Rethinking economic growth strategies and policies to achieve sustainable development goals: the role of productivity

Summary

Economic growth in the developing economies of the Asia-Pacific region has been declining since 2010 and is expected to plateau at around 5 per cent for 2015 and 2016. Although a sharp slowdown in external trade coupled with a decline in demand from China are chiefly responsible, total factor productivity growth has also weakened. Taking advantage of low inflation, primarily due to declining international commodity prices, many economies have lowered interest rates to support growth. However, just like concurrent exchange rate depreciations in export-oriented economies, they have had a limited impact so far.

While reviving economic growth is important for creating jobs and improving development outcomes, economic growth slowdown is not necessarily “bad”. What matters is that economic growth is more inclusive. As such, the post-2015 development agenda is much more than just economic growth. Yet, implementation of the sustainable development goals will certainly test the capacities of economies to meet the challenges and take advantage of emerging opportunities.

The region’s economies, therefore, will have to adjust their growth strategies in a manner that gives relatively more weight to domestic and regional demand and less to extraregional trade. They should also internalize sustainable development goals into national economic and development policies. Importantly, they will have to introduce policies that strengthen productivity growth and pass the gains on to the labour force. One way is to increase real wages to support domestic demand and ensure consistent increases in economic growth and well-being. Relevant policies would include minimum wage policies, greater social protection and public employment guarantees, while keeping in view the implications for the fiscal positions.

In addition to achieving greater balance through a more sustainable growth model, these policies would assist in attaining the sustainable development goals. Another way to strengthen demand is to increase investment in support of the sustainable development goals. Doing so will improve productivity, enabling countries to benefit from a virtuous cycle between the sustainable development goals and productivity.

Members and associate members are invited to consider the issues analysed in the note, share their experiences and provide guidance on the future regional policy agenda for inclusive and sustainable development.
I. Introduction

1. Most advanced economies are still struggling to revive their economic growth after the debacle of the global financial and economic crisis that started in 2008. Given the export-led growth orientation of many developing economies of the Asia-Pacific region, this poses a considerable challenge in reviving and sustaining the high levels of economic growth experienced before the crisis. Exporting economies in the region have experienced a significant slowdown in their export performance due to lower demand from developed economies and from China, which is being affected by weakness in the developed economies in the same manner as other regional economies. This has led to decreased demand for intermediate inputs from the region. Furthermore, China is also demanding less final goods and commodities from the region as the role of investment in the economy declines.

2. With this backdrop, the growth trajectory of the region has been on a declining trend since 2010. Growth in the region is set to plateau at around 5 per cent in 2015 and 2016. This is not necessarily a “bad” outcome, provided the economies continue to strive to make economic growth more inclusive. However, as highlighted in the Economic and Social Survey of Asia and the Pacific 2015, economic growth has not been sufficiently inclusive, despite significant progress over the years. Similarly, the post-2015 development agenda is much more than just economic growth. Implementation of the sustainable development goals will certainly test the capacities of economies to meet the challenges and take advantage of emerging opportunities.

3. Nevertheless, reviving economic growth is important for creating jobs, increasing financial resources to invest in the social sector and improving overall development outcomes. In the context of external trade headwinds, the Asia-Pacific economies will have to look more towards domestic and regional demand as their future drivers of economic growth, while keeping in view the broader objectives of sustainable development. At this point in time, it is not clear that domestic and intraregional demand will grow sufficiently to counteract the lower extraregional demand. The recent volatility in equity and currency markets, partly due to expectations of a rise in United States interest rates and partly due to concerns about weaker growth in the region, does not help matters. Lower international commodity prices have helped many commodity-importing economies in terms of easing
inflationary concerns and supporting domestic consumption. However, the commodity-exporting economies have been negatively affected. Domestic investment has been curtailed in many economies in the region due to credit cooling measures in some and lack of supply-side reforms in others, such as removing regulatory barriers or implementing infrastructure programmes.

4. The region has the capacity and possesses tools to engineer an increase in economic growth from within and make growth inclusive at the same time. Other than removing barriers to business, removing bureaucratic hurdles and improving governance, some economies that have the fiscal space can undertake expansionary fiscal measures. Economies should redouble efforts to remove logistical barriers to domestic and regional production and trade by improving physical infrastructure. In this vein, boosting regional economic cooperation and integration can go a long way in allowing countries of the region to tap into their own sources of demand. The quality of the workforce should be upgraded by investing in health and education. Domestic consumption could be propagated by improving social protection and therefore reducing the need for precautionary savings. Similarly, greater financial inclusion would further increase consumption by improving the access of the poor to financial products such as business loans and insurance products.

5. Above all, the region’s economies can benefit tremendously by focusing on and improving productivity. Over recent decades, the Asia-Pacific region has witnessed significant increases in productivity. Yet, growth in total factor productivity has declined in the aftermath of the global economic and financial crisis, and is now below that registered in the 1990s. Reversing this decline is important, especially in economies eager to move beyond middle-income status. At the same time, greater efforts must also be made to ensure that productivity gains are passed on to workers by linking more strongly wage increases to productivity increases. This would lay a more resilient and stronger foundation for growing from within by enabling the region to gradually shift to development in which domestic and regional factors play a larger role, rather than relying primarily on exports.

6. Importantly, while strengthening productivity will contribute to attaining the sustainable development goals, which member States will agree to this year as part of the follow-up to the Millennium Development Goals, countries will also be able to improve productivity through greater investment in support of such goals, thereby creating a virtuous cycle between them and productivity.

II. Macroeconomic performance, outlook and key challenges

A. Growth and trade prospects

7. Economic growth in the region is currently experiencing a “new normal” of somewhat lower growth. While the region’s economic growth still remains higher than any other in the world, after a strong initial recovery from the crisis in 2010-2011, it has been considerably lower compared with the pre-crisis average. Economic growth in the period from 2012 to 2014 averaged 5.2 per cent, whereas the average between 2005 and 2007 was 9.4 per cent.¹ Quarterly growth data for 2015 indicates that the region is slowing further from its performance in 2014 (see figure 1). Current ESCAP

¹ The average is for developing ESCAP economies, including those in North and Central Asia.
estimates for 2015 full-year growth for the developing ESCAP region are down to 4.8 per cent from the already low forecast of 4.9 per cent reported in the *Economic and Social Survey of Asia and the Pacific 2015*.²

8. The gradual growth slowdown in China over recent years (see figure 1), which constitutes 42 per cent of the developing ESCAP region’s GDP, has largely been a reflection of its ongoing efforts to rebalance the economy towards domestic demand. Manufacturing production in the country has slowed due to both external and internal factors. Sluggish demand from developed economies has curtailed demand for exports from China, in a similar manner to the experiences of other exporting economies. However, a more important factor has been the declining growth in domestic demand through the investment channel, as investment accounts for a much larger share of GDP, 44 per cent, than exports. Investment growth has slowed primarily in the large real estate sector, with previous construction activity leading to high levels of supply and therefore a reduction in the need for new projects. Encouragingly, the Government has shown commitment by sticking to the stated aim of rebalancing the economy away from investment, even as GDP growth has slowed.

9. Economic growth in the other major economies in the region has been held back in 2015 by slow progress in reform policies. Although India is expected to experience higher growth than China in 2015, this is due more to a change in the methodology of computing GDP than an increase in the growth rate in recent years. On the other hand, India has experienced

² All ESCAP GDP growth and inflation estimates are as of 20 August 2015. The estimate includes North and Central Asian economies.
difficulties in increasing growth due to delays in implementation of reform policies proposed by the new administration because of legislative hurdles. As a consequence, the current ESCAP estimate of growth for India is 7.6 per cent, down from the 8.6 per cent forecast earlier. Indonesia’s experience is not much different as regards implementation of reform policies; and its economy is expected to grow at its slowest rate, 5.2 per cent, since the global financial crisis. The reforms in both these large economies are intended to remove regulatory and structural barriers to production and therefore help increase the growth potential.

10. Exporting economies in the region have also experienced a significant slowdown in their export performance (see figure 2) due to lower demand from developed economies and from China. Global trade in the first six months of 2015 expanded at its lowest rate since 2009. In terms of developed economies, somewhat better growth in the United States of America is being offset by slow growth in the European Union and Japan. China is being affected by the weakness in the developed economies in the same manner as other regional economies. This has led to decreased demand for imports by China as there is less demand for intermediate inputs for processing in China and onward export to developed economies. This is reflected in the declining trend since November 2014 in year-on-year import demand, based on monthly data. Since many regional economies are linked to the Chinese economy through regional supply chains, this has negatively affected their economies as well. Among manufacturing economies in the region, China is the largest export market for Singapore, Thailand and the Republic of Korea, and the second largest market for Japan and Viet Nam. Furthermore, China is also demanding less final goods from the region as the role of investment in the economy declines. This is seen in significantly larger monthly import contractions when compared with monthly export contractions. This means that global and regional trade are likely to remain weak for some time to come.

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11. The slowdown in China has resulted in a decline in demand for commodities, which has negatively affected some large commodity-exporting economies in the region. While the decline in the price of oil by more than 50 per cent since mid-2014 has been dramatic, leading to the lowest Brent crude price since 2009, there has also been a sustained downward trend in other major commodity prices. In August 2015, the food price index of the Food and Agriculture Organization of the United Nations (FAO) stood at its lowest level since 2007, while the S&P GSCI Industrial Metals index was at its lowest level since 2009. Apart from slowing demand from China, another reason for the decline in oil prices is the increase in global supply due to shale oil production in the United States. Apart from the continuation of current supply and demand trends, a factor encouraging low oil prices for the near future is the planned lifting of sanctions on oil production in the Islamic Republic of Iran following the agreement on the country’s nuclear programme. Declining commodity prices have led to lower growth for commodity-exporting economies as corporate and government incomes have declined. Those particularly affected include the Russian Federation, a number of other North and Central Asian economies, Indonesia and Malaysia.

12. In the wake of weak export prospects it will be important for the region’s developing economies to identify and overcome the main barriers that are hindering domestic consumption and investment growth. In a number of major developing economies, domestic demand is likely to remain buoyant for a sustained period as they benefit from favourable demographics in terms of younger populations, rapid urbanization and a growing middle class. Growing incomes in such economies can be seen from increases in real wages in recent years. For example, real monthly wages in Indonesia
increased by 13 per cent between 2013 and 2014, while those in Bangladesh increased by 7.5 per cent in 2013. However, the supply side of economies will have to be improved to allow them to take advantage of rising demand. Critical supply-side barriers relate to infrastructure shortages, excessive regulation and governance deficiencies. Governments should continue to engage in concerted economic reform programmes in these areas to boost domestic demand-led economic growth.

B. Inflation, monetary policy and financial markets

13. Headline inflation in many economies has declined significantly, due to lower international commodity prices as well as weaker economic activity, in many economies. Current ESCAP forecasts show that inflation is likely to be 4.4 per cent in 2015; only slightly higher than the forecast of 4.3 per cent published in the Economic and Social Survey of Asia and the Pacific 2015. Of all the commodity prices, declining oil prices have helped the most in lowering the headline inflation rate in oil-importing countries in the region. The decline in inflation has been less pronounced for economies that have capitalized on lower oil prices to reduce fuel subsidies. This policy, while being beneficial for the fiscal position, has resulted in the decline in domestic fuel prices not feeding through completely to general prices. For example, in India, although global prices have come down by 44 per cent since January 2013, retail prices in Mumbai only fell by 6.5 per cent. The outlook for inflation remains benign in the short term for commodity-importing economies as commodity prices are likely to remain weak and global growth subdued.

14. For commodity-exporting economies, there has been a sustained upward impact on inflation from falling commodity prices. For example, the current ESCAP estimate of inflation for the Russian Federation is 16 per cent, up from the earlier forecast of 13 per cent. Similarly for Indonesia, the current ESCAP estimate of inflation is 6.8 per cent, up from the forecast of 5.5 per cent in March 2015. Lower commodity prices have negatively impacted the current account balances of these commodity-exporting countries, depreciating exchange rates and increasing the prices of imports. Lower exchange rates have been exacerbated by portfolio capital outflows in response to growing current account and budget deficits in some of the affected economies.

15. A major economic development of 2015 has been the accelerating trend of depreciating currencies across the region (see figure 3). This phenomenon has, however, been ongoing since 2013. One reason for the depreciations has been a general outflow of portfolio capital from the region’s economies. This has stemmed from the actual and anticipated divergence in the direction of growth and interest rate prospects of many of the region’s economies with those of the United States as it normalizes its interest rate. Another reason for the depreciations has been Governments’ willingness to allow for currency weakness due to concerns about export prospects. Indeed, some Governments have encouraged depreciation by decreasing interest rates as inflation concerns have receded. The managed depreciation of the Chinese renminbi in 2015 has also had important implications for currency movements in the region. The depreciation in August 2015 of 4.4 per cent over three days — with the stated aim of letting...
the currency follow market forces more closely within its trading band — has encouraged competing exporting economies to allow further depreciations. A number of currencies subsequently weakened to reach multi-year lows.

Figure 3

Exchange rate indices in selected developing Asia-Pacific economies, 2013-2015

Source: CEIC Data Company Ltd.

16. While currency depreciation is unlikely to stoke inflation in the current environment, it is also unlikely to significantly assist growth. Depreciating currencies have the potential to put upward pressure on inflation by increasing the price of imports; however, this factor has been offset by weak growth and lower commodity prices. For example, the Philippine peso has depreciated more than 15 per cent since March 2013 although monthly year-on-year inflation in August 2015 stood at only 0.7 per cent. Currency depreciation also poses a risk to economies if it leads to a cycle of competitive devaluations. Competitive devaluations are not beneficial to economies as there is no net gain for any country and yet every country suffers a loss in export value and therefore in their export receipts.

17. As inflation concerns receded and concerns about export weakness came to the fore, a number of economies in the region lowered their policy rates in 2015. These economies include China, the Republic of Korea, Pakistan, Thailand and Turkey. Even in the case of some commodity-exporting economies such as Indonesia and the Russian Federation, policy rates have been reduced to support growth although inflation remains at relatively higher levels. Nevertheless, in such countries, policy rates are still at relatively elevated levels — at 7.5 per cent for Indonesia and 11 per cent for the Russian Federation — and may not be able to support growth

7 “Philippines inflation falls to two-decade low”, Financial Times, 4 September 2015.
sufficiently. In the current environment, monetary policy has not been very effective in supporting growth in many export-oriented economies because of the major role of declining export demand in GDP. Similarly, currency depreciation, partly due to lower interest rates, has also not impacted growth as other competing economies have done the same. Furthermore, with interest rates already particularly low in many economies, a further reduction is likely to have only a small effect on increasing borrowing. For example, for the Republic of Korea and Thailand, policy rates are now at 1.5 per cent. With the current ineffectiveness of monetary and exchange rate policies, there is a greater potential role for fiscal policy in stimulating growth in the economy, provided that fiscal and debt positions are strong.

C. Fiscal policy and reform initiatives

18. Fiscal spending and fiscal policy reforms have been undertaken in a number of economies to support long-term growth and improve macroeconomic stability. On the expenditure side, countries like India, Indonesia and Malaysia took advantage of lower oil prices and phased out fuel subsidies. In Indonesia, savings of around $18 billion were reallocated to infrastructure and other priority areas; in India and Malaysia, which have relatively high public debt and budget deficits, lower subsidy bills will help restore the fiscal balance. In addition to reprioritizing expenditure, countries with adequate fiscal space have supported the economy through stimulus measures: Kazakhstan introduced a three-year stimulus package of $3 billion per year for infrastructure development and the construction of schools and social housing.

19. To finance critical expenditure in a sustainable manner, countries are trying to improve their domestic revenues, including tax revenues. Tax-to-GDP ratios are generally below 20 per cent and are close to, or at, single-digit levels in a number of countries. Malaysia introduced a goods and services tax in early 2015 to broaden the tax base and reduce reliance on oil and gas revenues. The Government of India has proposed a nationwide goods and services tax, which would replace various State and federal level indirect taxes. China plans to introduce a nationwide residential real estate tax, which would strengthen local government finances. On the tax administration side, Afghanistan, Bangladesh and the Maldives adopted more computerized data management systems to improve tax collection efficiency while the Philippines increased efforts to curb tax evasion and improve the collection of arrears.

20. Structural reforms are underway in a range of economies to boost, among other things, private consumption, investment and employment generation. China continues to be prominent in the region in undertaking economic reforms to improve development potential. Since late 2013, China has been opening up more sectors to private investment, including railways and small financial institutions, while streamlining administrative requirements such as firms’ registration and licensing. Despite expectations of expeditious implementation by new administrations, the major economies of India and Indonesia have already undertaken a number of significant economic reforms. In India, the Government has had considerable success in improving financial inclusion, which will help to spur domestic consumption. In the case of Indonesia, there have been a number of reforms to improve the business climate. For instance, in September 2015, it was announced that new companies with a minimum investment of about $70 million in “pioneer”

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8 Economic and Social Survey of Asia and the Pacific 2014 (United Nations publication, Sales No. E.14.II.F.4).
industries — including energy, telecommunications, maritime transport and agricultural processing — would receive tax cuts of between 10 and 100 per cent for up to 15 years.

21. To enhance efficiency, Viet Nam has been privatizing a number of state-owned enterprises. The Government of the Republic of Korea is pushing to liberalize key service industries, including health care. Kazakhstan set aside $2.8 billion to capitalize its problem loan fund and launched other schemes to maintain financial market liquidity and financial access by small and medium-sized enterprises. To boost employment, a number of Governments are also trying to ease overly restrictive or burdensome labour market rules and practices. For example, in mid-2014, Turkey introduced a new national employment strategy to strengthen links between education and employment and to balance security and flexibility in the labour market.

D. Selected economic challenges and policy considerations

1. Changes in the interest rates of the United States of America and the exchange rates of China: implications for monetary and exchange rate policies

22. Economies in the region will, in the coming months, have to contend with complications arising from volatile currencies and capital flows. The expectation of rising interest rates and stronger growth in the United States is one driver of currency depreciation in the region along with capital outflows. Another factor is the recent currency depreciation in China, which has put pressure on other economies to also allow their currencies to depreciate to maintain export competitiveness. Managing pressure for currencies to depreciate and for capital to flow out of asset markets when interest rates are coming down due to declining inflation is an unenviable trade-off and has surely complicated macroeconomic policy in some economies of the region. If they choose to continue to lower interest rates, to support economic growth for instance, then the possibility of further exchange rate depreciations and capital outflow cannot be ruled out. On the other hand, maintaining interest rates at current levels or increasing them after the United States increases its interest rate may not be consistent with the outlook for inflation and/or growth considerations.

23. For countries that have relatively high fiscal and current account deficits, capital outflow may turn out to be excessive if investors feel more concerned about the prospects for these economies than others. With capital outflow, economies could experience higher inflation through greater exchange rate depreciations and imported inflation. They would then have to maintain relatively high interest rates both to manage inflation and to prevent excessive capital outflow. Countries particularly at risk from the capital outflows are commodity-exporting economies in the region. The downturn in commodity prices stemming from the slowdown in the global economy, particularly in China, has impacted their economic growth, current account and government balances, exchange rates and inflation. Not surprisingly, capital outflows have been particularly large from these economies. Concerns about economic growth have nevertheless led to some of these economies recently reducing their interest rates. There will be a difficult balancing act for such commodity-exporting economies as excessive decreases in policy rates has the risk of stoking inflation and encouraging portfolio capital outflows.

24. Therefore, the countries are advised to display caution and prudence while setting their monetary policies so that they do not have to reverse their policy stance very soon. The perceived trade-off that they will not be able to
support growth through further interest rate reductions should be of secondary importance, given the fact that interest rate reductions so far have had very little impact on economic growth. Instead, they should focus more on structural policies and productivity enhancing measures to positively influence economic growth. Moreover, countries will need to focus more on devising policies and strategies to implement sustainable development goals and recognize that sustainable development can improve the quality of growth with an emphasis on inclusiveness, equity and sustainability.

25. While ensuring sound macroeconomic fundamentals on a sustainable basis in an effort to preserve capital inflows and maintain macroeconomic stability, economies are also increasingly complementing their toolkits with the use of macroprudential measures. Macroprudential measures provide countries with some monetary policy flexibility in terms of aligning their stance with domestic considerations such as inflation outlook and financial stability in the presence of global capital volatility. Unlike interest rate adjustments and interventions in the foreign exchange market, macroprudential measures directly target the source of instability of capital flow volatility, namely the domestic asset markets in which capital flows are invested, and thus help in containing market disruptions. A number of economies in the region have strengthened their capacities to implement macroprudential policies, such as caps on loan-to-value ratios, limits on certain segments of credit growth, and capital and reserve requirements.

26. Apart from the risks to macroeconomic stability, currency depreciations also pose risks to economies if they lead to a cycle of competitive devaluations. However, it is difficult to avoid competitive devaluations if decisions are taken autonomously by individual countries, with little coordination with other countries. There is an important role for Asia-Pacific cooperation in such a situation as most global manufacturing exports emanate from this region. A cooperative decision, particularly among the export-led economies of North and East Asia and South-East Asia, can play an important role in not propagating this harmful practice among countries. While exports may be a declining growth driver for economies in the region, Governments should not engage in self-inflicted actions to harm the sector. Nevertheless, in the medium term it remains likely that the role of extraregional exports will decline autonomously in importance, with instead a greater role for domestic and regional growth drivers.

2. Growing household and corporate debt and the need to deepen financial markets

27. Since the global financial crisis and as a result of expansionary policies pursued by major advanced economies, household and corporate debt has grown rapidly in many countries of the Asia-Pacific region, even as sovereign debt has remained relatively stable. In particular, private sector credit growth has outpaced output growth in a number of Asia-Pacific economies. For instance, year-on-year private sector credit growth stood at 10 to 15 per cent in China, India, Indonesia and the Philippines, even after moderating somewhat since 2013. Consequently, their total debt-to-GDP ratio, or credit intensity of GDP, is now much higher than it was just eight years ago. Based on data from the Bank for International Settlements, non-financial private debt, as a share of GDP, surged some 75 per cent in China and between 30 and 37 per cent in Malaysia, the Republic of Korea, Thailand and Turkey between 2007 and 2014.

28. While it is understandable that household debt tends to increase with income levels, the rapid pace of its growth in some economies raises
concerns. In Malaysia and Thailand, household debt as a share of disposable income has reached 140 per cent, on par with that found in the economies of the Organization for Economic Cooperation and Development (OECD). Moreover, many household assets as well as debt are tied to the real estate sector, making households vulnerable to house price fluctuations. Another concern is the disproportionate amount of debt held by households with low capacities to service debt. Similarly, corporate debt has increased at a very rapid pace although its structure has also improved, with more local currency and longer maturity debt. Nevertheless, the sheer size of debt is now much bigger and the rate of increase has been staggering in some instances. Moreover, in a similar manner to the household case, there are concerns over the sectoral composition of corporate debt and its distribution over companies with varying capacities to service debt.

29. This debt accumulation and credit creation took place through various channels such as domestic and cross-border loans and issuance of corporate bonds. Domestic banks provided the bulk of the total credit, as reflected in higher loan-to-deposit ratios. While major banks in the region are well capitalized, smaller banks could face problems against shocks, for instance, in the real estate sector. Non-bank financial institutions, or shadow banking, also played a prominent role in countries like China. As they potentially cater to poorer and riskier borrowers, appropriate supervisory and regulatory measures are needed. Foreign banks have also significantly increased their cross-border and local claims. In addition, corporate bond markets have expanded rapidly, thanks to relatively easy global liquidity conditions and regional initiatives to develop local currency bond markets. While corporate bonds have helped curb currency and maturity mismatches, vulnerabilities remain, particularly in countries where the domestic institutional investor base is small.

30. Going forward, there is a higher risk of financial stability problems. This is because as debt levels increase, borrowers’ ability to repay becomes more sensitive to drops in income and sales and increases in interest rates.\(^9\) The strengthening of the United States dollar poses another potential challenge for firms that borrowed heavily in dollars and have no hedges. Economies particularly at risk are those in which short-term external liability as a share of foreign exchange reserves is relatively large; this includes India, Indonesia and Malaysia. Stability concerns would be mitigated if borrowers and lenders have adequate buffers — for instance, household deposits and other financial assets, corporate cash holdings, and bank capital and liquidity.

31. Debt also has significant implications for future economic growth. Typically, financial booms go hand in hand with significant resource misallocations, with a damaging effect on productivity growth.\(^10\) While it is too early to say whether this was the case, given that the region’s stock of physical capital is still fairly low, it seems that at least some of the credit-driven investments in housing and infrastructure were not wasted and would ultimately result in higher productivity. The immediate growth outlook is a bit more subdued as household and corporate deleveraging affects private consumption and investment, and dampens domestic demand. However, the case is less clear for corporate debt, as the causes behind the recent build-up

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are yet to be fully understood. For instance, low interest rates may have increased the attractiveness of debt finance relative to equity or encouraged firms to build cash buffers for future investments.

III. Increasing productivity through sustainable development

32. The Asia-Pacific region’s spectacular economic growth over the last few decades has enabled it to attain — before the 2015 deadline — the first target under the Millennium Development Goal of eradicating extreme poverty and hunger by halving the proportion of people whose income is less than $1.25 a day. Yet, more than an estimated 743 million people are still trapped in extreme poverty, representing two thirds of the global total. Moreover, the region still faces an unfinished development agenda with significant challenges in the areas of health, education, gender equality, decent employment and access to safe sanitation and drinking water: 21 million children are not enrolled in primary school, and one in five children under the age of 5, representing 75 million children in total, are underweight. A staggering 1.7 billion people still lack access to safe sanitation. Levels of inequality — of incomes and opportunities — have also been increasing in several countries as economic growth has not always been inclusive, especially when social and environmental factors, as well as economic factors, are considered.

33. On 27 September 2015, the international community will adopt a set of sustainable development goals. These 17 goals, accompanied by 169 targets, are to be reached by 2030 and will provide a framework for the formulation of future development policies. In view of its prevailing development challenges, the Asia-Pacific region needs to fully embrace the sustainable development goals.

34. The region’s experience over recent years has shown that while economic growth is not sufficient for development to be sustainable, it is clearly a necessary component. However, lower growth has engulfed the region as developed economies continue to grapple with the aftermath of the global financial crisis, which in turn has dampened demand for exports from the region. While these dynamics highlight the region’s vulnerability to external shocks, they may catalyse a shift to a growth model in which domestic and regional factors play a larger role in driving demand. Such a model is potentially more stable and more sustainable. The challenge, however, that policymakers face is how to shift to such a development model.

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11 International Monetary Fund, Regional Economic Outlook: Asia and Pacific — Stabilizing and Outperforming Other Regions (Washington, D.C., 2015).

12 After the adoption of the Millennium Declaration, the line of extreme poverty was updated in 2008 from $1 to $1.25 a day (measured at 2005 international prices adjusted for purchasing power parity).


14 Economic and Social Survey of Asia and the Pacific 2015 (United Nations publication, Sales No. E.15.II.F.7).

35. Productivity plays an important part in development, especially in economies eager to move beyond “middle-income” status. Although productivity has declined in the aftermath of the global and financial economic crisis of 2008, the Asia-Pacific region has, in general, witnessed significant increases in productivity, in particular labour productivity since early 1990s. These improvements have, however, not translated into commensurate increases in real wages. Indeed, labour’s share of output has declined in recent years for the region as a whole. To foster domestic demand and ensure consistent increases in sustainable economic growth and well-being, countries must therefore adopt policies that help in reversing this decline in real wages.

36. Continued efforts are also needed to strengthen productivity growth and to pass productivity gains on to workers, by linking wage increases to productivity increases and/or by strengthening investment in human resources, which could contribute to further improvements in productivity and competitiveness. Doing so will make growth in the region more inclusive and sustainable and will contribute to attaining the sustainable development goals. For instance, by leading to higher standards of living, greater productivity (and wages) will enable countries to tackle the eradication of poverty (Goal 1), to end hunger and achieve food security (Goal 2) and to reduce levels of inequality within and among countries (Goal 10).

37. It is also important to highlight that investing in the sustainable development goals will foster productivity growth, creating a virtuous cycle between the sustainable development goals and productivity. For instance, expanding investment in health and education to reach Goal 3 (Ensure healthy lives and promote well-being for all at all ages) and Goal 4 (Ensure inclusive and equitable quality education and promote lifelong learning opportunities for all) will strengthen productivity by improving skills in the labour force. Productivity will also benefit from wider and better access to reliable and sustainable energy (Goal 7) and more resilient infrastructure and sustainable industrialization (Goal 9).

A. Trends in productivity and wages in the Asia-Pacific region

38. Productivity measures the effectiveness and efficiency of inputs to production, which primarily comprise capital and labour. Total factor productivity captures the portion of output that is not explained by the amount of inputs used in production. It captures, for instance, overall technological change, which makes existing inputs more productive. Productivity can be measured at different levels, for instance, across firms or across sectors. Across sectors, industrial/manufacturing productivity tends to grow faster than agricultural productivity due to a variety of factors, including technological change, agglomeration economies and economies of scale. Moreover, as the share of the manufacturing sector in GDP increases, so does aggregate productivity growth, as labour moves from a relatively low productivity sector (agriculture) to a higher productivity sector (manufacturing).18

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17 The term “agglomeration economies” refers to the benefits of firms, for instance, locating near each other. “Economies of scale” refers to the benefits of firms increasing their size.
39. Starting from a low base, developing countries in Asia and the Pacific grew rapidly in their initial stages of development as they were able to accumulate significant factor inputs by drawing upon large amounts of labour in the rural sector and by benefiting from high growth in savings and investment. During the period from 1990 to 2013, the total factor productivity of Asia-Pacific economies grew at an average annual rate of 1.77 per cent. However, total factor productivity growth has declined from 2.7 per cent during 2000 to 2007 to 1.2 per cent during 2008 to 2013 (see table below). Between these periods, it only increased in Mongolia and Sri Lanka, owing, respectively, to a boom in commodities and post-conflict recovery. In other countries, the slowdown of the total factor productivity growth can be partially explained by the impact of the global economic slowdown in the wake of the global financial and economic crisis. Yet, other factors should also be considered to explain the trend of total factor productivity.

**Total factor productivity growth in selected Asia-Pacific economies (average growth rate, in per cent)**

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<td><strong>Weighted average</strong></td>
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<td><strong>2.69</strong></td>
<td><strong>1.17</strong></td>
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1. **Determinants of total factor productivity growth**

40. Knowledge and skills are essential factors that contribute to total factor productivity growth. In fact, economic theory suggests that growth can be sustained through technological change — analysed through productivity growth — and the latter can be the result of research and development activities, which are knowledge intensive.\(^{19}\)

41. At the national level, education and research and development activities are core elements of total factor productivity growth. During the period from 1990 to 2013, Asia-Pacific economies made progress in enhancing the quality of labour forces: while the average years of schooling of adults increased from 6.2 to 8.2 years during the reference period, the literacy rate and the net enrolment rate at the secondary level increased respectively from 69.8 to 82.9 per cent, and from less than 50 to 66.8 per cent. In addition, average expenditure allocated to research and development activities in the region increased slightly from 1.9 per cent of GDP during the 1990s to 2.1 per cent during the 2000s, almost equal to the world average and only slightly below the OECD average of 2.3 per cent of GDP.\(^{20}\)

42. At the international level, exports, imports and foreign direct investment (FDI) inflows also contribute to total factor productivity growth as firms are exposed to different goods and practices and are thus more likely to innovate to compete.\(^{21}\) Thus, econometric analysis confirms that the expansion of trade that has taken place in the Asia-Pacific region over the past 25 years, and the dramatic increase in FDI into the region have contributed to the overall increase in total factor productivity. For instance, FDI inflows increased from about $34 billion in 1990 to $545 billion in 2013, while the value of international trade (exports and imports) was estimated to have reached $13,712 billion in 2013 compared with $1,506 billion in 1990.

43. Empirical analysis shows that poor governance, low institutional quality and inadequate infrastructure can also hamper total factor productivity growth by, for instance, increasing the cost of inputs. It also confirms that countries with lower levels of corruption experience higher total factor productivity growth. Similarly, lack of appropriate and adequate transport infrastructure and trade facilitation systems increase production costs and reduce productivity by, for instance, contributing to delays when importing or exporting shipments.

2. **Labour productivity and wages**

44. Wages in the Asia-Pacific region have increased significantly: in 2013, real wages in the region were more than 2.4 times as high as in 1999, compared with a global increase of only one third.\(^{22}\) This is due to the fact that labour productivity has increased significantly in the region, in particular relative to total factor productivity growth (see figure 4).

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\(^{20}\) Weighted averages based on countries with available data in the ESCAP database.


45. Despite these significant increases, growth in real wages has not been commensurate with increases in productivity, such that labour’s share (wages) in total income has declined in the Asia-Pacific region in recent years (figure 5), with a larger share going to owners of capital. This shift from wages to profits, which is associated with higher inequality, has taken place across the developed and developing world and stems from the increasing gap between productivity growth and wage growth.23

46. Economies in which economic growth is mainly export led are one of the reasons for the declining trend in the region. In those cases, wage increases tend to be limited and domestic labour employed in export industries tends not to share the productivity gains, so that product prices can be maintained, or even reduced, to increase international competitiveness. Such a strategy can, however, be self-defeating as when supply grows faster than domestic demand, innovation and productive investment may in fact be discouraged.24 Importantly, such wage-compression dynamics negatively affects demand in the economy. Reversing this decline is therefore important to foster domestic and regional demand and to making growth in the region more sustainable.

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Figure 5
Labour income share in Asia and the Pacific from 1991 to 2011
(in per cent of output)

Source: ESCAP calculations, based on the Penn World Table 8.1 (see table above) and the International Labour Organization, Key Indicators of the Labour Market (KILM) Database.

B. Policies to increase productivity through sustainable development

47. The *Economic and Social Survey of Asia and the Pacific 2016* will analyse in greater detail the policies that should be implemented to foster productivity and show that the implementation of these policies can be facilitated greatly by internalizing sustainable development goals into national economic and development policies. Important policy tools include, for instance, improving the available infrastructure in the region; expanding investment in education, particularly in science, technology and innovation, and in health.

48. Policies that increase the labour share in income are also important in strengthening domestic demand, thereby contributing to a more sustainable model of development in which domestic and regional factors play a larger role than relying primarily on the export demand of developed economies. Such tools include, for instance, minimum wage policies, greater social protection and social transfers that could support aggregate demand during times of crisis, as well as public employment guarantees, taking possible fiscal constraints into account.

1. Fostering productivity

49. Infrastructure investment plays a critical role in fostering productivity. For instance, better infrastructure can bolster labour productivity by reducing time spent commuting to work, by improving health and education outcomes and allowing for improvements in economies of scale.\(^{25}\) Better infrastructure also enables better market access; better energy infrastructure is critical to improving productivity of the industrial sector: in several countries, poor infrastructure for energy supply and distribution is already a major barrier to

productivity, output and employment growth, and thus to improving the welfare of the society. Moreover, infrastructure investment in urban areas is particularly important in the region as urbanization will increasingly become a driver of productivity as the share of agricultural workers declines and shifts instead towards manufacturing and services.

50. In several countries, a shortage of skills is constraining productivity growth, particularly in manufacturing, and is limiting economic diversification. It is therefore important to expand access to and improve the quality of education, particularly in science, technology and innovation. As the region aims for more balanced economic growth and begins to implement sustainable development goals, it also needs to strengthen rural industrialization through small-scale industries, considering that 4 out of 10 workers are still employed in agriculture in the region. Indeed, a second, more knowledge-intensive, green revolution would reverse the relative neglect of the agricultural sector in public policy. Promoting higher agricultural productivity is therefore a key policy response.

2. Increasing labour’s share in income

51. Productivity gains need to be passed on to workers in the form of higher real wages to enable greater domestic demand. Otherwise, the risk is that increases in domestic demand, especially consumption, end up getting financed by borrowings. To some extent, the weak link between productivity and wages that has been observed in the region may be a result of the surplus labour model in which wages are not determined by the productivity of labour. Yet, it may also be a result of weak, or absent, collective bargaining mechanisms and of weak labour market institutions. In such a setting, increasing minimum wages is an important policy tool, and is being actively pursued in several countries in the region. In Thailand, for instance, minimum wages were increased significantly in 2013 following a decade of flat real wages. Similarly, in the Republic of Korea, minimum wages grew faster than inflation between 2012 and 2014, whereas significant increases in minimum wages have revived wage growth in Malaysia and Viet Nam. In Cambodia, minimum wages in the garment industry increased on 1 January 2015 to $128 per month, compared with $61 per month in 2013. These developments will help stimulate domestic demand and enable the region to move towards a development model that relies less on exports and facilitates sustainable development instead of just promoting economic growth.

52. Strengthening social protection (such as providing unemployment insurance and strengthening access to old age pensions) is another important tool to foster domestic demand as it would protect the vulnerable in times of crisis and contribute to reducing inequality. Similarly, providing an employment guarantee, such as has been done in India, would form an important pillar in eradicating poverty and strengthening domestic demand. Importantly, such schemes would not be expensive, but are well within the reach of most developing countries in the region, especially when considering the existing tax potential in the region.

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27 The *Economic and Social Survey of Asia and the Pacific 2013* highlights the costs involved for these programmes, while the *Economic and Social Survey of Asia and the Pacific 2014* points to the existing tax potential.
53. With the Asia-Pacific region facing low economic growth in developed countries, it is important that productivity growth be accelerated, and that its benefits be passed on to the labour force. Doing so will enable the region to rebalance according to a more sustainable growth model and will assist in attaining the sustainable development goals. Moreover, through greater investment in support of the sustainable development goals, countries will improve productivity, enabling them to benefit from a virtuous cycle between the sustainable development goals and productivity.