



EXECUTIVE SUMMARY

The year 2016 represents a historic milestone in global development policymaking as it marks the beginning of the 2030 Agenda for Sustainable Development which, with its 17 Sustainable Development Goals and many targets, provides a comprehensive and universal framework for development policy over the coming 15 years. This is also an opportune time to rethink the region's development strategy, its overreliance on exports destined for developed economies and more recently the extent of the sharp increase in private sector debt leverage. With the centre of economic gravity continuing to move eastwards, it is time for the Asia-Pacific region to adopt a development model that relies more on domestic and regional demand that, among other things, nurtures inclusiveness, equality and social stability.

Eight years after the global financial and economic crisis that started in 2008, the impact of low economic growth in developed economies continues to linger in the Asia-Pacific region. Despite the extraordinary monetary and fiscal measures that have been taken to overcome the effects of those crises, global aggregate demand remains weak and the outlook uncertain. The region's continued exclusive reliance on export-led development is thus futile. At the same time, economic expansion in China, the engine of regional as well as global economic growth, is moderating; progress in reducing poverty is slowing and inequalities are rising, while demographic pressures, an expanding middle class and rapid urbanization are posing complex economic, social, environmental and governance challenges.

Added to these unfavourable phenomena is a sharp rise in private debt in some major economies as the region navigates through the impacts of depreciating currencies and rising interest rates in the United States. Nonetheless, the region has the wherewithal and dynamism to revitalize economic growth amid these challenging circumstances. Improving the quality of this growth by making it more inclusive and sustainable, however, is a more demanding task.

To bolster economic growth in Asia and the Pacific and effectively pursue the 2030 Agenda, Governments will need to strengthen efforts to stimulate domestic and regional demand, according to the *Economic and Social Survey of Asia and the Pacific 2016*. In addition to raising public spending, sustained increases in domestic demand will require steady growth in real wages. However, growth in productivity – after having increased markedly over the last couple of decades – has declined in recent years. This situation is worrying not only as wage growth has lagged productivity growth, but also as wage growth ultimately depends on productivity growth. Thus, if the region is to shift to a more sustainable development strategy that is driven by domestic demand, greater focus must be placed on productivity along with commensurate increases in real wages. Thus, it is argued in the *Survey* for 2016 that a productivity-driven, wage-led approach would enable countries to increase their aggregate supply and their aggregate demand, thereby enhancing the well-being of their societies.

The first chapter of the *Survey* contains an examination of the macroeconomic performance of and outlook for the Asia-Pacific region, analysing the implications of some of the economic challenges that the region is facing. It also contains a discussion on several policy options, with emphasis on the importance of fiscal policy. The chapter also includes an examination of the impact of the recent economic slowdown in the Asia-Pacific region in terms of its effects on poverty, inequality and employment prospects, along with challenges posed by an expanding middle class and rapid urbanization. In the second chapter, the diversity of the region is considered by providing a more disaggregated analysis of economic issues and challenges that each of the five subregions is facing. In doing so, a distinct issue is the focus for each subregion, which provides an opportunity for increased understanding of a variety of experiences and policy considerations. Finally, the third chapter contains analyses on the importance of productivity in the Asia-Pacific region and a set of policy recommendations on how to strengthen productivity growth.

Economic outlook and policy challenges

The economic outlook for developing Asia-Pacific economies is broadly stable but is clouded by uncertainty. Economic growth in 2016 and 2017 is forecast to increase marginally to 4.8% and 5%, respectively, from an estimated 4.6% in 2015, as a confluence of macroeconomic risks continues to buffet the region. These risks include: a somewhat uncertain outlook for the Chinese economy in the backdrop of a fragile global economic recovery; weak consumption and investment trends in major developing economies in the region; volatility in exchange rates, including that due to low oil prices for commodity exporters; growing private household and corporate debt; and an ambiguous path of interest rate increases being pursued by the United States. These uncertainties are interconnected and thus complicated to manage.

Prospects of an export-led recovery in developing Asia-Pacific economies remain broadly subdued due to the weak economic outlook for the European Union and Japan alongside the somewhat better growth performance that is expected in the United States. For many exporting economies in the region, particularly commodity-dependent economies, this challenge is compounded by moderating growth of the Chinese economy, which has been partly driven by much-needed rebalancing to sustain growth in the medium term. Indeed, with global commodity prices having declined to levels last seen at the time of the outbreak of the global financial and economic crises in 2008, with the most dramatic reductions having been observed recently in the case of oil, resource-dependent economies endured severe declines in their GDP growth rates in 2015.

The outlook for domestic demand, which will need to play a major role in supporting any future growth in most regional economies, is also expected to remain rather constrained. In some economies, this situation is partly due to the relatively high levels of household and corporate debt that have accumulated at a rapid pace over the past few years. High inflation in some economies and declining real wages are also contributing factors. In going forward, a larger share of household incomes and corporate earnings will be directed towards debt repayment, further constraining the impetus to increased domestic demand. Investment will also be affected by general uncertainty, excess capacity and low utilization rates, making investors wary of making long-term decisions. However, some support for growth in domestic demand may come from the expected progress in the reform policies of major developing economies in the region. Moreover, several lower-income economies are experiencing robust economic expansion fueled by higher levels of foreign investment and rapid growth in domestic credit, albeit from a low base. Policymakers should ensure, however, that such investments contribute to economic diversification and that credit growth does not hinder financial stability.

In the context of high levels of private debt, gradual yet expected increases in interest rates in the United States may increase the pressure on capital to flow out of the Asia-Pacific region. In turn, this could lead to higher interest rates in the region. The prospect of higher domestic financing costs does not bode well for growth in domestic demand or for fixed investment. Yet, if economies choose to maintain their interest rates or reduce them because of lower inflation, they may experience higher exchange rate pressures. Recent depreciation of the Chinese currency has already put stress on other currencies in the region. It is this tension in policy considerations that is increasing the level of “uncertainty” – *the* factor that is the ultimate detriment to investment.

While inflation is expected to remain low in the region as a whole, reaching a multi-decade low of 3.7% in 2016 compared with 4.1% in 2015, there is considerable divergence between subregions and individual economies. For instance, in economies with sizeable commodity exports, subdued commodity prices weakened their terms of trade and external account performance, which resulted in significant currency depreciations and higher inflation rates. In contrast in other economies, an overall low-growth, low-inflation environment, all things being equal, would suggest that there is further room for an easy monetary policy stance, although considerations relating to financial stability and exchange rate volatility are likely to influence the conduct of monetary policy. However, while many economies have continued lowering their policy interest rates, this approach so far has not had a notable impact on economic growth.

Countercyclical fiscal policy, unlike monetary policy, can potentially play a more supportive role in enhancing economic growth, particularly as most developing countries in the region, by and large, have relatively low levels of government debt, although debt servicing costs are high in some countries. Moreover, fiscal policy, particularly spending on education, health and infrastructure, has a significant impact on the distribution of income and opportunities and on long-term economic growth. In keeping in view their development needs, Governments of economies in the region must recognize that there is no mechanical or universally accepted

threshold for limiting public debt. Ultimately, each country needs to assess the costs and benefits of higher public debt, keeping in mind that the long-term sustainability of fiscal positions also depends on sufficient, consistent and equitable tax revenues.

Even as economic growth plateaus in Asia and the Pacific, it is not clear that growth in the past has been sufficiently inclusive, given the weak employment growth in 2015 for the region as a whole coupled with the mixed progress that has occurred in enhancing the quality of employment. These dynamics are also contributing to concerns about the extent of poverty reduction and rising inequality in the region. Available data on the post-crisis period indicate that some major developing economies, accounting for a large share of the population in the Asia-Pacific region, are experiencing a decelerating trend in the rate of poverty reduction. Similarly, indicators of income inequality have worsened in recent years. In particular, the outpacing of wage growth through increases in productivity in many developing economies in the region has led to more unequal distribution of incomes between capital and labour. Thus, ensuring steady increases in wages is one of the important factors for reducing poverty and inequality.

Active labour market policies can support employment in times of economic slowdown and foster a virtuous cycle in which good-quality education and vocational training increases labour productivity and this in turn translates into higher wages. Also, a productivity-driven, wage-led approach has a higher chance of addressing issues of poverty and inequality and supporting sustained increases in economic growth. At the same time, enhancing social protection for the poor and near-poor is critical as these groups tend to be highly vulnerable to economic downturns. Greater social protection in the region can also support regional economies in boosting the role of domestic demand in economic growth by reducing the need for precautionary savings. Regional economic cooperation and integration, particularly in the areas of capital markets, intraregional trade, infrastructure development, and energy and information and communications technology (ICT) connectivity, are other important avenues for boosting domestic and regional demand.

Despite the economic slowdown of recent years, faster growth in previous decades has resulted in a noticeable increase in the size of the “middle class” in many countries in the region. An expanding middle class, with higher disposable incomes, represents an increasing pool of domestic demand that can be tapped by economies to reduce their dependence on the struggling external sector. However, a rising middle class also tends to lead to increased demand for public services that go beyond basic needs, such as better-quality education; decent health, water and recreational services; reliable energy and ICT infrastructure; and clean air, along with less congested transport facilities. Such demands put pressure on Governments to provide these services and, in the case of expectation gaps, can lead to social tensions. Particular attention should be given to the group earning just above \$2 a day, a “transitional class” that remains very vulnerable to falling back into poverty due to external shocks. Governments should ensure that social protection is provided especially for this group in order to cement their position in the middle class.

A particular feature of the expansion of the middle class and the wider economic growth process in the region is the phenomenon of rapid urbanization. Despite the positive contribution of cities to economic growth, not all urban dwellers have benefited from this transformation, as they lack access to many basic services and rely on the informal sector for many of their needs. Rapid urbanization has also significantly raised the region’s exposure to natural hazards by exacerbating existing risks and creating new ones. Dealing with these challenges requires government policies that, among other things, would lead to development of the necessary infrastructure and improved social support structures. Implementing such proactive policies, however, requires sufficient government funding, especially at the local level.

Perspectives from subregions

The Asia-Pacific region is vast, varied and rich in development experiences. Consequently, the development challenges faced by the region are quite diverse. 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 therefore be evaluated separately, keeping in view their respective historical context, social and political traditions, and aspirations.

In East and North-East Asia, moderating growth 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. Key uncertainties to the outlook for the future are whether China's medium-term growth rate will settle around 6.5% and whether the Japanese economy would return to recession if the consumption tax is increased in 2017 as planned. As decelerating growth in China has been accompanied by heightened economic uncertainty, an immediate challenge is to manage the transition in China without causing too many negative spillovers into the regional and global economy. The size of the working-age population in all major subregional economies is projected to shrink after 2020 to the extent that the elderly could account for up to one third of the subregion's total population by 2035. That occurrence will pose a serious threat to the economic and social development of the subregion; its impact on fiscal sustainability, especially on the provision of social security, could be substantial.

The subregional economies in North and Central Asia faced a marked deterioration in economic growth performance and heightened macroeconomic instability in 2015. In most of these countries, a deep plunge in the 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. The outlook is very uncertain and the risks are clearly tilted to the downside. The current turmoil serves as a stark reminder that the subregion needs to diversify its growth engine beyond resource-based sectors. Although infrastructure connectivity has improved in recent years, reforms are needed to create vibrant business support services to complement a high value-added manufacturing sector. The challenge is to raise the required financing for diversification and push forward deregulation in a calibrated manner, such as easing market entry, while having in place strong regulatory bodies that protect consumer interests and ensure fair competition.

In the Pacific subregion, overall economic growth in 2015 was driven largely by elevated production of liquefied natural gas in Papua New Guinea, which accounts for 60% of output in Pacific island developing economies. This situation, however, masks much slower economic expansions and even contractions in other economies. 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. Public policies have been focused on enhancing an individual country's ability to cope with natural disasters but the sheer scale of those disasters calls for closer and perhaps more innovative partnerships between the Pacific island economies and the international development community.

In South and South-West Asia, India's economy is gradually gaining growth momentum amid making 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, however, small in view of the limited trade and financial interlinkages. Despite a recent increase, the subregion's economic growth rate remains below its potential. One option to close the output gap is to increase the participation rate of females in the workforce; currently, that rate is an average of 43% across countries in the subregion. Policy efforts have been made to overcome core barriers and offset disincentives for women to work. However, the key question is whether such policies are bold enough to alter social norms that discourage or even prohibit a role for women outside the household sector. Reforms to ease supply-side constraints, such as severe energy shortages and infrastructure deficits, are also critical in reducing production costs and promoting export competitiveness. Over time, such measures will help to relieve inflation and narrow the current account shortfalls, promoting greater macroeconomic stability.

In South-East Asia, economic growth was stable but at a low level in 2015. Exports declined amid China's growth moderation, and 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. Countries with lower income levels will continue to enjoy relatively robust economic expansion, thus narrowing the development gaps between frontier economies and emerging economies in the subregion. The recent launch by the Association of Southeast Asian Nations of the ASEAN Economic Community should provide a good opportunity for frontier economies to diversify their growth engines. However, 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. Competition to offer more generous tax privileges should be addressed through stronger regional tax cooperation. Tax reforms are also needed to meet the rising demand for public social services and urban infrastructure.

Importance of increasing productivity

The relatively strong economic growth witnessed in the Asia-Pacific region over the last few decades was driven primarily by factor accumulation, that is, by increases in the labour force and the capital stock through investment, including from abroad. Nevertheless, significant increases in productivity, particularly in labour productivity, also took place throughout the region, such that the gap in the level of labour productivity with developed economies has roughly been halved: labour productivity in the developed economies was about 12 times higher than that in the Asia-Pacific region in 2013 compared with 24 times higher in 1990. Moreover, as a reflection of higher levels of labour productivity, significant improvements in wage levels in the region have also been observed. For instance, in 2013 real wages in the region were more than 240% higher than in 1999 compared with a global increase of only 33%.

Economic growth and productivity growth have declined, however, in the aftermath of the 2008 economic and financial crises. Growth of total factor productivity (TFP) has declined by more than half in developing countries in the region, averaging only 0.96% between 2008 and 2014, while labour productivity has declined by more than 30% to 3.9% in 2013. Similarly, despite increases in wage levels, growth in real wages has not been commensurate with the observed increases in productivity levels. These trends are worrying as economic and productivity growth and sustained increases in real wages are vital for development. They also highlight the region's vulnerability to external shocks stemming from its reliance on exports to developed economies.

In most developing Asia-Pacific economies the contribution of the service sector to labour productivity growth has been the most important one. Indeed, many economies in the region have shifted from an agricultural to a service-based economy, leapfrogging the manufacturing stage. This shift is, however, coming at a too early level of development in many countries in the region and may not be conducive for fostering development. Across the globe, countries that have developed successfully have generally done so on the back of rapid industrialization. It is therefore imperative for these countries to reindustrialize and to stimulate productivity growth.

In this regard, strengthening the role of agriculture along with rural industrialization is vital not only because agriculture accounts for one in four workers and because 55% of people in the region live in rural areas, but also because greater labour productivity in agriculture would enable higher incomes in the rural sector, which would contribute to strengthening domestic demand and to reindustrialization of economies. Thus, the agricultural sector continues to play a significant role in poverty alleviation in the region. Indeed, a simulation exercise revealed that, if growth of TFP and fertilizer use remains unchanged and the recently observed decline in the use of farm machines is reversed, the corresponding increase in agricultural productivity could lift at least 110 million people out of extreme poverty in the next 15 years.

As the share of industry and services in GDP increases, so does aggregate productivity growth, owing to the fact that productivity in these sectors is generally higher, being more capital-intensive, than in agriculture. However, the skill bias of modern technology and rapid capital accumulation can reduce the pace of absorption of often unskilled labour freed from the agricultural sector, resulting in sluggish employment growth. This trend can be observed by the fact that agriculture's share in GDP in developing economies in the region has declined much faster than the corresponding decline of total employment in agriculture. Moreover, in many countries the relative position of agricultural incomes, measured by agricultural value added per worker, in comparison with GDP per capita has declined significantly over the years. The region has thus experienced faster economic growth without a corresponding ability to absorb the expanding labour force; at the same time, agricultural workers have become relatively poorer.

The Sustainable Development Goals provide an entry point to strengthen productivity. At the same time, focusing on productivity provides an overarching framework for countries to tackle the achievement of several Goals, thereby creating a virtuous circle between the Sustainable Development Goals and productivity. It must be recognized though that at an early stage of development productivity-driven growth may not immediately lead to increases in decent jobs and higher wages. An active and effective role of Government is therefore imperative to provide the necessary cushion in the meantime.

Raising agricultural productivity must be at the centre of the focus to end poverty (Goal 1) and end hunger and achieve food security (Goal 2). Increasing productivity, especially in the agricultural sector, contributes

to the reduction of poverty directly by positively affecting the rural households' income obtained from agricultural and non-agricultural activities. Efforts to eradicate poverty and achieve higher levels of productivity in agriculture would also foster development of the rural sector and encourage industrialization (Goal 9).

As higher levels of productivity in agriculture will free up labour from that sector, which would be available to work in the non-agricultural sector, it is important to consider a broader development strategy. Focusing on accommodating the "agricultural push" of labour would also provide an opportunity for moving towards full and productive employment (Goal 8), especially if a structural change could be achieved in following an agriculture-industry-service sequence and rural industrialization through small-scale industries. Doing so would, however, require additional training of people, particularly of labour with low-level skills. Thus, mechanisms are needed to ensure that populations have access to good-quality education and lifelong learning (Goal 4). Combating climate change and its impacts (Goal 13) could also produce a beneficial impact on productivity growth, especially productivity in the agricultural sector.

To identify gaps and take relevant steps to accelerate productivity growth, enhance its level and share the resulting gains, it is important to understand what drives productivity. Key factors that have a particularly strong impact on productivity are: labour quality, which includes knowledge and skills, as well as the health of the workforce; innovation through enhanced openness via trade, foreign direct investment and participation in global value chains; adequate infrastructure, such as transport, energy and ICT; and access to finance, especially by small and medium-sized enterprises.

In addition to promoting policies that strengthen the contribution of these factors to productivity growth, it must be remembered that such policies do not work in isolation; a comprehensive, cross-sectoral and integrated approach is needed. For instance, the issue of extensive "surplus labour" in agriculture cannot be solved within the boundaries of agriculture alone. Appropriate strategies and policies are needed to absorb the agricultural push of labour from the agricultural sector and to accelerate aggregate productivity growth. For instance, these policies include developing the non-farm sector by fostering rural industrialization through small-scale industries. Such measures can strengthen linkages between agricultural and non-agricultural sectors and would lead to backward-forward and production-consumption linkages within agriculture and between the agricultural and non-agricultural sectors. Governments' policies should also facilitate such movements by retraining workers to improve their skills thus making them more employable and offering productivity-based financial incentives for encouraging such movements.

The importance of good-quality education in enhancing productivity on a sustained basis cannot be overemphasized. Such education provides people with the skills required to apply current technologies as well as to be able to assimilate, adapt and develop new technologies and adjust to changing economic conditions. Such endeavours to promote good-quality education need to be complemented with active research and development programmes that facilitate innovation and technical education through vocational schools that help upgrade skills of the workforce. Similarly, investment in infrastructure, physical as well as financial, together with efforts to improve accessibility of enterprises to information and communications technology would significantly contribute to productivity growth in the industrial sector, while also spurring foreign direct investment-related positive spillover effects. Most such initiatives would require strong support from the Government, and that in turn would require strong fiscal positions.

Finally, Governments will need to step in to ensure that increases in labour productivity are passed on to workers so that economies in the region will be able to shift to a development strategy in which domestic and regional demand plays a greater role. Doing so will require linking gains in labour productivity more closely with increases in wage levels. Strengthening the enabling environment for collective bargaining is one necessary component in a Government's policy arsenal; enforcing minimum wages, in consultation with the private sector, is another important policy tool. Similarly, balanced use of social protection measures, including unemployment insurance and pensions keeping in view labour market flexibility considerations, could also foster domestic demand and smoothen the reallocation of workers between sectors. Again, effective and credible implementation of a host of such policies will be contingent upon strong and sustainable fiscal positions, which would be difficult to attain without reforming tax administration and improving revenue collection.