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Summary of the Economic and Social Survey of Asia and the Pacific 2010

Summary

By early in 2010, following the first global economic contraction in modern history, the contours of a "V-shaped" rebound had become evident in Asian and Pacific economies, shaped in large part by unprecedented fiscal stimulus packages. The rebound remains fragile and uneven, however, with a number of downside risks. While 2009 was a year for crisis management, 2010 will pose even greater complexity for policymaking. Turning the rebound into a sustained recovery requires maintaining the momentum together with macroeconomic stability in the face of rising inflationary tendencies and the potential for asset bubbles.

The crisis has drawn attention to the underlying global and regional structural imbalances built up over decades. Redressing them and the concomitant development gaps, and sustaining recovery after the withdrawal of the fiscal stimuli, require fairer, more balanced and sustainable patterns of development. Asian and Pacific countries are not likely to be able to return to business as usual. Instead, they need to drive their own development and create new sources of economic growth from within the region. In the radically altered global panorama, the Asia-Pacific region has emerged as a central participant in international economic relations. To fulfil its potential, however, it needs to implement an ambitious set of policies.

This document summarizes the key findings of the Economic and Social Survey of Asia and the Pacific 2010 which explores that complex environment and — lest the V-shaped rebound induce complacency — outlines the elements of a coherent regional policy agenda.

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I. Introduction

1. In 2010, as the region rebounds from economic crisis, a much more complex policy environment is emerging. The radically altered global panorama has placed the Asia-Pacific region at the cusp of an historic moment as a central participant in international economic relations. The crisis also presents an opportunity for policymakers to reorient macroeconomic recovery towards more inclusive and sustainable development.

2. The present document summarizes the key findings and policy recommendations that emerge from the *Economic and Social Survey of Asia and the Pacific 2010*. The current edition of the annual ESCAP survey presents an assessment of the economic crisis and its emerging policy challenges, followed by analysis of the many underlying imbalances and the ways in which the region could increase aggregate demand and supply. *Survey 2010* urges expeditious action on a policy reform agenda, lest the "V-shaped rebound" induce complacency.

II. Coping with external vulnerability in 2009

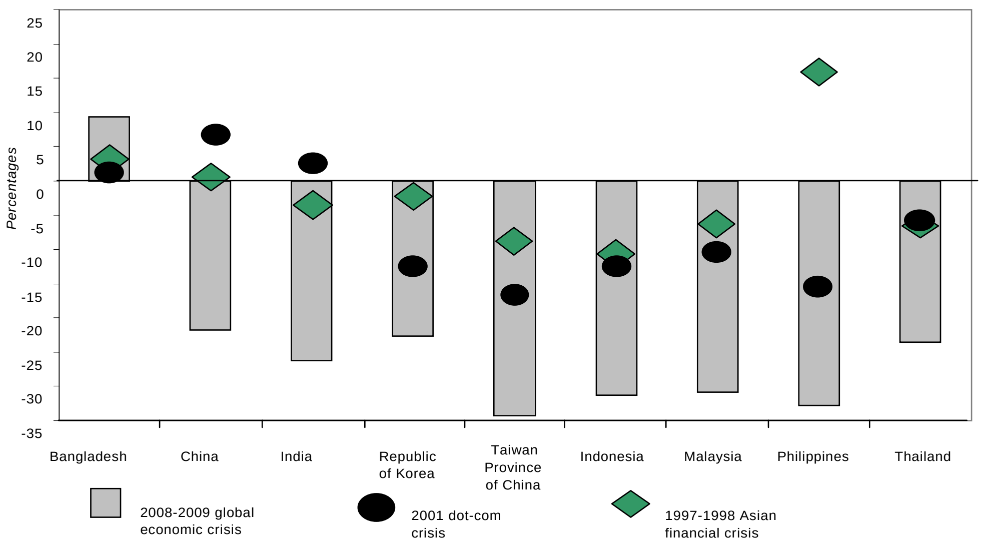
3. The developing economies of Asia and the Pacific emerged in 2009 as the world's fastest growing: their annual growth rate as a whole was 4.0 per cent, with China and India growing at 8.7 per cent and 7.2 per cent, respectively. Excluding those two rapidly growing economies, however, the other developing economies in the region were in negative territory in 2009, contracting by 0.6 per cent.

4. The regional impact of the global economic crisis varied across countries, a reflection of each country's vulnerability to external shocks according to its dependence on export-led growth and exposure to financial and exchange-rate instabilities. The degree of exposure depended on the demand structure in each economy, its fiscal space and the extent of its foreign-exchange reserves.

A. Exposure to developed-country demand

5. The impact of the crisis was transmitted through trade shocks to the highly export-oriented economies in the Asia-Pacific region. From August 2008 to June 2009, exports dropped sharply at annual rates almost twice as large as those experienced in the aftermath of the 1997 Asian financial crisis and the 2001 dot-com recession (figure I). Monthly contraction rates were even more dramatic, exceeding 30 per cent in many countries and even 40 per cent in certain instances in the Philippines, the Russian Federation and Singapore. As income growth in the region waned, imports dropped even more sharply, owing to the high import content of the region's exports.

Figure I
Comparative growth performance of goods exports of major Asian developing economies during three crises, 1997 to 2009



Source: ESCAP calculations based on data from CEIC Data Company Ltd., available from http://ceicdata.com/ (accessed 16 Feb. 2010).

Note: Growth rates of 2008 and 2009 were computed using data of the first half of 2009 and the first half of 2008; those of 2001 were computed on the basis of 2001 over 2000; and those of 1997 and 1998 were computed on the basis of 1998 over 1997.

6. Three factors exacerbated the region's vulnerability to the crisis:

(a) First, the greater the share of the trade sector in the economy of each country, the worse the impact. Developing economies in the region inevitably took a hard hit since their export sector comprises close to 38 per cent of GDP, or 250 per cent more than the corresponding share of the three developed economies in the region;

(b) Second, with the region's large share of trade in developed markets, the direction of trade came to reflect the exposure of an economy to the source of market perturbation. The fall in import demand of the United States, Europe and Japan had a direct bearing on Asian and Pacific exports because of the region's large share in the imports of those developed countries;

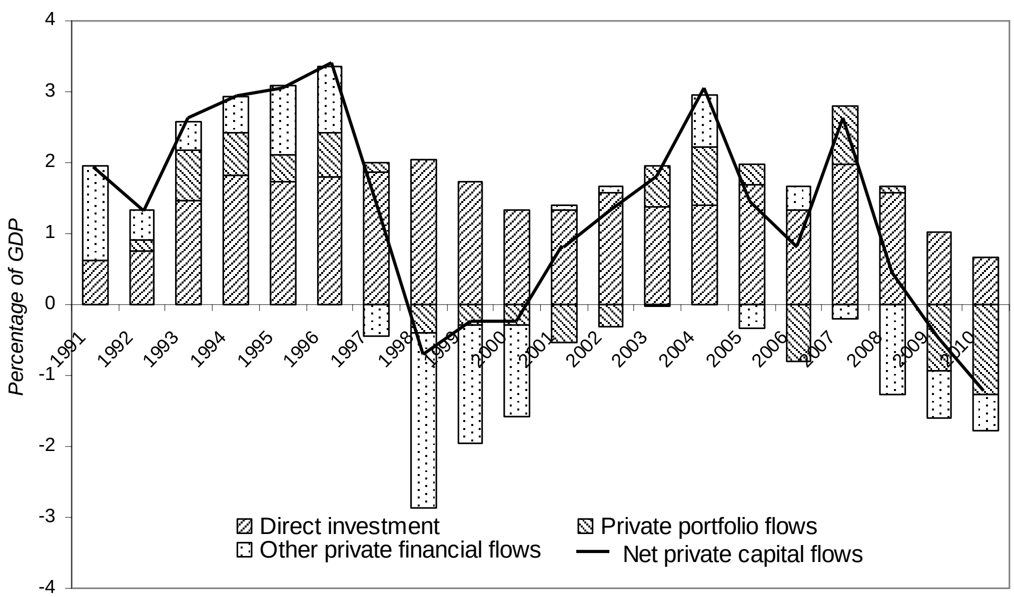
(c) Third, product mix was crucial. Trade in export items with a significant proportion of imported inputs fell first. The higher the share of products in a country's export profile that used imported electronic and automotive parts and components as intermediate goods, the more vulnerable that country was to the crisis.

B. Exposure to capital flows

7. The region experienced the first impact of the crisis through short-term capital flows that triggered instability, not unlike in 1997. The manner in which capital flows operated in the current crisis was different than in 1997, however. At that time, the problem with capital flows lay more in excessive short-term foreign debt of domestic banks and other private-sector operators. Subsequently, during the past decade, another form of capital flow into the region was generated, that of foreign portfolio capital, which reversed direction when the crisis erupted in the United States and Europe. The patterns of net capital flows (figure II) show that the 1997 bust was due largely to reversal in short-term bank loans. In comparison, the crisis that began in 2008 was driven more by sharp reversals in portfolio flows, although inevitably many international banks retrenched on their lending in response to the financial stresses they faced.

8. The concern is exposure to risk of sudden outflows among countries that have experienced massive capital inflows during the previous year and thus have a stock of gross external liabilities that could potentially be reversible. Even countries with large current-account surpluses, such as Singapore and Malaysia, have experienced downward pressure on their reserves because of reversal of some gross external liabilities from previous years.

Figure II
Net private capital flows to "emerging" Asia, 1991 to 2010



Source: Based on data from IMF, *World Economic and Financial Surveys: World Economic Outlook Database*, Oct. 2009 ed.; available from www.imf.org/external/pubs/ft/weo/2009/02/weodata/index.aspx (accessed 25 Feb. 2010).

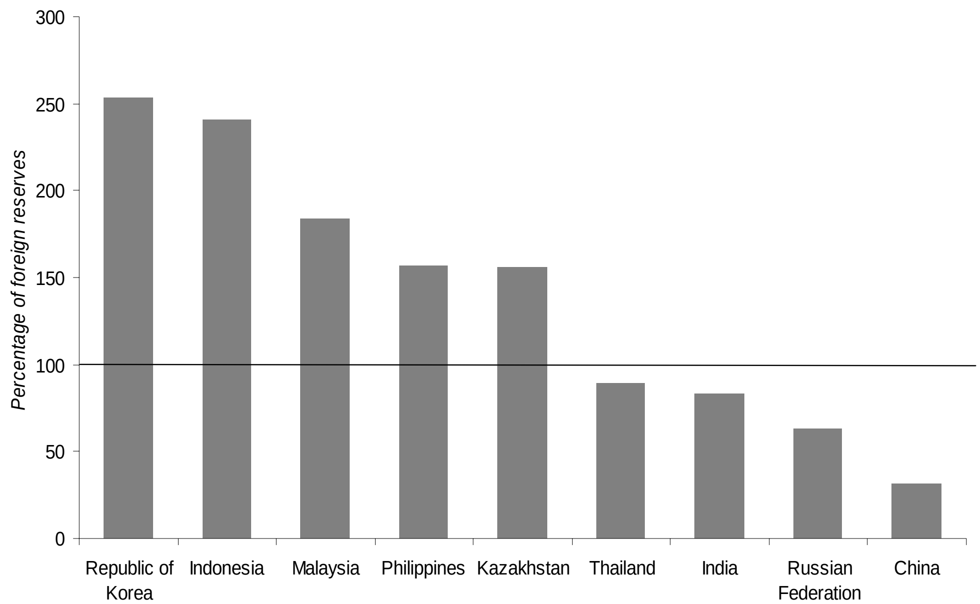
Notes: Data for 2009 and 2010 are projections by the International Monetary Fund. "Emerging" Asia comprises 26 Asian developing countries and newly industrialized economies.

9. The current financial crisis has underlined the importance of reserve holdings. The appropriate size of reserves remains a question; i.e. what defines an adequate or desirable amount of foreign exchange for any country to build up against possible need? As the current crisis has shown, holding reserves is neither cost- nor risk-free. Asia, as a whole, holds adequate reserves based on imports and short-term debt. To date, there is no yardstick to measure the potential vulnerability inherent in the reversibility of those other types of capital flows.

10. A more precise yardstick of vulnerability could encompass the overall gross external liabilities of a country that are most clearly reversible and measurable. The components would be short-term debt, the stock of portfolio inflows and the magnitude of imports over three months. The quantum of short-term debt and the stock of portfolio capital inflows are relevant because they could exit the country at any time and thus exert currency devaluation pressure. Similarly, the quantum of imports over three months represents the amount of reserves that would flow out as financing for imports. "Gross" would be more appropriate than "net" because, if foreigners chose to withdraw their funds, a country might not be able to coordinate its finances so as to be able to remit its gross external assets back to the originating country simultaneously (particularly if the investments to and from the country were executed by unconnected parties).

11. The threshold of foreign reserves is taken as 100 per cent. It is subject to a number of caveats, however. It may be an overestimate, if the portfolio market price in distress periods is much less than its historical value. Exchange-rate depreciations during a crisis may also reduce the stock of outflow. It may otherwise be an underestimate, in cases of countries that suffer exchange-rate pressure through capital flight by residents, or if short-term components of foreign direct investment such as private equity investment are not included. The likelihood of "internal drain" of such capital flight has increased in recent years because of liberalized regulation of financial outflows. Figure III displays the "vulnerability yardstick" of countries that were not fully covered by their foreign reserves at the end of 2008 after the worst of the financial impact of the crisis. In Indonesia, Kazakhstan, Malaysia, the Philippines and the Republic of Korea, the stock of foreign portfolio inflows accounted for the greatest part of the vulnerability yardstick, followed by short-term debt.

Figure III
Vulnerability yardstick as a percentage of foreign reserves in major Asian developing economies, 2008



Sources: ESCAP calculations based on data from IMF, *International Financial Statistics (IFS) Online Service*, available from www.imfstatistics.org/imf/ (accessed 24 Oct. 2009) and *World Economic and Financial Surveys: World Economic Outlook Database*, October 2009 ed., available from www.imf.org/external/pubs/ft/weo/2009/02/weodata/index.aspx (accessed 24 Oct. 2009); World Bank, *Quarterly External Debt Statistics* databases, available from http://web.worldbank.org/WBSITE/EXTERNAL/DATASTATISTICS/EXTDECQEDS/0,,menuPK:1805431~pagePK:64168427~piPK:64168435~theSitePK:1805415,00.html (accessed 13 October 2009); and CEIC Data Company Ltd., available from http://ceicdata.com (accessed 24 October 2009).

Notes: Vulnerability yardstick is the sum of short-term debt, imports of the last quarter of the year and stock of equity and debt portfolio capital. Data on stock of foreign portfolio investments of Indonesia, Malaysia and Philippines refer to figures for 2007.

12. How best to deal with portfolio capital flows? An uncontrolled inflow requires building up sufficient reserves to buffer sudden capital outflows — a costly undertaking. A completely open capital account might not be the right choice from a cost-benefit analysis; research suggests that the benefits of such openness are ambiguous, at best. Other options involve various types of controls, such as an international tax to moderate the volatility of portfolio inflows (the “Tobin Tax”), controls on inflows (Chile’s *Encaje*, a one-year, non-interest-paying payment with the central bank), or quantitative controls on portfolio outflows — all are under discussion.

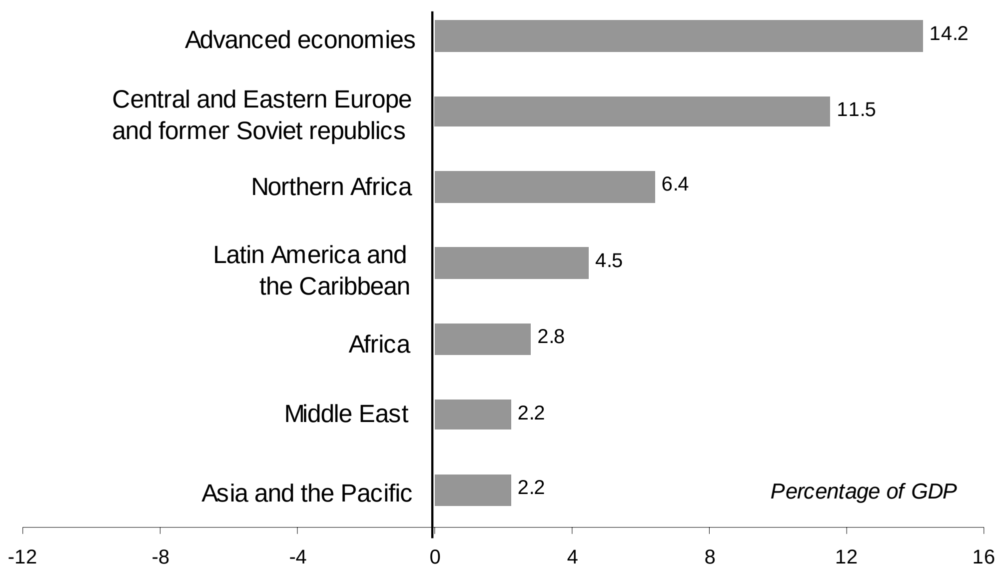
C. Impacts on jobs and income

13. The collapse in aggregate demand from developed countries led to factory closures and massive job losses in many of the key export-manufacturing industries in the region, including textiles, garments, electronics and autos. The International

Labour Organization (ILO) has estimated that the number of unemployed in the Asia-Pacific region increased by 10 million between 2007 and 2009, bringing the unemployment rate up to 5.0 per cent. While the average unemployment rate of the region was below that of the average rate of 8.2 per cent of countries of the Organization for Economic Cooperation and Development (OECD) in the second quarter of 2009, certain features of unemployment in Asian developing economies are worrisome.

14. Increases in unemployment in developing countries exert far greater socio-political repercussions than in developed countries because social protection systems are lacking. As a region that has the lowest level of public expenditure on social protection (figure IV), millions who took decades to work their way out of poverty could slip back into poverty within months or even days, once their personal savings have dried up. From the estimates of ILO economic growth in the region, the current crisis could trap an additional 21 million people below the poverty line of $1.25-per-day or 25 million under the $2-a-day line. Inevitably, abuse and violence against women, children and youth rise in such conditions, with the brunt of social fallout lasting much longer than the crisis itself.

Figure IV
Social expenditure as a percentage of GDP, for most recent year available



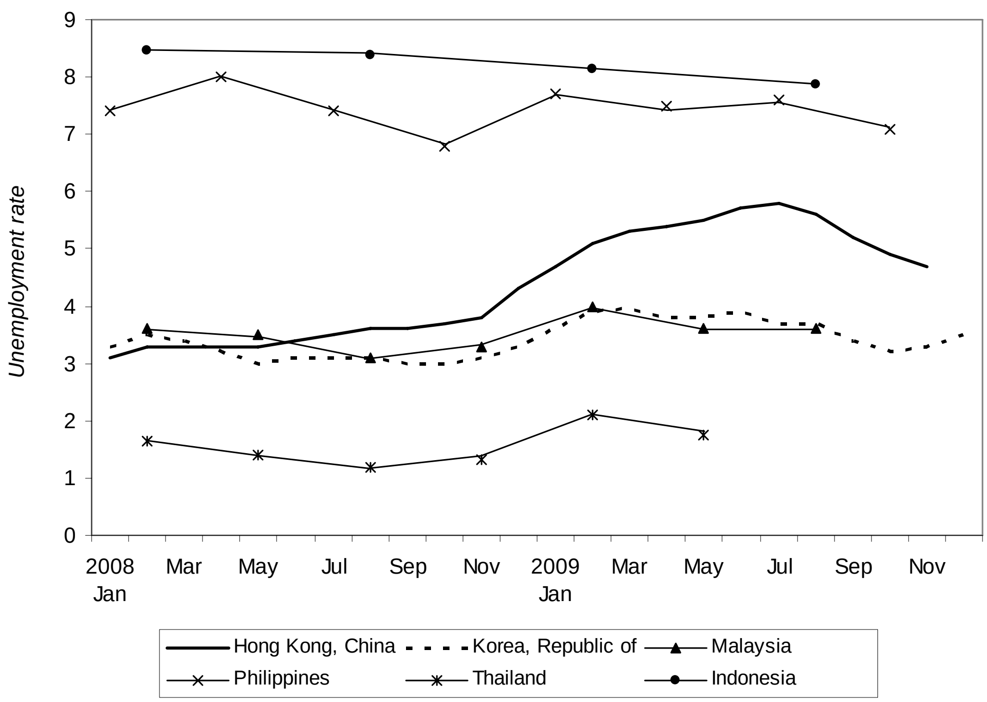
Source: ILO, *The Financial and Economic Crisis: a Decent Work Response* (Geneva, 2009).

15. For the region as a whole, “vulnerable employment” could have increased by as much as 47 million between 2007 and 2009, adding to the estimated 1.09 billion workers (60.7 per cent of all workers) who were classified as being in such employment in 2008. Unemployment figures in Asia and the Pacific are a crude measurement that grossly underestimates the fallout from the crisis. The lack of timely and reliable labour market information compounds the challenge of assessing the labour market impacts of the crisis. Furthermore, for many who have lost their job or whose income is reduced in the absence of social protection systems, shifting

to vulnerable and informal employment is often the only way they can support themselves and their family.

16. On a positive note, very recent labour-market data show signs of stabilization with unemployment rates having reached a peak in 2009 (figure V). Previous financial and economic crises have demonstrated a recovery lag in the labour market that can trail behind economic recovery by as long as 4 or 5 years. Furthermore, an additional 5 years may be needed in recovering lost ground in the struggle against poverty. Increases in informal employment are difficult to reverse. Real wages take time to recover, as does labour productivity. It is therefore imperative to (a) implement and sustain the appropriate mix of macroeconomic policies, (b) institute labour market reforms to enhance resilience and adaptability and (c) prioritize the allocation of resources towards building effective social protection systems.

Figure V
Monthly and quarterly unemployment rates in six Asian economies, 2008 and 2009



Source: ILO, *Laborsta* database, available from www.laborsta.ilo.org (accessed 18 Jan. 2010).

D. Migration and remittances: bucking the pressures

17. During the last two decades, remittances have become an increasingly important source of external development finance, supporting balance of payments and contributing to the gross national product. Nevertheless, with some variations across Asia and the Pacific, remittances are proving to be by far the most resilient source of foreign exchange earnings of all capital flows to developing countries that

have otherwise fallen dramatically since the beginning of the economic crisis. The resilience of remittance flows to the Asia-Pacific region has been largely attributed to the comparatively stable stock of the migrant population in a wide array of destination countries, including neighbouring economies and the countries of the Cooperation Council for the Arab States of the Gulf (GCC) which fared better during the economic crisis than did the United States and developed countries in Europe. The critical question is what will happen to the stock and flows of migrant workers, given the growth in unemployment in the major destination countries? The latest data from some migrant-sending countries in the region have shown reduced flows of new migrant workers while a number of countries have introduced policies to restrict migrant workers' access to labour markets.

18. Recognizing the potentially devastating socio-economic consequences that large-scale return of migrant workers could have on development and poverty, Governments in some of the major migrant-sending countries have taken measures to counteract the negative impact on migrant workers. As patterns of migration from and within Asia and the Pacific continue to be affected by the growth slowdown in the coming months, such support programmes need to be sustained well into the economic recovery process.

E. Fiscal stimulus packages: mitigating the losses

19. Asian and Pacific countries had varied capacities for responding to the financial crisis in 2009 which explains their contrasting experiences. The countries best able to mount rapid and large countercyclical spending programmes were those that entered the crisis with strong macroeconomic fundamentals; in particular, stable inflationary trends, sound fiscal balances and low ratios of public debt to gross domestic product (GDP). The massive additional fiscal spending helped reduce the impact of lower exports and the falling demand for services such as tourism, as well as reduced growth of migrant remittances. Even more importantly, the stimulus also afforded some protection to the vulnerable workers who had lost their jobs, typically the unskilled and very often women.

20. Quantitative analysis reported in the *Economic and Social Survey 2010* affirms that the stimulus packages have certainly had an impact and have offset to some extent the loss of exports. For each $1.00 lost in exports from the key economies in the region, the loss in GDP has been an average of $0.88; the losses have ranged from $1.10 in Japan, to $0.70 in China and to $0.40 in Malaysia and Singapore. If the only variable affecting GDP had been the fall in exports, GDP growth in 2009 would have dropped by 7.8 per cent. However, the actual shortfall in 2009 was only 4.2 per cent, thanks largely to the fiscal stimulus packages.

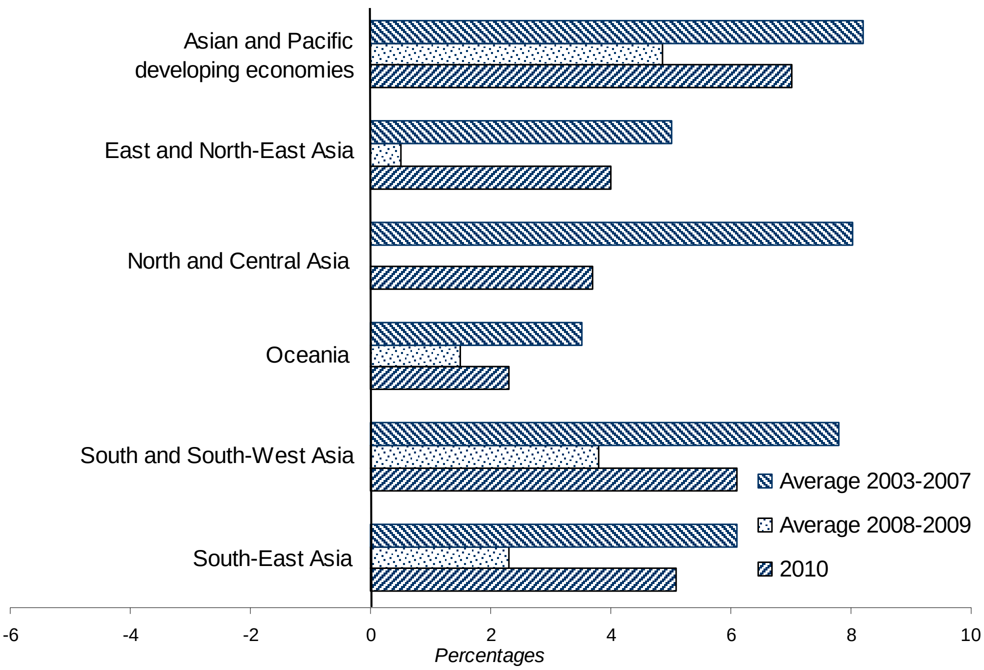
III. Recovery on the horizon and challenges in 2010

21. The outlook for 2010 has improved significantly, with developing Asian and Pacific economies forecast to grow by 7.0 per cent in 2010 (figure VI), led by the self-sustaining motors of China and India that are forecast to grow at 9.5 per cent and 8.3 per cent, respectively. The pace of recovery will vary across the subregion in 2010. South and South-West Asia will lead with growth of 6.1 per cent, after having performed at 2.9 per cent in 2009. North and Central Asia will experience

the largest rebound. The sharp downturn of the Russian Federation in 2009 saw growth in the subregion decelerate to -5.8 per cent; positive growth is expected to return in 2010, at 3.7 per cent.

22. Over and above the immediate risks in the recovery process, the nature of the recovery process holds issues of fundamental concern, particularly whether it will resurrect old challenges or create new obstacles for years to come. A complex set of policy challenges lies ahead.

Figure VI
Average growth rates and forecasts of Asian and Pacific economies by subregion, 2003 to 2010



Sources: ESCAP calculations based on national sources; IMF, *International Financial Statistics (IFS) Online Service*, available from www.imfstatistics.org/imf/ (accessed 26 February 2010); ADB, *Key Indicators for Asia and the Pacific 2009*, available from www.adb.org/Documents/Books/Key_Indicators/2009/default.asp (accessed 1 Oct. 2009); CEIC Data Company Ltd., available from http://ceicdata.com/; and website of the Interstate Statistical Committee of the Commonwealth of Independent States, www.cisstat.com (accessed 22 March 2010); and ESCAP estimates.

Notes: Rates of real GDP growth for 2009 are estimates and those for 2010 are forecasts (as at 15 Apr. 2010). Developing economies of the ESCAP region comprise 37 economies (excluding the Central Asian countries). Calculations are based on the weighted average of GDP figures in United States dollars in 2007 (at 2000 prices). Among the subregional groupings, Japan is included in East and North-East Asia, and Australia and New Zealand are included in Oceania.

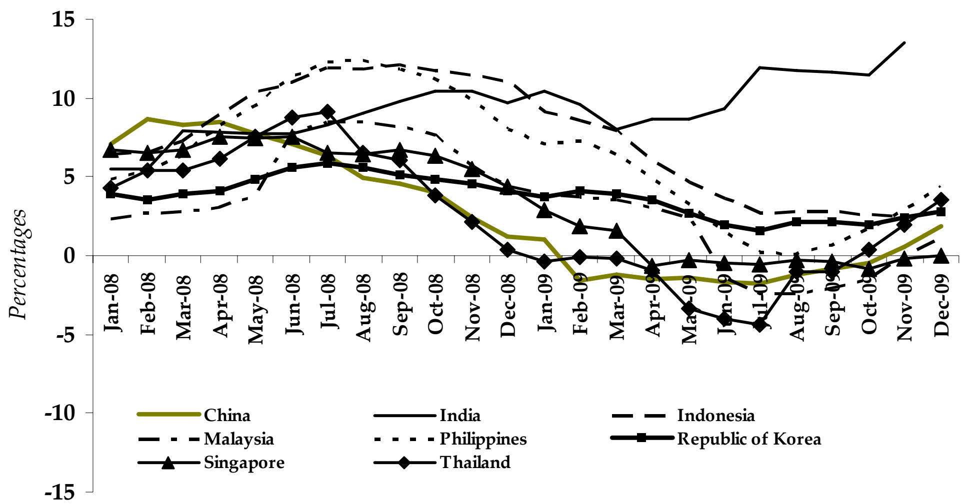
A. Inflation threatens from demand and supply sides

23. A key threat to the sustainability of regional growth is the return of inflationary pressures as the recovery gathers steam. Countries must balance the risk

of setting off an inflationary spiral with long-term negative growth against the risk of halting the short-term growth recovery trend. To date, increases in policy interest rates have been announced by Australia, Malaysia and India, among others. A critical decision for each economy is when and how to turn off the tap of fiscal stimulus and tighten monetary policy.

24. Inflationary pressure declined significantly after the last quarter of 2008, in tandem with the downturn in domestic economic activity (figure VII). The let-up proved to be short-lived as economic recovery led domestic demand to pick up, assuaging earlier fears of an unhealthy deflationary spiral. By July 2009, the fall in inflation rates since the start of the crisis had nearly stabilized in many countries, with inflation rates moving up in subsequent months.

Figure VII
Consumer price inflation, year-on-year, in major Asian developing economies, 2008 and 2009



Source: CEIC Data Company Ltd., available from http://ceicdata.com (accessed 20 Feb. 2010).

25. Other than increase in demand-side inflationary pressures, a key factor behind rising prices is the return of supply-side pressure from commodity price volatility. For that reason ESCAP urged policymakers in its *Survey 2009* edition to be vigilant in the post-crisis phase. Oil prices increased steadily during 2009. A return to high food prices could follow and requires close monitoring in coming months. Other factors potentially influencing a return to high food prices during 2010 could include weather-related events. Food price increases would seriously affect the poorest people of the region: impacting poverty, exacerbating inequality and worsening health conditions that would keep people trapped in their poverty.

26. Asset bubbles are another source of concern for the recovery process. Abundant foreign capital, provided via the fiscal stimulus packages and buoyed by liquidity support to financial institutions in developed countries, has been attracted to the region in recent months because of its relatively strong growth prospects. As the scale of inflows continues to rise, the risk also grows that any unexpected change in interest rates, or a sudden appreciation in value of the United States dollar, could trigger an exit of capital across target countries and financial asset

classes and precipitously bring down asset prices and exchange rates. The issue of how to manage the benefits from foreign portfolio investments and minimize attendant risks to macroeconomic stability remains a huge challenge for the region. Asset price bubbles could form in particular sectors with concomitant risks for domestic financial sectors and overall macroeconomic stability.

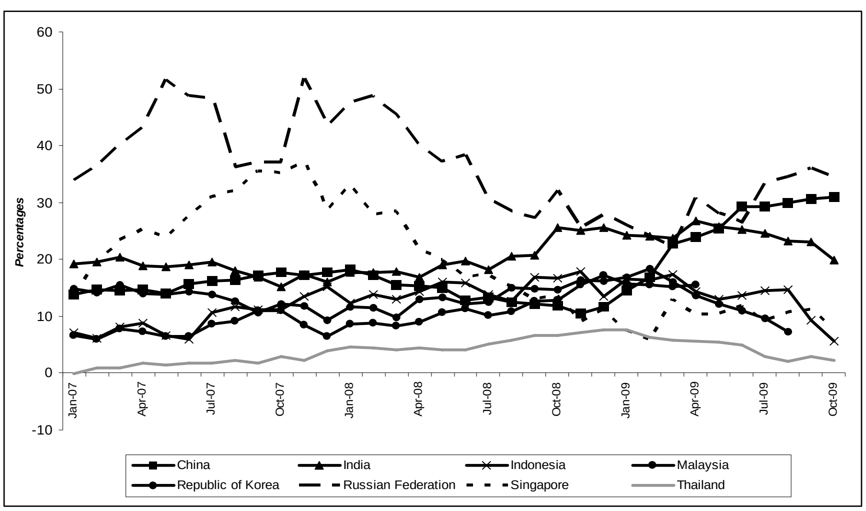
27. Liquidity has been injected into the United States financial sector through the Federal Reserve's purchases of mortgage-backed securities and other agency debt. Furthermore, foreign capital has been abundant with the rise in the dollar carry trade, with borrowings at low dollar interest for investment in currencies of the region, where expectations of appreciation are strong and interest rates comparatively high. Asian and Pacific countries have been particularly susceptible to the carry trade since earlier recovery than in other parts of the world has raised expectations of interest and exchange-rate expectations.

28. Domestic capital has also been attracted to regional asset markets by liquidity addition at the national level in a number of developing Asian countries as part of monetary stimulus policies. Credit provision (figure 8) and asset prices in a number of economies have increased substantially following declines during the early part of the crisis, notably in China, India and the Russian Federation.

29. Riding on expectations of early and strong recovery, equity markets in the region began an upward climb in the early part of 2009 (figure 9). In some cases, stock markets have returned close to levels seen immediately before the crisis. Furthermore, falls in the major markets before the beginning of their recovery path were far less severe, except for China, than those witnessed during the 1997 crisis. Consequently, in global terms, Asian equity markets have seen one of the greatest post-crisis recoveries of all developing country regions, reflecting investor expectations of comparatively healthy growth prospects in international terms.

Figure VIII

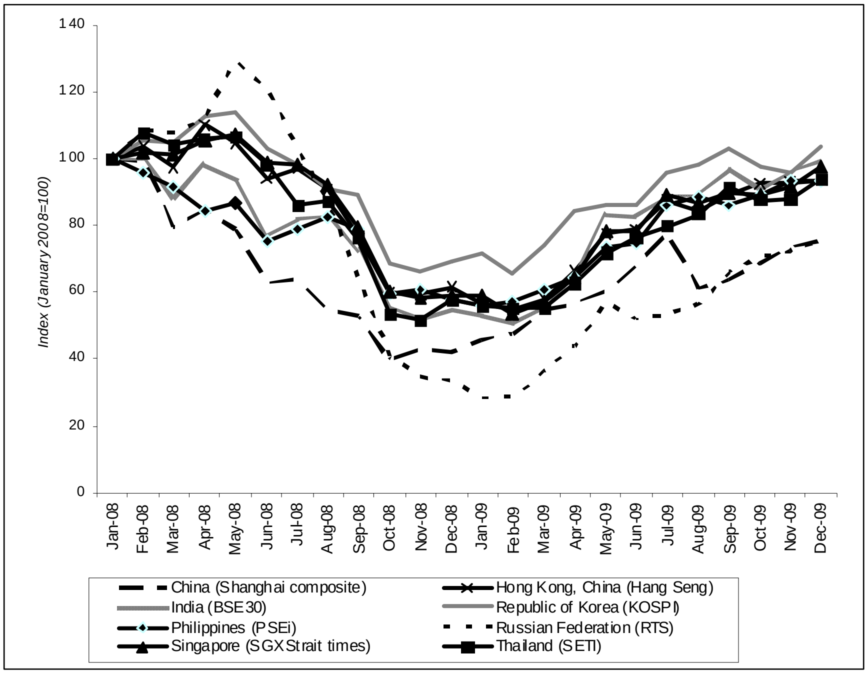
Credit growth, year-on-year, in major Asian developing economies, January 2007 to October 2009



Source: ESCAP calculations based on data from IMF, *International Financial Statistics (IFS) Online Service*, available from www.imfstatistics.org/imf/ (accessed 20 Jan. 2010).

Note: Data used in the chart refer to domestic credit comprising claims on central Government, claims on the private sector and claims on other financial institutions.

Figure IX
Equity market performance in major Asian developing economies, January 2008 to December 2009



Source: ESCAP calculations based on data from CEIC Data Company Ltd., available from http://ceicdata.com (accessed 20 Feb. 2010).
Note: The equity market of each country is noted in parentheses in the legend.

30. Asset markets are considered by many to be leading indicators of future economic performance. The recovery in prices appears to reflect the view of financial investors that growth will return to the region sooner rather than later. Whether investor optimism is exaggerated regarding recovery, or perhaps pushed by the need to invest buoyant funds available from the developed countries, is debatable. Consequently the risk of further volatility in financial markets looms in the months ahead.

31. Governments may consider moderating the inflows of short-term capital flows through various types of controls in order to maintain financial stability. Consensus is growing on the relevance of such measures as a part of the policy toolkit, especially in the context of huge expansion of liquidity in the world economy that is finding an outlet in the Asia-Pacific region.

B. Avoiding premature exit policies to preserve growth

32. The recovery phase for economies in the region challenges policymakers with critical questions: when, in what sequence and at what pace to start to withdraw stimulus programmes that have been key support for growth after the crisis. Provided inflationary and fiscal pressures remain within reasonable norms, the general priority for policymakers is to continue with such programmes until self-perpetuating motors of growth appear to be firmly entrenched.

33. Budget deficits across the region are naturally of concern. Resolving the consequences of deficits are a medium-term challenge. Those deficits were exceptions from otherwise prudent fiscal policies. The relatively stable macroeconomic fundamentals in most countries means that increased levels of borrowing remain sustainable and can be paid off over time. Therefore while fiscal pressure is undoubtedly a challenge in the medium term, the key short-term concern for the region remains inflationary pressure.

34. On the balance of risks, and with variations across countries, the region's interest lies in sustaining growth rather than in allowing inflation to rise. For that reason, policymakers should guard against a premature exit from stimulus policies until growth demonstrates that it is self-sustaining. Furthermore, when exit policies are enacted, the mix of fiscal and monetary policies is important for the twin tasks of sustaining growth while managing inflation. Monetary tightening is a most effective policy in controlling price pressures because it acts directly on credit build-up.

35. Decisions on timing of exit from stimulus policies depend on national considerations; yet a key role remains for regional coordination, primarily to prevent negative macroeconomic repercussions. For example, early withdrawal of fiscal stimulus in the larger countries could impact severely on regional aggregate demand and export prospects for smaller economies. Likewise, monetary tightening through an increase in interest rates, in the absence of similar rises in other economies, could attract portfolio flows that would increase inflationary pressures as well as exert upward pressure on nominal exchange rates, thereby dampening recovery prospects for exports.

C. New engines of growth for sustaining dynamism

36. Current projections show substantial declines in import demand in the United States over the next few years, as the debt-driven consumption pattern of the country remains constrained. Asian and Pacific countries are expected to be affected in varying degrees since they depend on exports to specific countries and exposure to the United States market.

37. Contrastingly, the period preceding the global financial crisis was one of exceptional export growth. Between 2001 and 2007, the exports of 11 Asian developing economies grew at an average annual rate of 12.8 per cent, more than doubling in value from $2.3 trillion to $4.8 trillion over that period. Recent forecasts of the export growth rate for those same countries from 2011 to 2014 predict an annual shortfall of between 3.1 per cent and 5.4 per cent from the 2001-to-2007 trend. In nominal terms the slowdown represents a drop in aggregate demand of $200 billion to $324 billion per annum, or between 1.4 per cent and 2.1 per cent of the GDP of those countries.

38. The foregoing portrait of performance is consistent with the observation of the Asian-Pacific Economic Cooperation (APEC) leaders at their 2009 summit in Singapore, that the advanced economies are unlikely to be able to return to "growth as usual" or "trade as usual". Even if the advanced countries achieve substantial economic recovery, their demand for imports from Asia and the Pacific is not expected to return to pre-crisis levels. In order to unwind global imbalances, many of the developed economies need to restrain debt-fuelled consumption. Asian and

Pacific countries, for their part, need to seek new sources of growth: to “rebalance” their economies in favour of increased domestic and regional consumption. For domestic and regional demand to increase its contribution beyond such temporary fillips, policy changes should induce a long-term structural rebalancing of economies. Such a strategy requires addressing critical global and regional imbalances.

IV. Imbalances and development gaps: new engines of growth?

39. The ESCAP *Survey 2010* investigates the different imbalances and gaps — macroeconomic, social, developmental and ecological — and considers ways of closing them and augmenting aggregate demand that could serve as new regional impulses for growth.

A. Macroeconomic imbalances

40. Global imbalances have in the past helped the Asia-Pacific region by expanding markets for exports and augmenting foreign exchange reserves. But those imbalances are not sustainable. They have resulted in growing trade and current account imbalances that the United States, in particular, with its high levels of accumulated debt, must unwind. Macroeconomic imbalances also exist within the region — notably between the economies of East and South-East Asia and those of South Asia. In East and South-East Asia net exports have increased as a proportion of GDP growth while in South Asia they have been increasingly negative. For East Asia that reflects a declining share of consumption in long-term economic growth, whereas for South-East Asia it reflects a declining share of fixed investment. In the South Asian case, on the other hand, the share of both consumption and investment has risen and is reflected in net import growth. Perhaps the most disturbing aspect of the global imbalances is the anomaly of investment capital flowing from developing Asia and the Pacific to developed countries in the West. That happens largely because Asia lacks a well-developed regional financial architecture wherein countries running current account surpluses could deploy them productively in other parts of the region.

B. Socio-economic imbalances and development gaps

41. Asia and the Pacific also harbour large socio-economic and development gaps. Although the rapid economic growth of the region has helped lift millions out of poverty, over 950 million people live under the $1.25-per-day poverty line. Moreover, development has been very uneven across subregions and between countries. The patterns of progress towards achieving the Millennium Development Goals reflect the gaps: South-East Asia leads the way and South Asia and the Pacific island economies lag behind. Similar gaps exist in infrastructural development, evident from the composite scores presented in *Survey 2010*. The high-scoring economies include Australia, Brunei Darussalam, Japan, New Zealand, the Republic of Korea, Singapore, and Hong Kong and Macao, China. Others still have considerable infrastructural gaps, particularly the least developed, landlocked and small island economies, such as Papua New Guinea, Nepal, the Lao People’s

Democratic Republic, Solomon Islands, Cambodia, Bhutan, Vanuatu and Mongolia. If the countries could invest in closing their socio-economic development gaps, they could also improve the quality of life for all as well as boost regional aggregate demand, opening the way for more inclusive and sustainable economic growth. That would demand high and sustained levels of investment that would involve creating a new regional financial architecture to mobilize the necessary resources from within the region and beyond.

C. Ecological imbalances

42. The Asia-Pacific region also has serious ecological imbalances that are observable in the degradation of such natural resources as forests and freshwater, the unsustainable use of energy and rapid growth in carbon emissions, among other evidence. Although such degradation might not appear to have immediate economic consequences, it impedes achievement of sustained economic growth in the long term. Investment in addressing the imbalances could help countries to preserve their natural environment on which so many poor people depend, as well as maintain the basis for long-term growth. In the short term, countries would also be providing an immediate economic stimulus that would further help alleviate poverty.

43. In summary, as the countries of the region take steps to address macroeconomic, developmental and ecological imbalances, they have the opportunity to create new motors for inclusive growth that could help them regain their economic dynamism. The region has close to 1 billion people living in poverty who at the same time constitute a potential source of demand, if national development programmes succeed, for boosting private consumption and investment. Similarly, Asian and Pacific economies have the opportunity to develop new and greener industries and businesses based on innovations that could save energy and materials. In so doing they could provide more affordable products for the poor while maintaining growth and promoting environmental sustainability.

44. In the aftermath of the global economic crisis, *Survey 2010* argues that inclusive and sustainable growth is not only a desirable but also a necessary condition for regaining regional dynamism. The current edition outlines a policy agenda at national and regional levels that is designed to help in unleashing the latent potential of domestic and regional demand to address the three imbalances in an integrated manner.

V. A policy agenda for inclusive and sustainable growth

45. The ESCAP *Survey 2010* explores ways of increasing aggregate demand and supply that could reconfirm for countries an inclusive and sustainable path of development and help them do their part in boosting regional connectivity. It proposes an agenda with four parts that could help in expanding domestic consumption and a fifth part for regional consumption.

A. Strengthening social protection

46. If poor households could rely on systems of social protection that automatically trigger social safety nets in adverse times, they would be able to maintain food intake and continue to use education and health services. During normal times their need to keep precautionary savings would be reduced, so they could use more of their income for consumption. Systems of social protection thus serve as automatic stabilizers, supporting households at times of crisis and, equally importantly, expanding opportunities for individual and national development.

47. The Asia-Pacific region can showcase ambitious examples of social security programmes that could be replicated and extended elsewhere. Since 2001 the Government of Thailand has sponsored health-care services for all people nationwide who are not covered by other insurance programmes. In India, the National Rural Employment Guarantee Act (NREGA) guarantees 100 days of employment each year to adult members of rural households in a programme with gender-sensitive considerations. For the past several years, the Philippines has provided, through the Pantawid Pamilyang Pilipino Program (“4Ps”), conditional cash transfers to poor households for their health and educational needs.

B. Fostering a second green revolution for agriculture and rural development

48. Since the 1970s agricultural growth has been largely based on “green revolution” advances that helped Asia and the Pacific to achieve significant yield increases — apart from the concomitant problems stemming from high inputs. As the region aims for economic growth with better “balance”, it needs a second green revolution that would combine further advances in science and agricultural engineering with its own traditional knowledge and could endow agriculture with greater environmental resilience. Governments also need to make agriculture more socially inclusive by returning ownership of land and resources to farmers and by economically empowering the poor. To do so requires setting appropriate prices for key inputs and establishing institutions to help small producers achieve economies of scale in marketing and in accessing international markets. Governments may have tried earlier to use State or parastatal agencies for the task. The path of choice for the future appears to lead through community-based organizations and farmers’ self-help groups. International partnerships and South-South cooperation could also help foster such a green revolution while also addressing concerns for food security.

C. Supporting new engines of growth: green innovations

49. “Green Growth” policies emphasize environmentally sustainable consumption and production to foster low-carbon, socially inclusive development. Governments may take the industrial policy approach by collaborating with industry to promote investment in environmentally friendly technologies and products. Such investments might not be immediately profitable, so many environmentally friendly technologies might initially need governmental support. The public sector could also help develop and commercialize products that raise people’s well-being generally by encouraging affordable and environmentally friendly innovations such as the solar

home-electricity systems popularized by Grameen Shakti in rural Bangladesh. A number of Asian and Pacific countries including Japan, China, India and the Republic of Korea are promoting such innovations as a part of national action planning on climate change. China, for example, has become the top investor in clean energy, with investments reaching $34.6 billion in 2009. The Republic of Korea plans to spend $84 billion over five years to develop environmentally friendly industries as engines of growth. Governments could also encourage adoption of environmentally sound practices and technologies through appropriate regulations and systems of incentives and taxes.

50. In developing countries the introduction of such innovations could be accelerated if the developed countries that already possess environmentally friendly technologies would relax some of their intellectual property rights provisions and help with acquiring financial backing, following the principles of common but differentiated responsibilities in the United Nations Framework Convention on Climate Change. Developing countries could also help each other in the area of sustainable consumption and production by sharing experiences and best practices. A number of them in Asia and the Pacific already have a range of technological capacities in such areas as biofuels production, waste management and solar and wind power. Waste Concern, a Bangladeshi non-governmental organization, has developed a system of decentralized treatment plants for managing solid waste; with ESCAP support it has encouraged similar approaches in Pakistan, Sri Lanka and Viet Nam.

D. Enhancing financial inclusion

51. A well-functioning financial system is crucial to economic growth, but it would not be enough to ensure expansion in aggregate demand. If the poor are to realize their potential market capacity, they will need access to a more diverse and appropriate range of financial products and services. Savings, credit and insurance products tailored to their requirements, on better terms and with less stringent demands for collateral, would be essential and already have demonstrated success in application. Households that are able to take advantage of microfinance and microinsurance, for example, are in a stronger position to increase their incomes and boost quality of living for families as measured in levels of nutrition and standards of education. Moreover, women in such households tend to have greater autonomy in decision-making and are better able to improve the well-being of their families. To date, however, across most developing Asian and Pacific countries, financial services are used by only a small proportion of the population. The poor are typically excluded from the formal financial sector and from commercial bank services. Barriers exist on both the demand and supply sides. Governments therefore need to ensure an institutional and regulatory environment that fosters inclusive, fair and efficient banking systems, in order to expand and safeguard options for the poor.

E. Evolving a regional framework for cooperative action

52. With some of the world’s largest and fastest-growing economies, Asia and the Pacific could grow as an economic powerhouse if it could integrate its own regional market. Such an advance would require a new development paradigm that would be

more inclusive and sustainable. For historical, political and topographical reasons, the region has customarily been better connected with Europe and North America than it has been within itself.

53. *Survey 2010* has identified four priorities to enable leveraging of complementarities across the region and help in securing a more inclusive and sustainable path of development:

(a) *Regional economic integration*: The Asia-Pacific region harbours a complex network of political groupings, whose leaders in recent times have envisioned the evolution of a unified economic space. The time has come to move from vision to action. To do so they could accelerate progress on two current overlapping proposals: the East Asia Free Trade Agreement (EAFTA) which brings together the ASEAN+3 grouping; and the Comprehensive Economic Partnership of East Asia (CEPEA) of the East Asia Summit (EAS), whose members include those in the ASEAN+3 grouping plus Australia, India and New Zealand (or ASEAN+6). The proposals could serve as stepping stones to an even broader, unified Asia-Pacific market and an economic community;

(b) *Integrated trade and transport policies*: The region has improved its highway and railway networks but cannot use the infrastructure effectively without a legal and regulatory framework to enable vehicles, goods and people to move across borders and transit countries. International movement in many parts of the region is hindered by slow and costly processes, formalities and procedures. The region needs to develop an integrated, multimodal transport system. To do so, intermodal transfer points, also known as dry ports, are one element in a holistic solution where goods, containers or vehicles could be trans-shipped using the most efficient mode of transport along with facilities for product grading, packaging, inspections and the processing of trade documentation. The areas surrounding dry ports could thus emerge as growth poles, bringing new investment and employment opportunities to impoverished hinterlands while reducing the pressure on coastal areas. Building on its Asian Highway and Trans-Asian Railway networks, the ESCAP secretariat is helping the region develop a network of dry ports while improving trade and transport facilitation. ESCAP and regional organizations are collaborating with ASEAN in developing a connectivity master plan;

(c) *Information and communications technology (ICT) superhighways*: Expanding markets and business opportunities and creating a more unified economic space depends crucially on improved intraregional ICT connectivity for reducing the digital divide and accelerating cross-border information and communication flows. One of the main tasks would be to expand international bandwidth, particularly for landlocked and Pacific island developing countries. New connectivity could help in establishing systems for early warning and disaster response;

(d) *Regional financial architecture*: The global economic crisis has highlighted the lack of regional response options. Governments have had to create most of the measures. So far, the cooperation has been largely limited to the Chiang Mai Initiative, which has been made multilateral with a reserve pool of $120 billion for meeting the temporary liquidity needs of ASEAN+3 countries. The region needs to develop its financial architecture further to include systems of intermediation between its large savings and its unmet investment needs. One option would be to create an infrastructure development fund managed by a regional institution. If such an institution could secure just 5 per cent of the region's reserves of nearly $5 trillion, it would have start-up capital of $250 billion and could borrow from the region's central banks. Pooling of reserves could help in meeting some of the regional investment needs for transport, energy, water and telecommunications, which are estimated at more than $800 billion per annum.

54. Another useful area for new financial architecture would be exchange-rate coordination. As trade among the economies of the region increases, a currency management system is needed for facilitating trade and macroeconomic stability. One option would be a basket parity relative to a number of reserve currencies instead of the United States dollar alone, and a common set of weights that is determined by regional trade share.

55. If Governments had access to a well-endowed regional crisis response and prevention facility, they would feel less in need of large foreign-exchange reserves to protect themselves against speculative attacks and liquidity crises, and could thus utilize their reserves for more productive investments. Enhanced regional cooperation should not, however, be regarded as an alternative to full participation in global economic relations. It should rather be seen as complementing participation — filling in the gaps and establishing the building blocks of global multilateral cooperation.

56. A new regional financial architecture would help in developing policy coordination and an Asian and Pacific perspective on various global proposals that are emerging from the G-20, the United Nations and other forums. Proposals under discussion include, for example, an SDR-based global reserve currency, a global tax on financial transactions to moderate short-term capital flows, and international regulations for the financial sector to curb excessive risk taking.

57. The Asia-Pacific region has an historic opportunity for regional cooperation. In recent months, some of the region's major economies have started a process of deepening mutual engagement. If they are to realize their more ambitious plans, they need to put forward more than general statements of intent.

58. Member States may rely on ESCAP, as the regional arm of the United Nations and the all-inclusive forum of the Asia-Pacific region, to provide the analysis and facilitate the policy consensus needed in order to move ahead on the collective journey.