revenues can be below "potential" for two reasons: a tax law which allows for various exemptions and the imperfect implementation of the tax law. For instance, in South-East Asia, the tax base tends to be narrow due to various exemptions and incentives, such as tax holidays and investment allowances, while tax compliance is undermined by weak enforcement and inadequate taxpayer services. These two gaps are discussed below for different income and consumption taxes.

The contribution of personal income tax to total government revenue is generally low, despite a rapid increase in the number of high-income individuals and the need for income redistribution amid rising inequality. Personal income tax revenue as a share of GDP ranged from 0.8% in Indonesia to 2.4% in Malaysia in 2012. While raising the top marginal rate may be difficult, partly due to the need to align corporate and personal tax rates to some extent,²¹ there appears to be room to lower the income threshold for the top bracket, particularly in the Philippines, Thailand and Viet Nam, where the threshold is 23-30 times higher than the countries' per capita income (ESCAP, 2014a). At the same time, compliance measures can be strengthened, especially for high-income individuals and self-employed professionals who have greater

opportunities for tax evasion and avoidance compared with salaried employees whose wages are subject to withholding. Some such people may not even be registered. For instance, it is estimated that, out of a population of 255 million in Indonesia, at least 44 million should be paying taxes, whereas the reality is that just 27 million are registered and only 10 million actually pay income tax in full every year.²²

A major source of government revenue, corporate income tax, is increasingly coming under pressure due to greater global economic integration, including mobility of capital. Corporate income tax contributed between 3.5% of GDP in the Philippines and 9% of GDP in Malaysia in 2012. While a declining corporate income tax rate is a worldwide trend, the issue seems to be exacerbated in South-East Asia with ASEAN integration. Since the adoption of the ASEAN Economic Community Blueprint in 2007, several countries have further reduced their corporate income tax rate and expanded tax incentives and exemptions for investors (see table 2.1). Viet Nam lowered its corporate income tax rate from 25% to 22% in 2014, and plans to lower it to 20% in 2016. In August 2015, Indonesia expanded its tax holiday from 10 to 20 years, while Thailand's new investment promotion strategy expands provisions for reduced rates. This is in contrast to the trend in OECD countries, where revenue loss from lower rates has been offset by base-broadening measures.²³ Therefore, tax coordination among ASEAN member countries seems desirable in order to avoid excessive tax competition. In addition, tax incentives can potentially erode revenues further by making enforcement more challenging. For instance,

investors could use transfer pricing to funnel profits from an existing profitable company through the “tax holiday” company and completely avoid paying taxes (World Bank, 2015c).

Value-added tax (VAT) has helped to offset revenue losses from trade liberalization. VAT revenues in 2012 stood at between 2.2% of GDP in the Philippines and 4.5% of GDP in Thailand. Malaysia introduced a goods and services tax, a variant of VAT, in April 2015 to broaden its tax base and reduce its reliance on oil revenues. Despite the relative success of VAT, there seems to be room to expand its base in the subregion, as there are currently many exemptions and a zero-rating on such areas as petroleum products and legal services. The services sector in particular tends to maintain traditional sales taxes and has yet to transition to VAT, which encourages production efficiency and tax compliance. Another issue is VAT collection for small businesses. While small companies may have limited revenue potential, bringing them into the tax net produces several benefits, such as enhanced taxpayer morale and record-keeping capacities (IMF, 2011). At the same time, current VAT rates in the subregion are generally lower than in other parts of the world and there seems to be room to raise rates, especially in Malaysia and Thailand. Conceptually, VAT should facilitate compliance through a built-in incentive structure. However, automatic audits on all VAT refund claims, as practised in many countries, tend to increase compliance costs for smaller firms while overlooking unreported cash transactions which could be better tackled through risk-based auditing.

Table
2.1

Statutory tax rates in 2015

(Percentage)

	PIT	CIT	VAT/ sales tax	SS-EE	SS-ER	WHT
Brunei Darussalam	..	20	..	8.5
Cambodia	20	20	10	..	0.8	14
Indonesia	30	25	10	2	5.74	20
Lao People's Democratic Republic	25	24	10	5.5	6	10
Malaysia	25	25	6	11	12	..
Myanmar	25	25	5	1.5	2.5	..
Philippines	32	30	12	3.63	7.37	15
Singapore	20	17	7	20	17	..
Thailand	35	20	7	4	5	10
Viet Nam	35	22	10	8	18	..

Sources: National tax administrations and the professional services company, KPMG.

Note: PIT = personal income tax (top marginal rate); CIT = corporate income tax (top marginal rate); VAT = value-added tax (standard rates for both VAT and sales tax); SS-EE = social security contributions by employee; SS-ER = social security contributions by employer; and WHT = withholding tax on dividends. No entry indicates that such taxes are not collected.

*Successful tax reform requires
more effective coordination
among relevant agencies and
greater use of information technology
in tax administration*

Tax reforms can be challenging and require strengthening of institutional capacity and effective governance, which cannot be achieved overnight. Setting medium-term strategies and targets is therefore recommended. Political leadership is critical. To ensure that tax policy and administration are properly aligned, Governments could focus more on improving coordination among finance ministries, boards of investment and other bodies that grant tax incentives, regional and local governments and the revenue administration. To narrow policy gaps, a recommendation highly relevant but not limited to corporate income tax is that Governments publish tax expenditures as part of their national budget reporting to enhance transparency and encourage proper cost-benefit analysis of tax exemptions and incentives.

Countries could also intensify regional dialogue to curb excessive tax competition. With regard to personal income tax, in view of the increasing challenges of implementing a global income tax, Governments may consider adopting a dual income tax, which levies a proportional rate on capital income and a progressive rate on labour income. Tax compliance-related priorities include effectively engaging taxpayers in the process of registration, collection, audit and appeal, while making good use of information technology and modern tools of tax enforcement, such as withholding and third-party information sharing. Staff development is critical for all these activities. Better taxpayer services are needed to encourage voluntary compliance. As noted in the case of VAT, risk-based audits rather than automatic audits on all refund claims could help ease administrative pressure and improve compliance.

Additionally, it seems that corrective taxes, such as those levied on tobacco or fuel, are underutilized in South-East Asia, but they could contribute to revenues and enhance social welfare by addressing health and environmental externalities. Examples include the Philippines' excise tax on alcohol and tobacco and Viet Nam's environmental protection tax. Wealth-related taxes, such as those on property, inheritance or capital gains, are also underutilized, but could be a stable and progressive source of revenue, including for local governments. An example is Thailand's new inheritance tax and gift tax. While these taxes may not help boost revenue as much as VAT, the marginal impact could still be significant.

Endnotes

- ¹ For the range of the country's economic growth rates, see United Nations, Department of Economic and Social Affairs, National Accounts Main Aggregates Database. Available from <http://unstats.un.org/unsd/nationalaccount/data.asp> (accessed 20 December 2015).
- ² For further details, see Global Information and Early Warning System and Food and Agriculture Organization of the United Nations, GIEWS Country Briefs. Available from www.fao.org/giews/countrybrief/country.jsp?code=PRK.
- ³ The first phase of construction was started in 2010 and completed in 2013 at a total cost of \$6.6 billion. The project is expected to produce annually 430,000 tons of cooper and 425,000 ounces of gold.
- ⁴ This conclusion is based on data contained in Organisation for Economic Co-operation and Development, *Pensions at a Glance 2013: Retirement-Income Systems in OECD and G20 Countries* (Paris, OECD Publishing, 2013). Available from http://dx.doi.org/10.1787/pension_glance-2013-en. It is also based on information from various other sources.
- ⁵ For rankings under the Doing Business project, see www.doingbusiness.org/rankings and <http://data.worldbank.org/indicator/IC.BUS.EASE.XQ>.
- ⁶ For more details, see European Bank for Reconstruction and Development (EBRD), "Forecasts, macro data, transition indicators". Available from www.ebrd.com/what-we-do/economic-research-and-data/data/forecasts-macro-data-transition-indicators.html; *Transition Report 2015-16* and *Transition Report 2015: Rebalancing Finance* (London, EBRD, 2015). Available from www.ebrd.com/documents/oce/pdf-transition-report-201516-english.pdf, and www.ebrd.com/news/events/transition-report-2015-rebalancing-finance-.html, respectively.
- ⁷ For details, see www.worldbank.org/projects/P133255/pacific-catastrophe-risk-insurance-pilot-program?lang=en and pccrafi.sopac.org.
- ⁸ The roadmap is available from www.sprep.org/2011sm22/pdfs/eng/Officials/WP_8_2_1_Att_1_PIFACC%20Roadmap.pdf
- ⁹ Opium production, which is illegal, was reported to have dropped to about 3,300 tons in 2015, or an amount almost 50% lower than that in 2014. The area devoted to cultivation of the opium poppy fell in 2015 for the first time since 2009. For more details, see United Nations Office on Drugs and Crime and Afghanistan, Ministry of Counter-Narcotics, "Afghanistan Opium Survey 2015: executive summary". Available from www.unodc.org/documents/crop-monitoring/Afghanistan/Afg_Executive_

- summary_2015_final.pdf. The full report will be available in 2016.
- ¹⁰ This information is based on the Afghanistan Chamber of Commerce and Industries “ACCI Business Tendency Survey Report, June 2015”. Available from [www.acci.org.af/media/7th%20ACCI%20Business%20Climate%20Monitor%20Survey%20\(English\)_%20June%202015.pdf](http://www.acci.org.af/media/7th%20ACCI%20Business%20Climate%20Monitor%20Survey%20(English)_%20June%202015.pdf).
- ¹¹ Energy distributor payment arrears were estimated to be 1.4% of GDP in 2012/13, with collection challenges feeding into intercompany debt problems within the energy sector. For details, see International Monetary Fund, “Pakistan: Staff report for the 2015 Article IV consultation” (Washington, D.C., IMF, 2016). Available from www.imf.org/external/pubs/ft/scr/2016/cr1601.pdf.
- ¹² Based on various initial estimates reported in media.
- ¹³ The participation rate among urban women has been largely stable in past decades. The rate among rural women decreased from about 33% in 2004/05 to 25% in 2011/12, likely due to higher school enrolment, agricultural mechanization and higher household income. As a country with a young population and increasing educational enrolment, the female participation rate, typically based on the age group of 15-64, would appear low in India because many girls are in school. Once adjustment has been made for girls aged 15-21 years, the participation rate among urban women in 2004/05 would increase from 25% to 36%. For more details, see Sonali Das and others, “Women workers in India: why so few among so many?” IMF Working Paper WP/15/55 (Washington, D.C., International Monetary Fund, 2015), and Surjit Bhalla and Ravinder Kaur, “Labour force participation of women in India: some facts, some queries”, Asia Research Centre Working Paper 40 (London, London School of Economics and Political Science, 2011).
- ¹⁴ Parental leave should be funded fully by the Government so that the cost involved is not a factor when employers consider hiring women. Data in a recent publication suggest that this is currently the case only in the Islamic Republic of Iran, Pakistan and Turkey. For details, see World Bank, *Women, Business and the Law 2016: Getting to Equal* (Washington, D.C., 2016).
- ¹⁵ For example, a study showed that in societies where the dominant agricultural practice during the pre-industrial period required stronger body strength thus giving more economic roles to men, there is weaker female participation in job markets and politics today. For details, see Alberto Alesina, Paola Giuliano and Nathan Nunn, “On the origins of gender roles: women and the plough”, *Quarterly Journal of Economics*, vol. 128, No. 2, pp. 469-530.
- ¹⁶ The agricultural sector accounts for a third or up to two thirds of total employment in most countries and consists largely of small-scale subsistence farmers. In Indonesia and the Philippines, nearly a third of those employed across all sectors earn less than \$2 a day.
- ¹⁷ The share of dollar-denominated debt in total non-financial corporate debt as of mid-2015 has been estimated at 10% in Malaysia, 29% in the Philippines and 52% in Indonesia. For details, see Robert McCauley, Patrick McGuire and Vladyslav Sushko, “Dollar credit to emerging market economies”, *BIS Quarterly Review*, 6 December 2015, pp. 27-41. Available from www.bis.org/publ/qtrpdf/r_qt1512e.htm.
- ¹⁸ The latest available official data show that the economy contracted by 13.9% in 2013 compared with its positive growth rate of 5.2% in 2012.
- ¹⁹ The share of higher-value exports, such as telephones, computers and related components, has increased to a third from less than 5% a decade ago, while the share of primary commodities fell.
- ²⁰ Excluding Brunei Darussalam and Timor-Leste, which derive most of their government revenues from the oil and gas sectors, with a fine line drawn between tax and non-tax revenues.
- ²¹ This step is intended to minimize the incentive for shifting income from a personal to corporate tax base, for instance by changing the form of compensation, activity or asset.
- ²² Estimates by Indonesia’s Ministry of Finance, as cited in Ben Otto, “Can Indonesia boost tax revenue by 30%? Good goal, economists say, but no”, *Wall Street Journal*, 14 April 2015.
- ²³ Countries in South-East Asia typically offer firms five to eight types of tax incentive compared with only one or two in many developed economies. The literature suggests that reduced tax rates and incentives can attract foreign investment, but only where other business conditions are good.