Southeast Asian Economic Outlook 2013

WITH PERSPECTIVES ON CHINA AND INDIA

Narrowing Development Gaps

OECD DEVELOPMENT CENTRE

ASEAN SECRETARIAT

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Foreword

Is this the Asian century? Emerging Asia has experienced remarkable economic growth and a steadfast recovery from the global crisis. According to this new edition of the OECD *Southeast Asian Economic Outlook*, a number of fast growing Southeast Asian economies, as well as China and India, will maintain their overall dynamism in the next five years. Strong economic performance will be essential for achieving sustained improvements in living standards and laying the foundations for more inclusive societies.

Over the medium term, Asia's economic prowess will be supported not only by strong export performance, which has been a powerful driver of growth in the region, but also by the growing strength of domestic demand. In particular, private consumption and investment will become the main engines of growth in many ASEAN countries. Indeed, several large infrastructure projects are being undertaken and social policies are being strengthened in a number of Southeast Asian economies. An expansion of the middle class will also likely provide further impetus for domestic demand-led growth in the region.

However, Southeast Asian governments need to take further action to narrow the region's considerable social and economic disparities and to sustain robust growth. This third edition of the *Southeast Asian Economic Outlook* has therefore a special thematic focus on narrowing development gaps in Southeast Asia, addressing disparities both within and among countries. The report emphasises that development gaps go beyond poverty and income inequality, and encompass several non-monetary dimensions, including infrastructure, tourism, trade and investment, as well as information and communication technology. The report also calls for continued efforts to fight poverty and promote human resource development.

This publication is the result of close collaboration between the OECD Development Centre and the ASEAN Secretariat in Jakarta. It will contribute to inform the debate on the key policy requirements and challenges to reduce development gaps and promote further economic and social integration in the region.

The OECD is committed to supporting Asian countries in their efforts to promote economic and social well-being through rigorous analysis, peer learning and best practices.

November 2012

Angel Gurría
OECD Secretary-General

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The OECD-ASEAN Narrowing Development Gap Indicators (NDGIs), introduced in this volume, were prepared by a joint team from the OECD Development Centre and the ASEAN Secretariat. We thank Elizabeth Alarilla and Agus Sutanto of the ASEAN Secretariat for their co-operation.

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Acronyms and abbreviations

ABCIs	Asian Business Cycle Indicators
ABMI	Asian Bond Market Initiative
ADB	Asian Development Bank
AEC	ASEAN Economic Community
AFTA	ASEAN Free Trade Area
APEC	Asia-Pacific Economic Co-operation
ASEAN	Association of Southeast Asian Nations
BAU	Business-As-Usual
BND	Brunei dollar
BTA	Border Tax Adjustment
CC	Command and control
CCT	Conditional cash transfer
CGE	Computable General Equilibrium
CGIF	Credit Guarantee and Investment Facility
CNY	Yuan renminbi (People's Republic of China)
CPI	Consumer Price Index
CPS	Country Partnership Strategy
EC	European Community
ECEC	Early Childhood Education and Care
EMEAP	Executives Meeting of East Asia-Pacific Central Banks
ETI	Environmental Tax Instrument
EU	European Union
FAO	Food and Agriculture Organization
FDI	Foreign direct investment
FTA	Free Trade Agreement
GDP	Gross Domestic Product
GMS	Greater Mekong Subregion
GST	Goods and Services Tax
GVA	Gross Value Added
HTA	Health Technology Assessment
ICT	Information and communication technology
IDR	Indonesia rupiah
IEA	International Energy Agency
ILO	International Labour Organization
IMF	International Monetary Fund
INR	Indian rupee

ISO	International Organization for Standardization
JICA	Japan International Cooperation Agency
KHR	Cambodian riel
LDCs	Least-developed countries
LPG	Liquefied petroleum gas
MDGs	Millennium Development Goals
MPF	Medium-Term Projection Framework for Growth and Development
MYR	Malaysian ringgit
NDGIs	Narrowing Development Gaps Indicators
NGO	Non-governmental organisation
NLD	National League for Democracy
OECD	Organisation for Economic Co-operation and Development
PHP	Philippine peso
PISA	Programme for International Student Assessment
PITA	Petroleum income tax
PPP	Public private partnership
PPP	Purchasing power parity
PRC	People's Republic of China
PSC	Public Sector Comparator
R&D	Reseach and Development
RCA	Revealed Comparative Advantage
RTA	Regional Trade Agreement
SAEO	Southeast Asian Economic Outlook
SGD	Singapore dollar
SITC	Standard International Trade Classification
SMEs	Small and medium-sized enterprises
SOCBs	State-owned commercial banks
SOEs	State-owned enterprises
TVET	Technical and vocational education and training
THB	Thailand baht
TMS	Target management system
UN	United Nations
UNCTAD	United Nations Conference on Trade and Development
UNDP	United Nations Development Programme
UNESCAP	United Nations Economic and Social Commission for Asia and the Pacific
UNFCCC	United Nations Framework Convention on Climate Change
UNSO	United Nations Statistical Office
UNWTO	United Nations World Tourism Organization
USD	United States dollar
VAT	Value-Added Tax
VND	Vietnamese dong
WEF	World Economic Forum
WEO	World Economic Outlook
WIPO	World Intellectual Property Organization
WTO	World Trade Organization

Preface

Current global uncertainty underscores the need for Asian economies to rethink their growth and development strategies. The export-oriented approach, while successful in earlier decades, has now shown weaknesses. Excessive dependence on external demand has made many Asian countries vulnerable to fluctuations in global demand and to external shocks. Domestic demand will be an important engine for medium-term growth in the region.

Many Asian countries are searching for "new growth and development strategies" to reflect the changing growth dynamics in the region and international markets. Formulating new growth and development strategies will require the adoption of a comprehensive package of reform measures; enhancing productivity through structural policy reforms will be the key in the region. In their medium-term development plans, many Asian countries have included human capital development, social and labour market policies, green economies and disparity issues – all elements which are addressed in the *Southeast Asian Economic Outlook 2013: With Perspectives on China and India* (SAEO).

As a special theme, this edition is focusing on economic disparities and development gaps both within and among Southeast Asian countries. Narrowing development gaps presents one of the most important and challenging policy tasks in the region.

The OECD Development Centre is committed to working alongside governments of developing and emerging economies and regional actors to identify key areas of intervention to address this challenge. SAEO is the result of three policy dialogues and consultations at regional level, namely Jakarta in November 2011, Seoul in February 2012, Singapore in September 2012 and country-based consultations in Asia in August and September.

This Outlook – the third edition – is prepared for the first time, in collaboration with the ASEAN Secretariat, like other regional economic outlooks produced by the OECD Development Centre. The ASEAN-OECD Narrowing Development Gaps Indicators (NDGIs) discussed in this book are one of the results of the collaboration. In addition, this edition of the Outlook includes the key policy challenges of China and India to fully reflect the economic landscape in the region. While strengthening the co-operation with countries in the region, this edition will be presented at the occasion of the ASEAN Business and Investment Summit in Cambodia, in November 2012. I hope that this third volume will continue to serve as a tool to foster a better understanding of the growth and development of Asian economies.

Mario Pezzini
Director
OECD Development Centre
Paris, November 2012

Executive summary

Part 1. Regional economic monitor: Medium-term economic outlook

Southeast Asia is resilient: Southeast Asian economies are projected to perform robustly in the period to 2017, returning to growth rates seen in the years before the financial crisis (2000-07). Growth will be driven by strong domestic demand, particularly private consumption and investment, and will be less reliant on exports. Fiscal deficits will generally fall, leading to stable or declining ratios for public debt to GDP.

The OECD Development Centre forecasts that real growth in the region will return to pre-crisis levels of 5.5% in 2013-17. Indonesia is projected to reach a growth rate of 6.4% over the period, equalling the pace set before the 1997 Asian financial crisis. The favourable outlook reflects a significant improvement in its standing with international investors and ambitious infrastructure investment and economic reforms.

Projected growth in Singapore is 3.1%, Malaysia 5.1%, the Philippines 5.5% and Thailand 5.1%. The lower projections for these countries compared to Indonesia show that some are at the stage where further rapid gains in productivity become harder to achieve and where they face a greater risk of falling into the middle-income trap.

Growth in other parts of the region is also projected to be robust, with Cambodia reaching 6.9%, Lao PDR 7.4%, Myanmar 6.3% and Viet Nam 5.6%. Myanmar's outlook has improved following recent political reforms, which should encourage foreign investment. Growth in Cambodia and Viet Nam is projected to be somewhat slower than before the global financial crisis; in Cambodia's case, this is largely because of slowing demand for its textile exports. High inflation is a major downside risk for Viet Nam.

Despite the forecast of a strong regional performance, growth overall in Emerging Asia (Southeast Asia plus China and India) is projected to average 7.4% in 2013-17, a little over a percentage point lower than the pre-crisis rate. That decline is due in large part to slowing growth in China and India.

Consumption and investment are driving growth, along with an expanding middle class: Robust private consumption will be the main contributor to growth, which partly reflects changing government policies. For example, rising government spending on health and social safety nets is freeing up household resources by reducing their need to save for a rainy day. Government spending on infrastructure should also contribute significantly to growing investment. The region is also seeing a rapidly emerging middle class, which tends to spend more on cars and consumer durables than poorer households and to invest more in education and health.

Region largely spared from global uncertainty, but challenges remain: Strong domestic fundamentals have generally insulated the region from slow growth in the United States and uncertainty in the euro area. Nevertheless, some impact has been felt, mainly through trade. Despite being spared the worst of the problems facing OECD member countries, the region still faces significant policy challenges:

- **Mobilising government tax revenues:** Governments in the region generally collect less tax than might be expected, reducing their ability to invest in areas like education and infrastructure. Several factors are at work, including low incomes in the general population and a relatively underdeveloped business sector, which makes tax collection unviable; weak capacity; and the size of the informal economy. Tax collection could be improved if, among other reforms, governments made greater use of value-added taxes and property and environmental taxes.
- **Managing capital inflows:** Uncertainties in the external economic environment raise the risk of volatility in capital inflows. In the medium term, further development and regional integration of domestic financial markets would help countries in the region to reap the benefits from capital flows and reduce the risks. Longer term, priorities should include developing corporate bond markets to reduce the private sector's dependence on bank financing and strengthening regulation.
- **Managing dollarisation:** US dollars are widely used alongside the local currency in Cambodia, Lao PDR and Viet Nam. Although this allows businesses and individuals to cushion the effect of high inflation and macroeconomic instabilities there are also negative effects, most notably that the economic authorities may lose control over monetary and exchange rate policies, weakening their ability to respond to major external shocks.

Part 2. Structural policy country notes: Medium-term policy challenges

Development policies are shifting away from traditional growth models: The global financial crisis highlighted the risk for regional economies of continuing to rely largely on export-oriented growth strategies. As a result, many are searching for development strategies that focus more on domestic demand and are more flexible in the face of changing international conditions. Policy makers have included several elements in development plans that reflect this, including human capital development, social and labour market policies and policies to promote greener economies and address economic and social disparities.

Part 2 presents structural policy notes on seven countries – Cambodia, Indonesia, Malaysia, the Philippines, Singapore, Thailand and Viet Nam – that discuss relevant experiences in OECD countries, provide useful insights and suggest "best practices" for policy makers.

Part 3. Thematic focus: Narrowing development gaps

Development is spread unequally: Wealth disparities between and within countries are notable across the region. At their extreme, they can be seen in variations in GDP per capita, ranging from USD 1 300 in Myanmar to over USD 48 000 in Singapore and Brunei. Narrowing these gaps will be essential as the Association of Southeast Asian Nations moves towards its stated goal of creating an ASEAN Economic Community by 2015.

Disparities also need to be considered in wider contexts, as they are in the ASEAN-OECD Narrowing Development Gaps Indicators (NDGIs), which examines several policy areas, including human capital development, trade, tourism and poverty. These indicators show particularly wide disparities in socio-economic development between two sets of countries: On the one hand, Brunei, Indonesia, Malaysia, the Philippines, Singapore and Thailand and, on the other, Cambodia, Lao PDR, Myanmar and Viet Nam.

Tackling disparities: ASEAN has done much to foster regional co-operation, but more needs to be done to pursue greater social and economic integration, particularly in human capital development and poverty. Progress has been especially slow in these last two areas because countries continue to prioritise and pursue their own agendas rather than the common goal. Indeed, across a range of areas, measures taken at regional, sub-regional and country levels can lack coherence.

Special action is needed in Cambodia, Lao PDR, Myanmar and Viet Nam: Although all these countries have seen a decline in poverty, inequality has risen in Lao PDR. Policies for all four should aim to broaden tax bases, improve transport and communications links and encourage institutional capacity building.

Overview

Part 1. Regional economic monitor: Medium-term economic outlook

Southeast Asian economies show resilience, although China will begin to slow gradually

Real growth in Southeast Asia as well as the People's Republic of China and India should recover from the slowing during 2011-12 and achieve a robust pace over 2013-17, according to the results of the OECD Development Centre's Medium-Term Projection Framework for this Outlook (MPF-2013). Growth of the Southeast Asian region is projected to average 5.5% over 2013-17, the same rate recorded during the pre-crisis period (2000-07). The success of the Southeast Asian economies in sustaining robust growth in the near term attests to their resilience in the face of major external shocks (Table 0.1).

The projected growth for ASEAN countries highlights the fact that some are at an earlier stage of development, while others are at a stage where further rapid gains in productivity become more difficult to achieve. Indonesia is projected to lead the ASEAN-6 countries with a growth rate of 6.4% over 2013-17, significantly above its average after the 1997 Asian crisis (5.1% over the 2000-07 period) and equal to that recorded in the two decades prior to that crisis. This favourable outlook for Indonesia reflects the significant improvement in the country's standing with international investors and the ambitious infrastructure investments and economic reforms specified in Indonesia's medium-term development plan. Projected growth in Singapore, Malaysia, the Philippines and Thailand compares favourably to growth for other developing countries at a comparable stage of development, owing in part to the comparatively high national savings rates in the Southeast Asian countries.

Growth in the CLMV countries (Cambodia, Lao PDR, Myanmar and Viet Nam) is also projected to be quite rapid over the medium term, ranging from over 6% for Cambodia and Myanmar, and more than 7% in Lao PDR. Myanmar's growth outlook has improved substantially as a result of the political reforms beginning in 2010, which are expected to lead to a large influx of foreign investment. Growth in Cambodia and Viet Nam is projected to be somewhat slower than before the global financial crisis: in Cambodia's case, this is largely because of slowing demand for its textile exports. High inflation, due partly to the weak macroeconomic management framework, is a major downside risk for Viet Nam.

Growth in Emerging Asia (Southeast Asia, People's Republic of China and India) as a whole is projected to be 7.4% by 2017, though slower than its pre-crisis rate (8.6% over the 2000-07 period). This moderated growth momentum is largely due to weakening in the two big giants (China and India) in the region. Growth in China is projected to slow somewhat from the nearly 10% recorded over the first three decades of its reform period, though its growth rate will be above 8% over 2013-17. The projected slowdown is attributable to slower growth in demand for China's exports along with lower labour force growth and the waning of productivity gains from shifting labour from agriculture to industry and the incorporation of existing technologies.

Table 0.1. **Real GDP growth of Southeast Asia, China and India**
(annual percentage change)

	2011	2017	2000-07	2013-17
ASEAN-6 countries				
Brunei Darussalam	2.2	2.9	-	2.4
Indonesia	6.5	6.6	5.1	6.4
Malaysia	5.1	5.5	5.5	5.1
Philippines	3.9	5.3	4.9	5.5
Singapore	4.9	3.7	6.4	3.1
Thailand	0.1	5.3	5.1	5.1
CLMV countries				
Cambodia	7.1	7.3	9.6	6.9
Lao PDR	8.0	7.6	6.8	7.4
Myanmar	5.5	6.7	-	6.3
Viet Nam	5.9	6.1	7.6	5.6
ASEAN-10 average	**4.6**	**5.8**	**5.5**[a)]	**5.5**
CLMV average	**6.0**	**6.4**	**7.8**[b)]	**5.9**
Emerging Asia average	**7.9**	**7.4**	**8.6**[a)]	**7.4**
China and India				
China	9.3	8.0	10.5	8.3
India	6.9	7.0	7.1	6.4

Notes: The cut-off date for data is 1 November 2012. For more detailed information on MPF, see www.oecd.org/dev/asiapacific/mpf. Emerging Asia includes ASEAN 10 countries plus China and India.
a) excludes Brunei and Myanmar; *b)* excludes Myanmar.
Source: OECD Development Centre, MPF-2013.

The main results of the MPF-2013, discussed in detail in Chapter 1, are as follows:

- Southeast Asian economies show resilience through 2017, maintaining the same level of growth momentum as during the pre-crisis period, although real gross domestic product (GDP) growth in the rest of Emerging Asia, in particular China, will begin to slow gradually.
- The impact of global uncertainty has remained limited overall.
- Domestic demand growth, particularly private consumption and investment, will be the main driver of growth in most cases. Growth will be less reliant on net exports than in the past.
- A growing middle class will certainly affect the level and structure of demand in Emerging Asia.
- Fiscal deficits will fall in most countries, leading to stable or falling public debt-to-GDP ratios. However, countries will also need to strengthen their fiscal capacities through improved mobilisation of revenues.
- Countries will face significant macroeconomic policy challenges from potentially rising capital inflows and, in Cambodia, Lao PDR and Viet Nam, from extensive dollarisation.

The impact of global uncertainty, in particular from the euro area, has become apparent but remains limited overall

Since the global financial crisis and the onset of the European sovereign debt crisis, there has been a sharp increase in market concerns regarding fiscal sustainability in major economies in the world. At present larger economies in the euro area, such as Spain and Italy, continue to face difficulties in accessing market financing. The United States (US) economy still has not fully recovered from the recession; its housing and labour markets remain weak, and fiscal uncertainties remain at the forefront.

Table 0.2. **Southeast Asian countries' indirect trade exposure to G3**
(percentage of exports)

Source Country	Export Market	Indirect export exposure to euro area	Indirect export exposure to US	Indirect export exposure to Japan
Indonesia	Euro area		0.3	0.1
	US	0.7		0.2
	Japan	1.8	3.3	
	China	2.9	3.6	1.6
Malaysia	Euro area		0.2	0
	US	1.0		0.3
	Japan	1.3	2.3	
	China	5.0	6.1	2.8
Philippines	Euro area		0.2	0
	US	1.6		0.5
	Japan	1.4	2.6	
	China	5.5	6.7	3.0
Singapore	Euro area		0.2	0
	US	0.5		0.2
	Japan	0.1	0.2	
	China	1.0	1.3	0.6
Thailand	Euro area		0.1	0
	US	0.6		0.2
	Japan	0.7	1.2	
	China	2.3	2.8	1.3
Cambodia	Euro area		0	0
	US	0.1		0
	Japan	0	0	
	China	0.3	0.3	0.1
Viet Nam	Euro area		0.3	0.1
	US	0.6		0.2
	Japan	0.8	1.5	
	China	1.6	1.9	0.8

Note: The cut-off date for data is 15 October 2012.
Source: OECD Development Centre's estimates.

Emerging Asian financial markets have been buffered from these uncertainties but the effects seem to have been muted by the region's strong domestic fundamentals.

The impact on Southeast Asia from the slowdowns in OECD countries has been limited thus far, coming mainly through the trade channel. Slowdowns in the advanced economies have real effects on the demand for ASEAN's exports. The US, the euro area and Japan (G3) remain the key export markets for Southeast Asian countries, and a slowdown in these countries would have ripple effects on Asia, with subsequent spillover effects on private investment and consumption spending.

A more complete assessment of trade exposure has to include indirect exports to the G3 economies, that is exports of intermediate goods that are processed in Emerging Asian countries and subsequently exported to one of the G3. The indirect channel is estimated to be non-negligible for Southeast Asian countries and the indirect export exposure to the G3 economies through China is larger than the indirect channels through the United States, Japan and the euro area. The indirect channel through China has been growing over the years, indicating that Southeast Asian countries are becoming more dependent on China as a key trading partner (Table 0.2).

Private consumption and investment will be the main drivers of growth

Private consumption is likely to be especially robust over the medium term and the main contributor to overall growth in many countries of Emerging Asia. A combination of cyclical factors, government policies and longer term shifts in economic structure that have supported consumption growth over the past several years are likely to continue. Government policies are becoming increasingly supportive of private consumption. Furthermore, increasing government spending on health and social safety net programmes in much of Emerging Asia will continue to encourage consumption spending by freeing up household resources and by reducing their need for precautionary savings.

In many Emerging Asian countries, investment growth should be as or more rapid over the next five years compared to the five years leading up to the global financial crisis. Government infrastructure spending is slated to be an important contributor to overall investment growth in a number of Southeast Asian countries. Another important factor is recent movements in the environment for private investment in the region.

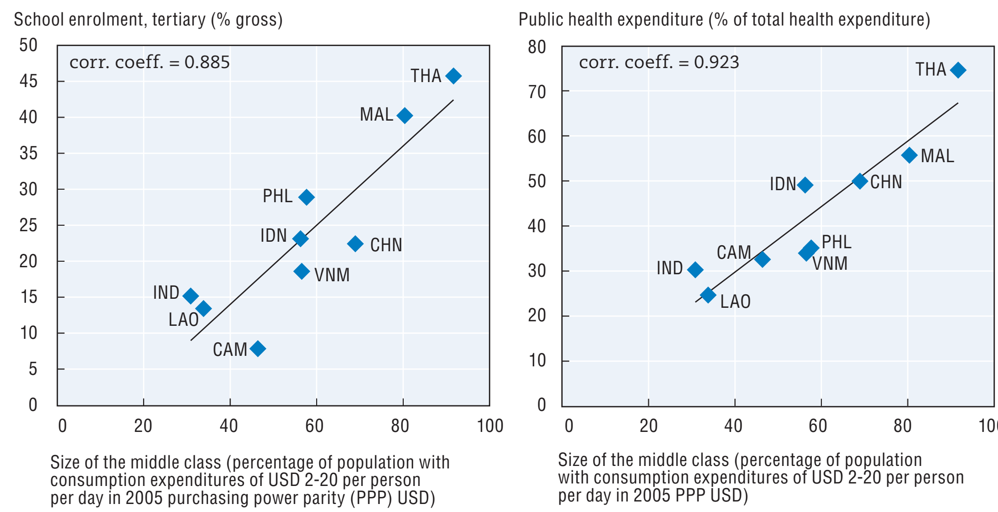
Middle-class growth in the region has been among the most rapid in Asia and has boosted consumption growth

Rapid growth in Southeast Asia, China and India over the past two decades has produced a remarkable expansion in the middle class. The rising middle classes have also encouraged strong consumption growth.

Middle-class development is affecting the structure of demand in Emerging Asia. Middle-class households, particularly those in the higher portion of the middle-income range, tend to devote a larger portion of their income to purchases of automobiles and other major consumer durables than do poor households. This increased demand for consumer durables and other consumer goods is also helping to spur innovations. Middle-class households also tend to spend a higher portion of their income on education and health services, and to purchase more sophisticated services, than do poorer households (Figure 0.1).

Middle-class growth is spurring the development and broadening of financial instruments and services in Southeast Asia, China and India. Middle-income households are more likely to have some debt and to have access to some consumer and housing finance. Hence, the growth of the middle class has also fostered the development of consumer credit facilities, which in turn give households greater scope for spending. Rapid growth of consumer credit has been an important factor supporting consumption growth particularly in higher income Southeast Asian countries. At the same time, the need for precautionary savings to insure against destitution from economic setbacks diminishes as household incomes rise into the middle-class ranges.

Figure 0.1. **Middle class size versus tertiary school enrolment and public health-care spending in Southeast Asia, China and India**



Notes: Latest year available: Cambodia, 2008; Indonesia, 2011; Lao PDR, 2008; Malaysia, 2009; the Philippines, 2009; Thailand, 2009; Viet Nam, 2008; China, 2008; India, 2009.

In the case of Indonesia, China and India the latest figures for the size of the middle class are estimates combining the separate urban and rural distributions, weighted by share of urban/rural to total population.

Source: OECD Development Centre.

StatLink *http://dx.doi.org/10.1787/888932773312*

Middle-class growth has several other important economic implications, including:

- Boosting demand for government services, in terms of quality and quantity. Roadways and related infrastructure need to be improved and expanded to accommodate the growing population of automobiles and other motor vehicles. Larger houses and apartments equipped with refrigerators and other electrical appliances increase demand for electricity and clean water and waste treatment facilities. Greater and more sophisticated health and education services are likely to be required.
- Changing priorities for social safety net development and, to some extent, making that development more feasible.
- Increasing migration as middle-class households are more likely to migrate in search of opportunities outside their home area and spend more on education and other human capital development in their effort to rise economically.

Emerging Asia needs to strengthen fiscal capacities through improved mobilisation of revenues

Emerging Asia faces two sets of obstacles in mobilising government tax revenues: a policy gap and a compliance gap. First, the scope of tax policies is constrained by the relatively low incomes of most of the population and the earlier stage of development of the business sector compared to more advanced economies, creating what is known as a policy gap. Personal income taxes are typically levied on only a small fraction of the population, those with the highest incomes, since they would impose unacceptable burdens on lower income households and would be too expensive to collect relative to their potential yield. Similar considerations limit the scope for collecting corporate income and other business taxes. The use of tax exemptions, preferences and subsidies for policy goals, such as poverty reduction or to promote "infant industries" – although hardly unique to developing countries – further limits tax bases. Second, collection of tax revenues that are legally due is limited by the early stage of development and other institutional weaknesses in tax administration and law enforcement and by the large amount of economic activity carried out in the informal sector, facilitating widespread tax evasion and smuggling – the so-called compliance gap.

Highly open economies, such as those of many Emerging Asian countries, can face particularly acute constraints on tax policy scope and collection. Most taxes, but particularly business taxes, raise costs in export industries and can, if too high relative to competitor countries, discourage direct investment inflows. This competition for foreign direct investment (FDI) has led to the proliferation of tax holidays, exemptions from certain taxes and other tax preferences for foreign and domestically owned export businesses, in developing countries. Collection of taxes on the domestic activities of foreign multinational companies can be difficult given the capabilities of these countries to book profits offshore through transfer pricing and other devices.

Existing tax systems in many Emerging Asian countries are underperforming in terms of revenues they are generating. The net result of tax policy and compliance gaps is that tax revenues collected are nearly always lower than those that would theoretically be collected if legislated tax rates were applied uniformly and fully collected. A number of studies have attempted to empirically measure the maximum tax revenues that could be collected in order to compute the ratio of actual tax revenues to this theoretical maximum. This ratio provides a rough indication of the effectiveness of country tax systems in mobilising revenues.

In Asia, overall tax "effort" by this measure is the lowest in China and the highest in Viet Nam. All ratios except for that of Viet Nam are below the median of the respective income group to which the countries belong. These measures are far from conclusive – there are many legitimate reasons why countries may not raise all the revenue that they theoretically could from their taxes.

Three areas of tax reforms have particular potential to improve revenue mobilisation and the overall efficiency of the tax systems in many countries in the region. First, reforms to the value added tax (VAT) have great potential for substantial increases in revenue in many countries. Broadening the VAT base and improving revenue collection could raise revenues by several percentage points of GDP in Indonesia, Malaysia and the Philippines. The "productivity" of the VAT systems in terms of the revenue actually raised compared to the revenue that would be raised if the statutory rate were applied to the entire (consumption) base is quite low in these countries, both in absolute terms and relative to the median of countries in their income group. Thailand could also raise significant further revenue by increasing its comparatively low VAT rate to a level more in line with the rest of the Emerging Asia region.

In addition to reforms of the main tax sources, a number of other taxes are relatively under-used in some or many countries in Southeast Asia, China and India, such as real estate taxes and environmental tax instruments (ETIs). Consideration could be given to expanding their use, either to increase overall tax revenues or to finance reductions in corporate or other taxes where they are now comparatively high.

Management of capital inflows continues to be an important issue

Southeast Asian countries and China are likely to continue to face potential risks of volatility of capital inflows in the medium term, depending on the external economic environment. Further development and regional integration of domestic financial markets will help to better reap the benefits from capital flows and reduce the risks they can pose to domestic economic stability. Emerging Asian countries have made considerable progress since the global crisis in strengthening the financial soundness and governance of their banking systems. Over the longer term, however, further development of domestic capital markets is very important to realising the benefits of capital inflows and containing their risks. Deeper capital markets dampen the volatility in prices arising from fluctuations in foreign (and domestic) investors' demands for domestic equities and fixed income instruments. More efficient capital markets are less susceptible to mispricing of assets and their risks and to speculative bubbles.

Corporate bond markets in particular need to be developed further in Southeast Asia. The limited development of corporate bond markets has left their private sectors more dependent on bank financing than comparable emerging economies in other regions. Countries also need to strengthen legal and regulatory rules critical to all capital markets, including corporate bond markets. These include stronger disclosure requirements in the capital markets and measures to better protect minority shareholders, corporate governance reforms and reforms to bankruptcy codes.

Managing the extensive dollarisation and further strengthening of the financial sectors are the main challenges for CLMV countries

In Southeast Asia, dollarisation is most extensive in Cambodia, followed by the Lao PDR and Viet Nam. The experiences of Cambodia, Lao PDR and Viet Nam in conducting monetary policy illustrate the complications posed by dollarisation. Holding around 90%, 50% and 20% of M2 in foreign currency deposits in Cambodia, the Lao PDR and Viet Nam, respectively, allows businesses and individuals to cushion the effect of high inflation and macroeconomic instabilities and imposes a certain degree of dollarisation in these economies. However, a high degree of dollarisation also entails substantial costs.

The use of multiple currencies can result in economic authorities losing control over monetary and exchange rate policies. The ability of the private sector to switch between the local currency and the dollar or other foreign currencies makes it more difficult for central banks to control the money supply through their determination of base money, reserve requirements, and/or policy interest rates. The demand for local money is also likely to become less stable, making the effect of changes in the domestic money supply on the economy less predictable. Largely for these reasons, the adjustment to major external shocks can be more prolonged and painful when dollarisation is extensive. The potential fall in the exchange rate and the resulting contraction in economic activity from a loss in confidence in the domestic currency could be especially great for Cambodia, Lao PDR and Viet Nam, given their extensive dollarisation.

Part 2. Structural policy country notes: Medium-term policy challenges

Many Southeast Asian countries are searching for "new growth and development strategies"

The global financial crisis has underscored the need for Asian economies to rethink their past growth models. The export-oriented growth strategies, successful in earlier decades, have shown their weaknesses. Excessive dependence on external demand has made many Asian countries vulnerable to fluctuations in global demand and to other external shocks. Domestic demand will be an important engine for medium-term growth in the region.

Many Southeast Asian countries are searching for new growth and development strategies which are more focused on domestic demand and better adapted to changing international market conditions. Policy makers in the region recognise the need to adapt their development strategies and indeed have included several new elements that reflect a shift towards a new growth model in their medium-term development plans. These elements include human capital development, social and labour market policies, policies to promote greener economies and policies to address economic and social disparities. Implementation of the new development strategies will require the adoption of a comprehensive package of reform measures (Table 0.3). Overall, enhancing productivity through structural policy reforms will be key to the success of the new development strategies in the region.

Table 0.3. **Medium-term development plans of Southeast Asian countries**

Country	Period	Theme/vision
Cambodia	**2009-13**	For growth, employment, equity and efficiency
Indonesia	**2010-14**	Towards the realisation of an Indonesia that is prosperous, democratic and just
Malaysia	**2011-15**	Charting development towards a high-income nation
Philippines	**2011-16**	In pursuit of inclusive growth
Singapore	**2010-20**	Highly skilled people, innovative economy, distinctive global city
Thailand	**2012-16**	Philosophy of a Sufficiency Economy
Viet Nam	**2011-15**	Strong and sustainable growth by improving the quality and competitiveness of the economy

Source: OECD Development Centre based on national sources.

This Outlook includes notes on seven countries, namely Cambodia, Indonesia, Malaysia, the Philippines, Singapore, Thailand and Viet Nam. The policy areas discussed in each note are identified in the national development plan of the country concerned. Each note also discusses relevant experiences in OECD countries, providing useful insights and suggesting "best practices" that may be of use for ASEAN policy makers. These structural policy country notes address two key questions: what kinds of elements will be important for the new development strategies in Southeast Asia; and how does each country incorporate its new development model into its medium-term plans?

New development strategies will differ from country to country

The policy challenges facing each country depend to a large extent on their level of development (Table 0.4). For instance, **Cambodia** faces the challenge of building and upgrading its infrastructure to bring its agriculture sector into the commercial mainstream. Milled rice exports could become an engine of growth and thereby help to reduce poverty, but not until the export procedures have been streamlined and the milling process made more efficient. Productivity is a weakness not only in agriculture but in most other sectors. Human capital development would help to boost productivity, but Cambodia's education and technical and vocational education and training (TVET) systems need to be reformed. Enrolment rates at all levels are very low. The result is a mismatch with economic needs and a large unskilled labour force. The banking sector offers a relatively brighter picture. Its capital base is sound and growth has been brisk, with microfinance business burgeoning. Cambodia's central bank must build its capacities and modernise its infrastructure so that it can support economic growth. The central bank also needs to establish effective supervisory processes that can ensure customer protection and the stability of the financial sector.

Table 0.4. **Summary of medium-term policy challenges and responses in Southeast Asia**

Cambodia	**Agriculture**	Build agricultural productivity and tap the export potential
	Human capital development	Increase enrolment rates at all levels of education and strengthen TVET to build a skilled labour force
	Reform of financial sector	Strengthen the banking sector and prudential measures
Indonesia	**Infrastructure**	Narrow the regional divide by enhancing connectivity and the capacity of local government
	Education	Strengthen the capacity of local government to provide education infrastructure
	Social security reform	Accelerate health-care reform, focusing on coverage and access to health-care services
Malaysia	**Human capital development**	Strengthen TVET and the education system to address skills shortages
	Labour market	Address weaknesses in labour market functioning
	SME development	Enhance productivity of SMEs
Philippines	**Infrastructure**	Improve road transport, power and energy infrastructure and strengthen public and private investment
	Labour market	Focus sharply on job creation strategies
	Education	Improve access to quality education and training by strengthening the K+12 programme
Singapore	**Labour market**	Manage foreign worker dependence by increasing the productivity of local workforce
	SME development	Sustain SME growth through fostering entrepreneurial environment
	Innovation	Enhance the innovation capabilities of local enterprises
Thailand	**Education**	Raise the quality of education and reduce disparities
	Health-care system	Achieve a more equitable health-care system
	Green economy	Foster green growth through investment and fiscal reforms
Viet Nam	**Human capital development**	Reform training and education to better meet demand for skilled labour
	Development of banking sector	Strengthen the banking system by establishing effective supervision
	SOEs reform	Strengthen market-based reforms and monitoring of SOEs

Source: OECD Development Centre.

Indonesia faces a number of challenges which centre on the key question of equality. It must build and upgrade its infrastructure primarily to close the development gap between urban and rural areas and the west and east of the country. As a vast sprawl of scattered islands, connectivity is a key first step in its infrastructure policy. The same gaps – west-east, urban-rural – affect education and, by the same token, human resource development. A widely available health-care system needs to be established. Indonesia's expenditure on health care is among the lowest in Southeast Asia. Access to health care and public confidence in the healthcare system are both limited. The government has undertaken far-reaching social security reform, including to the health-care system, but much is still to be done to create a sustainable and equitable system.

Malaysia will need to address some important long-standing economic weaknesses in the medium term in order to progress toward becoming an advanced economy within the next decade. Skill shortages and mismatches and the deficiencies in the education system that underlie them and the low participation of women in the work force particularly need to be remedied. Measures to improve small and medium-sized enterprise (SME) productivity and to reduce gaps between rural and urban SMEs will also be needed.

The major policy challenges **the Philippines** faces in its Medium-Term Development Plan are to improve its road infrastructure, increase access to education and development resources, and ensure jobs for all. Both road transport and power are critical to achieve a more closely integrated Philippine economy, thereby helping to attract private-sector investment. Increasing secondary school enrolment and improving the standards of teachers and pupils are vital reforms, without which there can be no adequate human and economic development or job creation.

Singapore is aiming to reform several structural policies to be a hub of the global economy. Political pressure is forcing Singapore to rethink the liberal immigration policy that was part of its drive to be a global city. The government is tightening entry conditions for foreign workers while encouraging foreign entrepreneurs and investing heavily in developing the human capital of indigenous workers. It is also encouraging businesses to upgrade their technology and production methods. As part of that effort, the government has lent strong backing to SMEs. Research and Development (R&D) has been an important component of Singapore's policy of productivity-driven economic growth. Combined public and private R&D expenditure has put Singapore among the most R&D-intensive countries. Nevertheless, Singapore lags behind in private R&D spending.

Thailand faces challenges to further improve its education and health-care systems while addressing the accumulated environmental damage from its rapid growth. The country has made impressive progress in providing education and health care to most of the population. However, significant disparities in access remain, especially for poorer households and between rural and urban areas, that need to be addressed. Education quality needs to be improved, particularly the quality of teachers, and rising health-care costs need to be contained through reforms to improve efficiency in the delivery of services. Thailand also needs to address environmental damage from past growth and achieve greener growth in the future by reducing carbon emissions and other forms of pollution. This will require commitment to greener growth by government, business and the public, and new policies including increased use of fiscal incentives to encourage more environmentally friendly activities and behaviours.

Viet Nam will need to meet several challenges in the medium term to sustain rapid growth and realise its development potential. As in several other countries in the region, the supply of skilled labour needs to be increased and better adapted to the needs of industry through reforms to the vocational training and education systems, including further encouragement of workplace training. Reforms to the financial system and to state-owned enterprises need to be broadened and accelerated. The bad loans of the commercial banking sector need to be addressed in the medium term but reforms to improve their governance and to strengthen regulatory oversight are crucial to ensure that banks function effectively and prudently in the future. Ownership diversification of state-owned enterprises (SOEs) needs to be broadened and governance and oversight improved. Reforms to allow all businesses to compete on equal terms will be especially critical to ensuring that SOEs can compete as fully market-based enterprises.

Part 3. Thematic focus: Narrowing development gaps

Narrowing development gaps between countries are key challenges in ASEAN

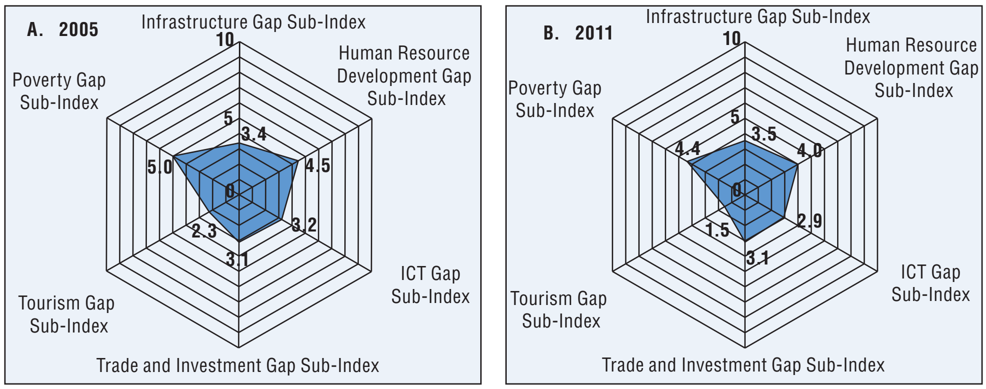
At the 9th ASEAN Summit Meeting, held in Bali in 2003, ASEAN leaders adopted ASEAN Concord II, a joint statement in which they set out their vision of an integrated ASEAN community. In 2007, ASEAN leaders declared that they envisioned regional economic integration as culminating in the end-goal of the ASEAN Economic Community (AEC) in 2015. Narrowing social disparities and economic development gaps between countries are key challenges facing ASEAN. The Initiative for ASEAN Integration (IAI) was launched in 2000 with precisely the purpose of narrowing the developments gaps among ASEAN member countries.

Development disparities need to be examined from various angles in addition to income level

GDP per capita – one measure of income disparity among countries – rose faster between 2005 and 2011 in the ASEAN 6 countries (Brunei Darussalam, Indonesia, the Philippines, Singapore, Malaysia and Thailand) than in CLMV. The result was a widening of the income gap between the two country groupings. Although Viet Nam's per capita GDP was just behind that of the poorest members of ASEAN 6 – the Philippines and Indonesia –Cambodia's was only USD 2 200 and Lao PDR's USD 2 800 in 2011. Myanmar lagged even further behind with an estimated GDP per capita of USD 1 300. However, even within the ASEAN 6 countries there are wide disparities. At over USD 48 000, Singapore and Brunei record the highest GDP per capita, while the rest (Indonesia, Malaysia, the Philippines and Thailand) have less than half that level.

Income level differences are just one aspect of disparities, which need to be examined from various angles. In order to monitor the progress of efforts to reduce disparities in development, the ASEAN Secretariat and the OECD Development Centre jointly developed a set of indicators – the ASEAN-OECD Narrowing Development Gaps Indicators (NDGIs) (Figure 0.2). The NDGIs measure gaps in six policy areas – namely infrastructure, human capital development, information and communication technology (ICT), trade and investment, tourism and poverty – identified in the IAI's Strategic Framework and Work Plan 2 (2009-15). For each policy area a sub-index of 10-15 key variables was constructed to quantify the development gap (see Chapter 3 for more details).

Figure 0.2. **Narrowing Development Gap Indicators (NDGIs): disparities between ASEAN-6 and CLMV**



Note: Each sub-index of the NDGI, whose value ranges from 0 to 10 base points – where 0 denotes no gap and 10 the widest gap – is built from multiple variables within six key policy areas shown above.
For more detailed information, see www.oecd.org/dev/asiapacific.

Source: ASEAN Secretariat and OECD Development Centre.

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The indicators show that significant discrepancies in socio-economic development persisted in 2005-11 between ASEAN 6 and the CLMV countries. The main findings to be drawn from the ASEAN-OECD NDGIs, which are discussed in detail later, are as follows:

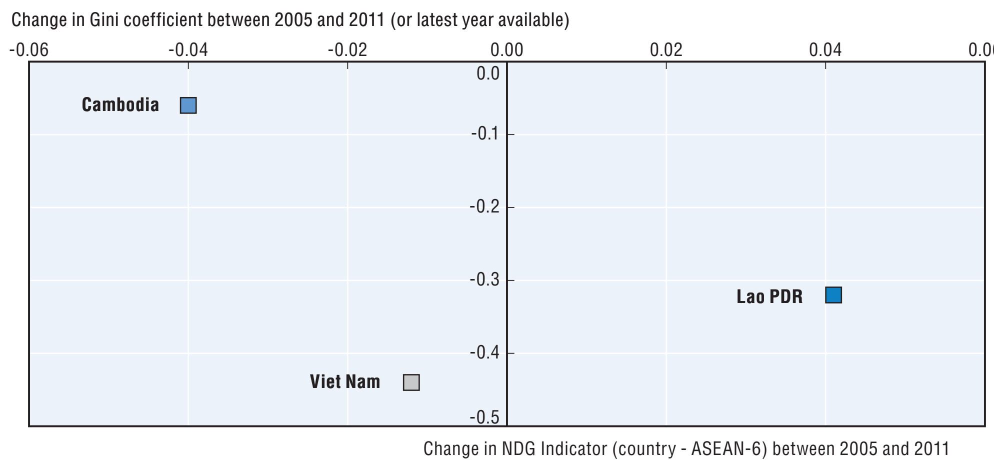
- Disparities are at their widest in poverty and human resource development. Greater efforts are consequently required in these areas and regional support should prioritise CLMV.
- Disparities in tourism and ICT between ASEAN-6 and CLMV countries were the narrowest in 2005 and continued to be so in 2011, which suggests that efforts undertaken by ASEAN member countries to accelerate development in both fields have been successful. However, there is room for improvement in all countries: they should seek to attract more international visitors and expand access to Internet technology.
- Between 2005 and 2011, disparities in poverty, human resource development, ICT, and tourism gradually narrowed. However, over the same period, the infrastructure and trade and investment development gap indicators showed no improvement. Many regional projects designed to increase connectivity in transport and energy need to be strengthened. Legal and regulatory structures for investors must be made more transparent and logistical procedures more efficient.

Disparities both among and within countries need to be addressed

The region faces an issue of dual disparities – i.e. disparities both among and within countries. Examination of recent patterns in income inequalities within countries, as measured by the Gini coefficient, reveals different trends among ASEAN countries. Between 2005 and 2011, inequality eased in Cambodia and Viet Nam and grew in Lao PDR, even though it started from a very low level. Patterns of change in income inequality also vary in ASEAN-6 economies. Indonesia and Malaysia became more unequal, while the Philippines and Thailand managed to reduce inequality to a certain extent. Income inequality in Singapore seems to have been stationary at a relatively high level since 2005.

Study of the relationship between disparities among countries and within countries yields some interesting observations (Figure 0.3). Viet Nam has been the most successful CLMV economy both in reducing income disparities at home and in closing the gap between the ASEAN-6. Lao PDR and Cambodia show different growth and development paths. Lao PDR has successfully caught up with ASEAN 6 countries at the cost of increasing domestic inequalities, while Cambodia has been slower to make ground on ASEAN-6 but effective in reducing income disparities within the country.

Figure 0.3. **Disparities "among countries" and "within countries" in Southeast Asia**



Note: Change in Gini coefficient between: 2004 and 2008 for Cambodia; 2002 and 2008 for Lao PDR; 2004 and 2008 for Viet Nam.
Source: OECD Development Centre.

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The diversity of CLMV countries' export focus and markets in global value chains can help narrow development gaps

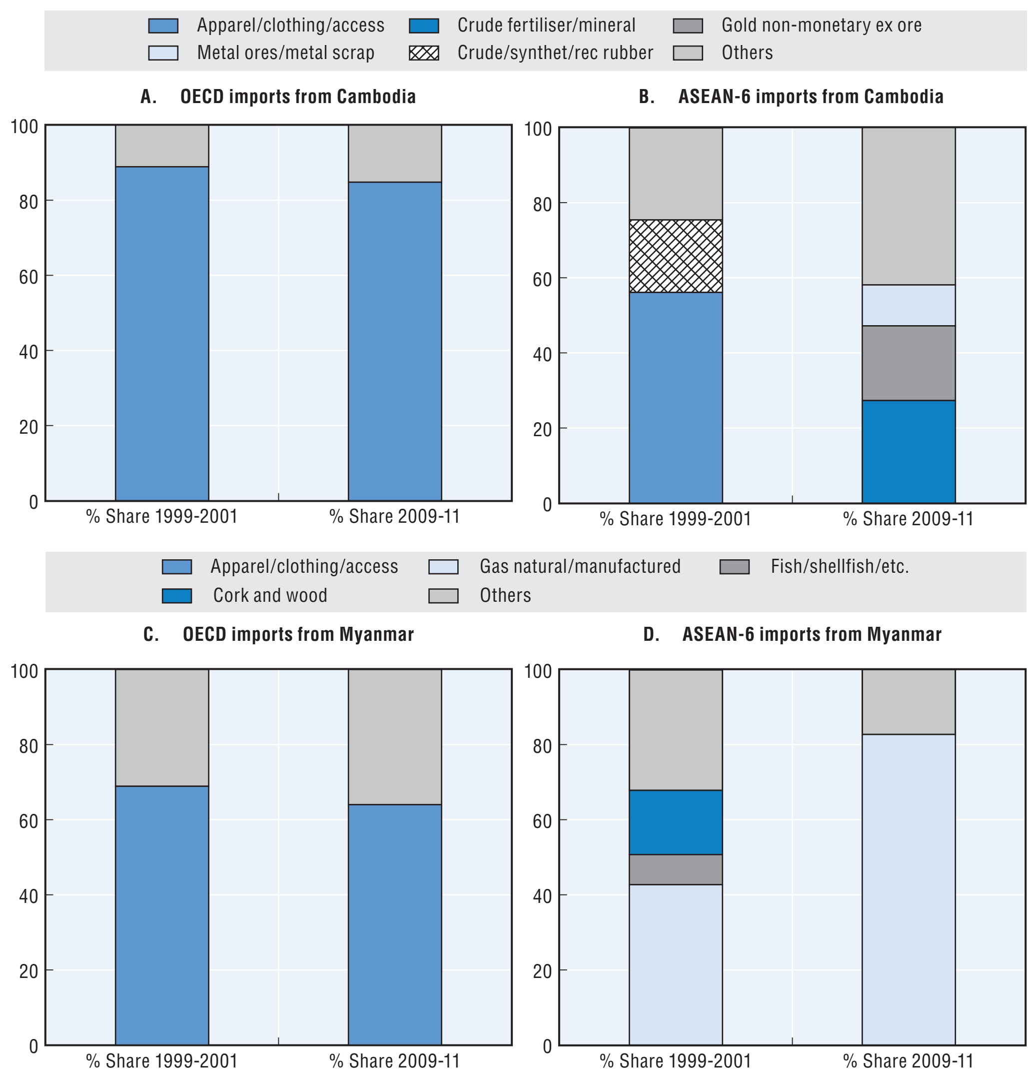
The variety of exports of CLMV countries may be unexpected given the historical dominance of apparel. The apparel sector has been the single most important CLMV manufacturing industry and has a strong export orientation. Historically, the rapid growth of an export-oriented apparel sector has played a critical role in generating more income and providing better jobs, so contributing to industrial development. It has also helped to increase off-farm income-generating activities for women, who typically account for the bulk of the apparel labour force in these countries.

Since transition and integration, the product pattern of specialisation has undergone major transformations in the CLMV countries. It has now become quite distinct from one country to another. Cambodia, for instance, remains highly specialised in apparel exports which accounted for almost three-quarters of its total merchandise exports in 2009-11. On the other hand, specialisation has shifted towards natural resource-based products, particularly hydropower generation in Lao PDR and gas extraction in Myanmar, with both activities assuming prominent places in exports to neighbouring markets. At the same time, exports of food and industrial materials have continued to grow in the regional markets, whereas apparel exports have become less buoyant, and are principally targeted at the OECD-area market where they enjoy preferential tariff treatment (Figure 0.4.)

More recently, the increased importance of ASEAN-6 countries as major trading partners has significantly altered the product patterns of specialisation in the CLMV countries. There are some signs of a new division of labour in East Asian supply chains, with Viet Nam becoming an export production platform not only in traditional labour-intensive products, but also in machinery and equipment. In Viet Nam, both SOEs and foreign-funded firms have played an important role in the country's industrial growth. In contrast, Cambodia finds itself in the special position of being the economy that has specialised most heavily in apparel exports shipped to the OECD market. The growth of Cambodia's apparel sector has been fuelled by export-oriented FDI, as the country's preferential market access and low-cost labour has attracted foreign investors.

Figure 0.4. **Composition of imports from CLMV countries**

(share of total imports, %)



Source: OECD Development Centre's calculations based on UN Comtrade.

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Opening up of CLMV countries has supported growth but further reforms will be needed

The strong trade and FDI growth in the CLMV countries has been a result of their open-economy reforms. The institutional and policy reforms undertaken in trade and investment have improved the business environment and attracted both domestic and foreign investors in export-oriented industries. At the same time, greater openness has revealed further weaknesses in the economy which will necessitate more in-depth reforms at later stages.

For instance, to realise its investment potential, Cambodia needs to take some specific measures. Particularly important is further budget prioritisation in order to address critical infrastructure bottlenecks (such as reliable and affordable access to electricity) and encourage private-sector participation in infrastructure development. Other concrete measures are the implementation of anti-corruption legislation and the new rice-growing development policy to support rural development. Such reform commitments can help eradicate absolute poverty and reduce the relative poverty still prevalent in the country. Lao PDR has recently undergone a major transformation from subsistence to commercial agriculture such as sugar cane and rubber production in Luang Natha Province and maize production in Oudomsay Province. The regulation of cross-border trade continues to be a major challenge to local authorities in Lao PDR – even if the national regulatory environment for trade and investment has seen considerable improvement in recent years.

Reducing inequality within CLMV countries is critical to narrowing development gaps in the region

Although, in recent decades, the CLMV countries have progressively reduced poverty, many of their inhabitants are living with inequality. The interaction of trade, technology and market-oriented reforms is actually one driver of inequality, yet that is no reason to reverse the openness, technological progress, or reform processes now underway.

The response should be to direct infrastructure investment to lagging regions and remove barriers to migration to the fast-growing regions. Three sets of policy measures are recommended to address the constraints and challenges that need to be faced to alleviate rising inequality.

- An efficient fiscal policy should be implemented. Because CLMV economies draw their fiscal revenue from a small base, they should broaden their tax bases and improve their tax administration. CLMV governments should also develop better targeted social protection schemes and conditional cash transfers that would be granted to the poor on condition that they invest in the human capital of their children.
- Each CLMV government should intervene to address the economic development and capacity-building needs of regions that lag behind the rest of the country. Measures should include building transport and communication infrastructure to improve regional connectivity. Access to public services should be improved and barriers to migration from poor to prosperous areas removed.
- Last, the CLMV countries should act to narrow the labour income gap created by technology which, because it favours capital at the expense of labour, is a key driver of rising inequality. Employment policy should incorporate measures to create more productive, better-paid jobs for a much wider section of the population.

Since the CLMV economies are still based chiefly on agricultural output, it is essential to increase productivity in the sector and sustain it at a high growth rate through structural transformation. Governments should implement agricultural policies that increase production per hectare and include provisions that ensure the rural poor enjoy access to irrigation, electricity, transport, new technology and improved seeds, as well as to agricultural extension and financial services – all of which are vital for boosting farm productivity.

Measures taken at regional, subregional and country levels need to be consistent in promoting the ASEAN Economic Community

While many of the reported development gaps have narrowed over time, some – poverty and human resource development, for example – are still relatively wide and require critical attention from national policy makers.

At the regional and subregional levels, ASEAN has busily undertaken numerous initiatives to foster regional co-operation and to share experience in each key policy area. However, greater efforts are needed in the push for greater social and economic integration, particularly in infrastructure and in trade and investment. The slow pace of infrastructure development, for example, may be attributed chiefly to resource constraints and a lack of consensus in implementation. As for regional attempts to attract investment and liberalise trade, progress has been slow because countries continue to prioritise and pursue their own agendas rather than the common goal. ASEAN needs to step up and strengthen monitoring and enforcement mechanisms to ensure that progress stays on track.

At the country level, policy areas such as human resource development and poverty alleviation lag behind. Disparities in these areas are harder to fix and policies tend to be longer term in nature.

In human resource development, the common issues that almost all ASEAN needs to address are low labour productivity; skills mismatches; large informal sectors; and unequal, inequitable access to higher education and its uneven quality. Low labour productivity stems partly from the fact that in some countries, chiefly CLMV, a large proportion of the workforce is still employed in the agricultural sector where productivity is low. As disparities in poverty also remain wide, more vigorous policies are needed to speed up poverty alleviation.

Measures taken at regional, subregional, and country levels are not always consistent with one another. The result is slow progress at the ASEAN level, especially as national strategies and interests take precedence. To harmonise policies and initiatives at all three levels and speed up the narrowing of social and economic gaps, a better understanding of country sensitivities and differences is critical.

PART ONE

Regional economic monitor

CHAPTER ONE

Medium-term economic outlook for Southeast Asia, China and India: Prospects and assessments

Abstract

The resilience of the economies of Southeast Asia as well as China and India to external shocks from Europe and the United States and two major natural disasters has highlighted the strength of their underlying economic fundamentals. Growth should continue to be robust over the medium term, led in Southeast Asia by Indonesia, and with growth in China and India maintaining continued high level growth rates by 2017. Growth will be more dependent on domestic demand and current account surpluses will be considerably smaller in relation to gross domestic product (GDP) than in the years leading up to the Global Financial Crisis.

Southeast Asian countries as well as China and India face important challenges in realising their medium-term growth potential. Capital inflows are likely to continue to be strong and will require careful management and further development of financial markets if their benefits are to be realised and their risks contained. Cambodia, the Lao PDR and Viet Nam will need skilful monetary policy management to deal with their extensive dollarisation and to foster gradual de-dollarisation. Fiscal capacities in all the countries of the region will need to be reformed to improve revenue mobilisation and create more efficient tax systems.

The emergence and rapid growth of the middle class in Southeast Asia, China and India is already having important economic effects. Consumer demand is shifting towards greater importance for automobiles and other consumer durables and housing, as well as education, health and other services where governments play a key role. Prospects for continued rapid growth in the middle classes in the region are favourable but governments face important challenges in ensuring that this growth is supportive of further poverty reduction and other social goals and that the "middle-income trap" that has sometimes afflicted other developing countries is avoided.

Introduction

Growth of Emerging Asia (Southeast Asia plus China and India) as a whole began to slow gradually in 2012, but the region in general has shown resilience to the external shocks from the euro area, slowing growth in the United States, and aftershocks from two regional natural disasters in 2011. Growth of China and India has been slowing but remains high compared to most other emerging economies. Strong domestic demand in most of the Emerging Asian countries has cushioned the effects of weakening external demand on aggregate real growth.

This pattern of greater dependence on domestic demand is facilitating substantial declines in current account surpluses in relation to GDP in Southeast Asia as well as China. Inflation should remain contained to levels consistent with central bank targets and low fiscal deficits are likely to lead to declines in public debt levels relative to GDP.

The shift toward domestic demand is being partly driven by the rising middle class in Emerging Asia. The growth of the middle class is likely to continue to shift domestic demand toward greater emphasis on consumer durables, housing, as well as education and health services. Governments are preparing to reorient their development strategies – toward reducing reliance on export-driven growth, strengthening competitiveness in higher value-added industries, and improving utilisation of their human resources – in order to sustain further development in the middle class in a way that supports other development goals.

Southeast Asian countries as well as China and India will have to successfully deal with several macroeconomic policy challenges if they are to fully realise their medium-term development potential. Capital inflows into the region are likely to continue to be strong and their potential risks need to be managed. Further development of bond markets and their improved regional integration will be key to realising the full benefits of capital inflows. Cambodia, the Lao PDR and Viet Nam face challenges posed by extensive dollarisation of their economies to monetary and exchange rate policies. Emerging Asian countries also need to improve their fiscal capacities by better mobilising revenues through tax reforms and improved collection of existing taxes.

Overview and main findings: The economic outlook for 2013-17

Real growth in Southeast Asia as well as China and India should recover from the slowing during 2011-12 and achieve a robust pace over 2013-17, according to the results of the OECD Development Centre's Medium-term Projection Framework for this Outlook (MPF, see www.oecd.org/dev/asiapacific/mpf and Box 1.4 for more details). Growth of the Southeast Asian region is projected to average 5.5% over 2013-17, the same rate recorded during the pre-crisis period (2000-07). The success of the Southeast Asian economies in sustaining robust growth in the near term attests to their resilience in the face of major external shocks.

The projected growth for ASEAN countries highlights the fact that some are at an earlier stage of development, while others are at a stage where further rapid gains in productivity become more difficult to achieve. Indonesia is projected to lead the ASEAN-6 countries with a growth rate of 6.4% over 2013-17, significantly above its average after the 1997 Asian crisis (5.1% over the 2000-07 period) and equal to that recorded in the two decades prior to that crisis. This favourable outlook for Indonesia reflects the significant improvement in the country's standing with international investors and the ambitious infrastructure investment and economic reforms specified in Indonesia's medium-term development plan. Projected growth in Singapore, Malaysia, the Philippines and Thailand compares favourably to growth for other developing countries at a comparable stage of development, due in part to the comparatively high national savings rates in the Southeast Asian countries.

Growth in the CLMV countries (Cambodia, Lao PDR, Myanmar and Viet Nam) is also projected to be quite rapid over the medium term, ranging from over 6% for Cambodia, and Myanmar, and more than 7% in Lao PDR. Myanmar's growth outlook has improved substantially as a result of the political reforms beginning in 2010, which are expected to lead to a large influx of foreign investment. Growth in Cambodia and Viet Nam is projected to be somewhat slower than before the global financial crisis: in Cambodia's case, this is largely because of slowing demand for its textile exports. High inflation, due partly to the weak macroeconomic management framework, is a major downside risk for Viet Nam.

Table 1.1. **Real GDP growth of Southeast Asia, China and India**
(annual percentage change)

	2011	2017	2000-07	2013-17
ASEAN-6 countries				
Brunei Darussalam	2.2	2.9	-	2.4
Indonesia	6.5	6.6	5.1	6.4
Malaysia	5.1	5.5	5.5	5.1
Philippines	3.9	5.3	4.9	5.5
Singapore	4.9	3.7	6.4	3.1
Thailand	0.1	5.3	5.1	5.1
CLMV countries				
Cambodia	7.1	7.3	9.6	6.9
Lao PDR	8.0	7.6	6.8	7.4
Myanmar	5.5	6.7	-	6.3
Viet Nam	5.9	6.1	7.6	5.6
ASEAN-10 average	**4.6**	**5.8**	**5.5**[a)]	**5.5**
CLMV average	**6.0**	**6.4**	**7.8**[b)]	**5.9**
Emerging Asia average	**7.9**	**7.4**	**8.6**[a)]	**7.4**
China and India				
China	9.3	8.0	10.5	8.3
India	6.9	7.0	7.1	6.4

Note: The cut-off date for data is 1 November 2012. For more detailed information on MPF, see www.oecd.org/dev/asiapacific/mpf. Emerging Asia includes ASEAN 10 countries plus China and India.
a) excludes Brunei and Myanmar; *b)* excludes Myanmar.
Source: OECD Development Centre, MPF-2013.

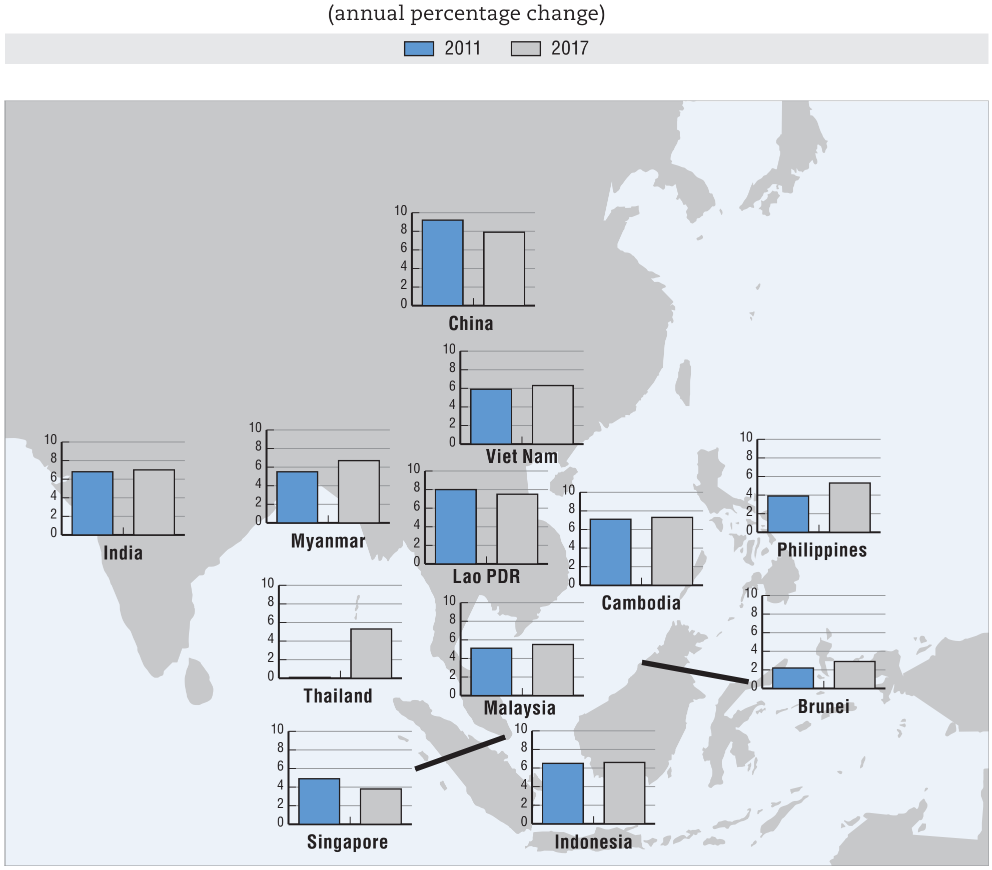
Growth in Emerging Asia as a whole is projected to be 7.4% by 2017, though slower than its pre-crisis rate (8.6% over the 2000-07 period). This moderated growth momentum is largely due to weakening in the two big giants (China and India) in the region. Growth in China is projected to slow somewhat from the nearly 10% recorded over the first three decades of its reform period, though its growth rate will be above 8% over 2013-17. The projected slowdown is attributable to slower growth in demand for China's exports along with lower labour force growth and the waning of productivity gains from shifting labour from agriculture to industry and the incorporation of existing technologies.

The main results of the MPF-2013, discussed in detail in the remainder of this chapter, are as follows:

- Southeast Asian economies show resilience through 2017, maintaining the same level of growth momentum as during the pre-crisis period, although real gross domestic product (GDP) growth in the rest of Emerging Asia, in particular China, will begin to slow gradually.
- The impact of global uncertainty has remained limited overall.
- Domestic demand growth, particularly private consumption and investment, will be the main driver of growth in most cases. Growth will be less reliant on net exports than in the past.
- A growing middle class will certainly affect the level and structure of demand in Emerging Asia.
- Fiscal deficits will fall in most countries, leading to stable or falling public debt-to-GDP ratios. However, countries will also need to strengthen their fiscal capacities through improved mobilisation of revenues.
- Countries will face significant macroeconomic policy challenges from potentially rising capital inflows and, in Cambodia, Lao PDR and Viet Nam, from extensive dollarisation.

Figure 1.1. **GDP growth in Southeast Asia, China and India: Comparison between 2011 and 2017**

(annual percentage change)



Source: OECD Development Centre, MPF-2013.

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Near-term macroeconomic developments and prospects

Real growth in Southeast Asia has been resilient given the severity of the external shocks it has felt from the euro area crisis and two natural disasters in the near term. This resilience owes much to the generally sound underlying financial and macroeconomic conditions Southeast Asian countries have maintained in recent years. However, the region will continue to face external risks in the near term that will require skilful policy management.

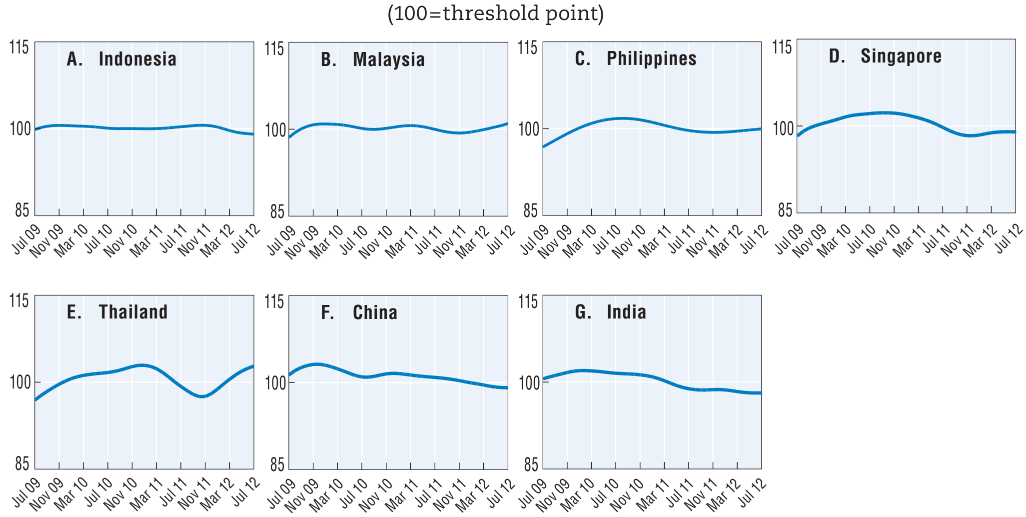
Growth in the region has been facing headwinds from weakening external demand …

External headwinds faced by Southeast Asian economies have intensified during 2012 with the renewed weakness in the United States and the slowing in China. However, economic activity has so far held up in much of the region. Growth in Thailand has rebounded sharply and was positive on a year-on-year basis by the first half of 2012. Growth in the Philippines picked up in the first half of 2012. Indonesia has so far sustained the rapid growth of real GDP of 2011, with real GDP rising by 6.4% at an annual rate in the second quarter. However, the economy contracted modestly in the second quarter in Singapore and slowed further in China, although growth levelled off (on a year-on-year basis) in India.

Recent indicators suggest that growth is likely to moderate in the second half of the year as the weakness in external demand becomes more evident. The OECD Development Centre's Asian Business Cycle Indicators (ABCIs) for most Southeast Asian countries and (particularly) China and India have fallen during 2012 to levels indicating near-term slowing in real growth, although the indicators for Thailand and Malaysia have showed resilience (Figure 1.2) (see Box 1.1).

Figure 1.2. **Business cycle composite leading indicators of Southeast Asia, China and India**

(100=threshold point)



Note: see www.oecd.org/dev/asiapacific/abcis for more detailed information.
Source: Asian Business Cycle Indicators, *This Quarter in Asia vol.9* and OECD Composite Leading Indicators.
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Box 1.1. **Growth slowdowns in China and India**

China and India have been experiencing growth slowdowns. Real GDP growth in China fell to 9.2% in 2011 from 10.4% in 2010 and slipped further to 7.7% (year-on-year) in the third quarter of 2012. Figures on industrial production and fixed investment released in September suggest growth may have slowed further in the third quarter. The slowdown in India has been even more pronounced. Real GDP growth dropped to 6.5% in 2011 from 8.4% the previous year, and fell further to an average of 5.4% in the first half of 2012 – its slowest pace in more than ten years.

Weakening external demand was the main factor behind slowing growth in China and the current account surplus falling to less than 3% of GDP, its lowest ratio since 2003. Domestic demand growth remained comparatively robust, especially consumption, whose contribution to growth increased over the course of 2011. In India, the effect of weaker export growth has been reinforced by weakening investment performance. The weakness in investment is partly attributable to the slump in external demand but also to comparatively tight monetary policy and uncertainties engendered by the large budget deficit and the increased current account deficit, which rose to 3.2% of GDP in 2011.

China has had considerable room to use macroeconomic policies to cushion the slowdown in external demand but India's policy room has been more constrained. With inflation on the decline by the second half of 2011, the People's Bank of China began to ease monetary policy at the end of 2011. With inflationary pressure decreasing, authorities should have some further room to ease if necessary. Fiscal policy was expansionary in 2011 but the budget deficit remains moderate at 1.8% of GDP. Plans announced in September 2012 for additional infrastructure spending of CNY 1 trillion (Chinese yuan renminbi) (USD 158 billion), which will be spread over several years, will help to further support domestic demand. China's macroeconomic policy space has been further reinforced by its strong external payments position and comparatively high confidence of international investors, as reflected in the surge in foreign direct investment (FDI) inflows in 2011 to a record level of USD 114 billion.

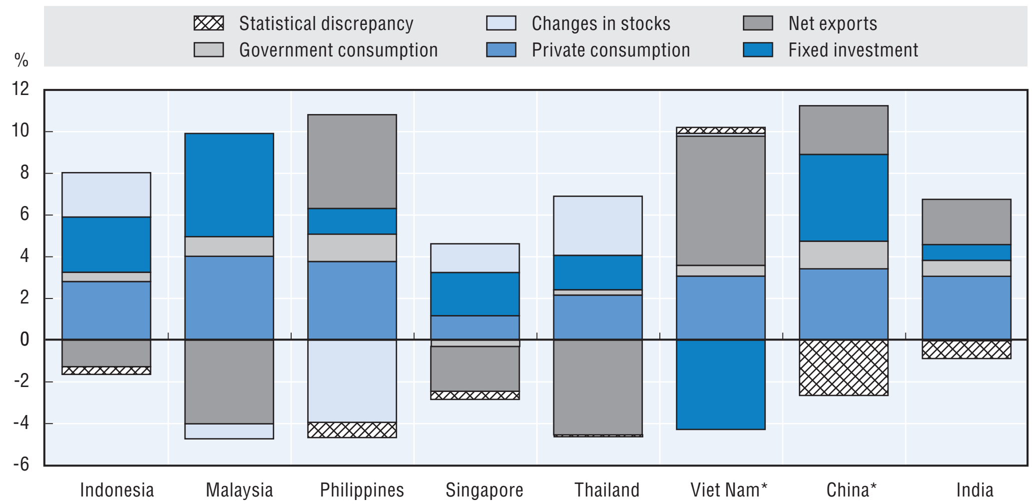
Macroeconomic policies in India have had to focus on reducing high inflation and the large budget deficit. Headline consumer price inflation dropped during the last four months of 2011 but has since rebounded to nearly 10% on a year-on-year basis. After being raised progressively by nearly 350 basis points between April 2010 and October 2011, the central bank policy rate was cut by 50 basis points in April 2012 but there have been no further reductions as yet despite the weakening in growth. The urgent need for fiscal consolidation to bring down the budget deficit, which for the general government as a whole was 8.2% of GDP in the fiscal year of 2011, means that fiscal policy is likely to be at best neutral and more likely contractionary over the medium term. Concerns over the rise in the current account deficit relative to GDP along with worries over India's growth prospects amid uncertainties over the course of its reform agenda have led to downward pressures on the rupee in the foreign exchange markets, further limiting the room for macroeconomic stimulus.

… but the impact has been cushioned by comparatively robust domestic demand

The slowdown in aggregate real growth in Emerging Asia would have been greater were it not for the robustness of domestic demand in much of the region. Private consumption accounted for more than half of the total real growth in 2011 in Malaysia, the Philippines, Viet Nam and India and more than a third of the growth in Indonesia and China. Private consumption has continued to be a key support to demand during the first half of 2012 (Figure 1.3).

Figure 1.3. **Contributions to growth in Southeast Asia, China and India in the first half of 2012**

(percentage of GDP)



Notes: *Data for Viet Nam and China refer to contribution to growth in 2011.

Source: CEIC and national sources.

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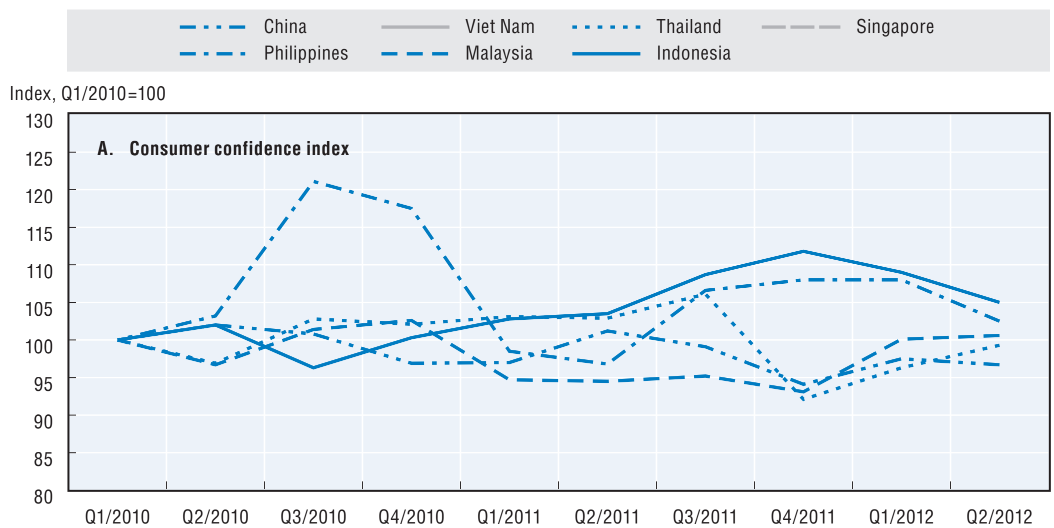
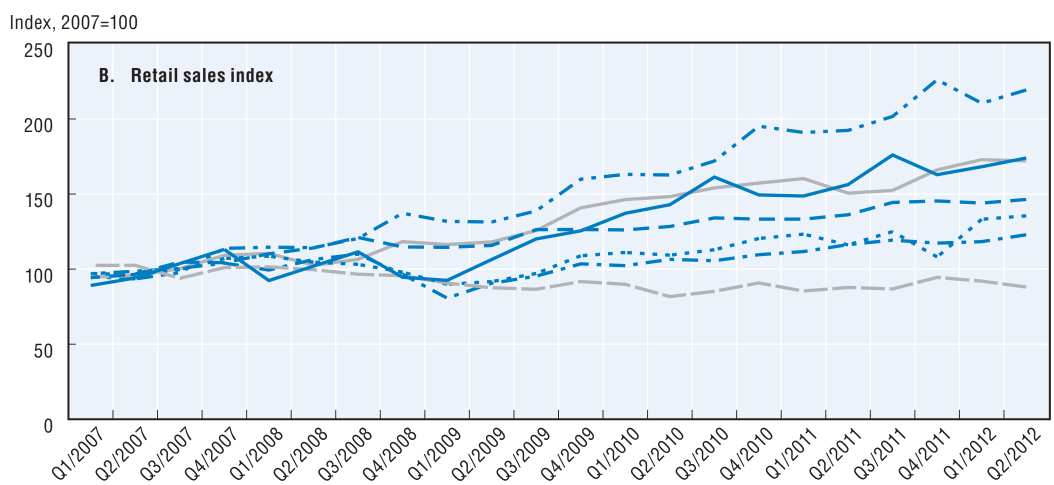
Consumption has been underpinned by strong employment growth and falling inflation and is being increasingly supported by spending of the growing middle class. Retail sales have continued to be strong in most Southeast Asian countries, except for Singapore, and consumer confidence has remained high or risen in most cases (Figure 1.4). Consumption growth is likely to be particularly strong in 2012 in Thailand as households replace consumer durables lost during the flooding. However, declines in consumer sentiment in the second quarter of 2012 in the Philippines and Indonesia may signal a slight softening in consumption growth in the second half of this year. In China, purchases of household durables in certain regions have contracted in the wake of the termination of the government's programme to support purchases of those goods by rural households but the overall impact on consumption growth seems to have been limited. Consumption growth is being supported by cash payments to households and increases in minimum wages in a number of Southeast Asian countries.[1]

Figure 1.4. **Private consumption indicators in Southeast Asia and China**



Notes: Indonesia: Consumer Confidence Index. Malaysia: MIER: Consumer Sentiment Index. Philippines: Consumer Expectations: Next Qtr: Diffusion Index. Thailand: Consumer Confidence Index. China: Consumer Confidence Index.

Source: CEIC.



Notes: Indonesia: Retail Sales Survey (RSS): Retail Sales Index. Malaysia: Retail Sales (2005 prices). Philippines: Net Sales Index (NSI): Value. Singapore: Retail Sales Index (RSI): 2010=100: Constant Price. Thailand: Retail Sales Index: 2002=100. Viet Nam: Retail Sales: Total (2005 prices). China: Retail Sales of Consumer Goods: Total.

Source: CEIC.

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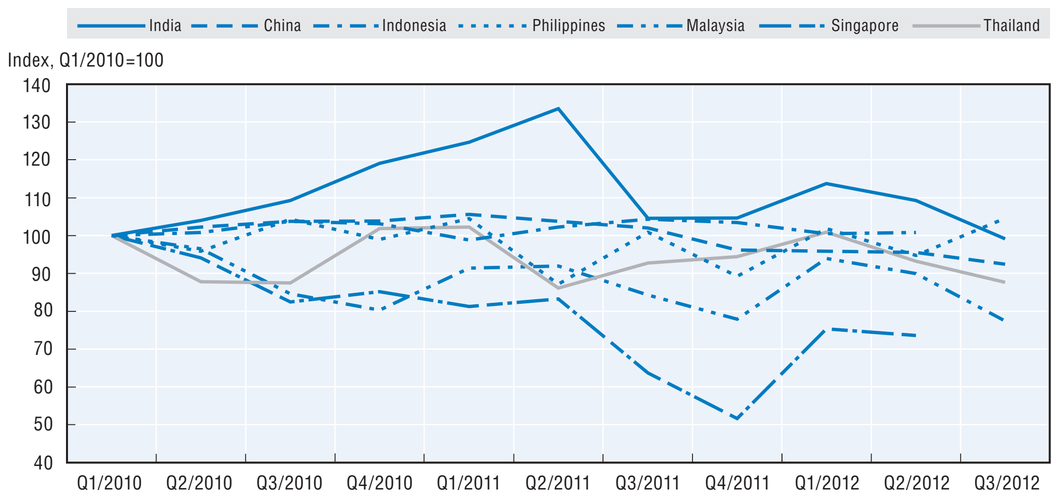
Investment growth in Emerging Asia has also been quite robust on average since the 2007 global crisis, buoyed in some cases by infrastructure investments contained in the fiscal stimulus packages adopted in the wake of that crisis. While public investment spending has slowed as the stimulus has wound down, private investment has remained strong and business sentiment surveys in some cases suggest it may remain strong in the near term despite the weakening of external demand (Figure 1.5). Comparatively low interest rates and sound financial positions of domestic lenders are favouring private investment. Investment prospects in Southeast Asia have been further boosted by the improving foreign perceptions of their financial soundness and competitiveness (Box 1.2). Although industry profits have fallen off in China as aggregate growth has slowed, the impact on investment spending should be at least partly offset by recent steps to ease monetary policy.

Figure 1.5. **Business confidence indices of Southeast Asia, China and India**



Notes:
Indonesia: BS: Business Tendency Index.
Malaysia: MIER: Business Condition Index.
Philippines: Business Outlook: Index: All Industries: Next Quarter.
Singapore: Business Expectation (BE): Next 6M (simple average of Commerce, Manufacturing and Real Estate).
Thailand: Business Expectation Index.
China: Business Climate Index (BCI).
India: Business Expectation Survey: Business Optimism Index (Jun 1999=100).

Source: OECD Development Centre`s calculations based on CEIC.

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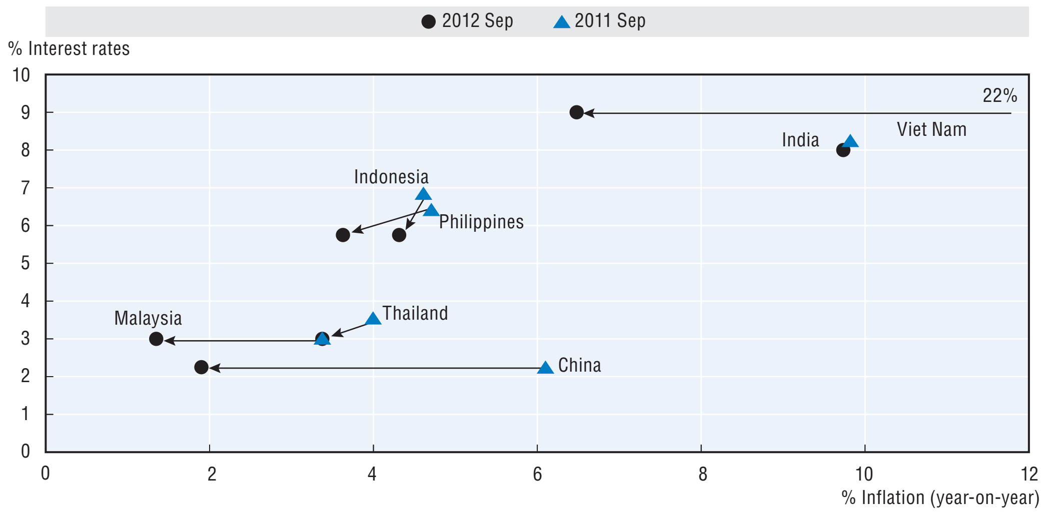
Most Southeast Asian countries have enjoyed room to use monetary policy to support growth relatively well

A number of Emerging Asian countries have responded to the weakening of external demand with monetary policy easing but policy has been essentially unchanged in others. Since the fall of 2011, policy interest rates in Southeast Asia have been cut by a total of 100 basis points in Indonesia, 75 basis points in the Philippines, and 50 basis points in Thailand. The Monetary Authority of Singapore eased mildly in April 2011 by raising slightly the slope of its targeted path for exchange rate appreciation. China began to ease in December 2011 with a lowering of the commercial bank reserve requirement ratio by 50 basis points, followed by another 50 basis point cut in February 2012. These were followed by cuts in the central bank's one year lending and deposits rates in June and July of 2012, bringing them to 6% and 3% respectively.

However, policy rates have remained constant for nearly two years in Lao PDR and were raised by 25 basis points in Malaysia in April, 2011 (Figure 1.6). Facing high inflation, the Reserve Bank of India has held its policy rate at 8% since April 2012, which remains the highest of the largest Emerging Asia economies.

Figure 1.6. **Evolution of inflation and policy interest rates in Southeast Asia, China and India**



Notes: The figure above illustrates inflation on the horizontal axis and policy interest rates on the vertical axis. For each country, the figure plots inflation and interest rates in September 2011 and September 2012.
As a consequence, a movement to the right in the figure means rising inflationary pressures, while a movement upwards corresponds to tightening monetary policy in the same period.
Indonesia: Policy Rate: Month End: 1 Month Bank Indonesia Certificates Auction.
Malaysia: Policy Rate: Month End: Overnight Policy Rate.
Philippines: Policy Rate: Month End: Repurchase Rate.
Thailand: Policy Rate: Month End.
Viet Nam: Policy Rate: Month End: Prime Lending Rate.
China: Policy Rate: Month End: Rediscount Rate.
India: Policy Rate: Month End: Repo Rate.

Source: CEIC, Datastream and national sources.

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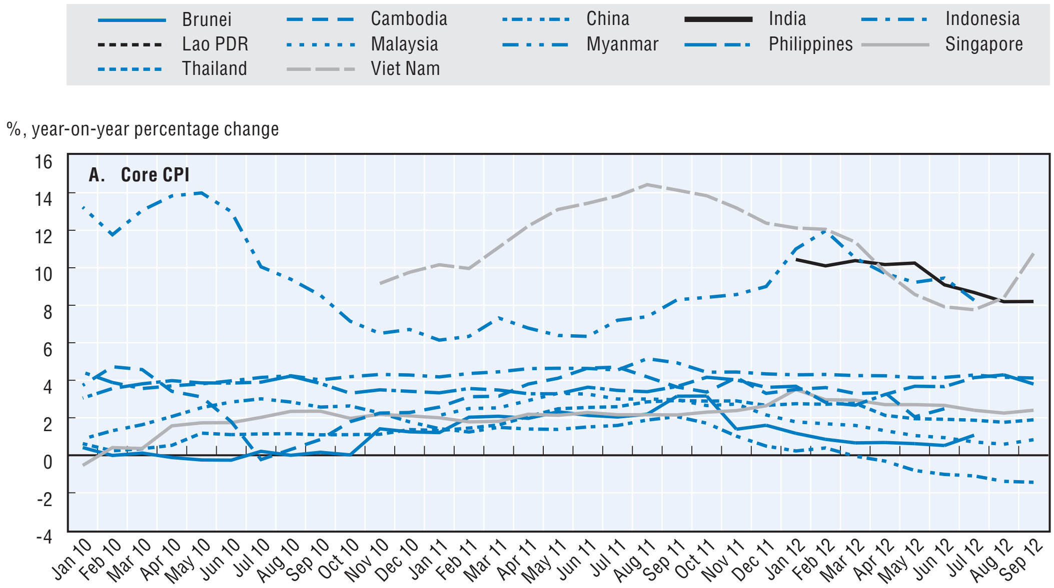
The different monetary policy responses largely reflect the easing of inflation pressures to acceptable levels in the first group of countries versus continuing concerns over inflation in the others. After accelerating in 2010 under the pressure of surging international commodity prices, headline inflation rates eased in 2011 and, except for Indonesia have either remained roughly constant or fallen further over the first half of 2012 (Figure 1.7). Inflation rates (at least core inflation rates) are now broadly in line with central bank targets in Malaysia, the Philippines and Indonesia but inflation is higher than desired in Singapore and Viet Nam.

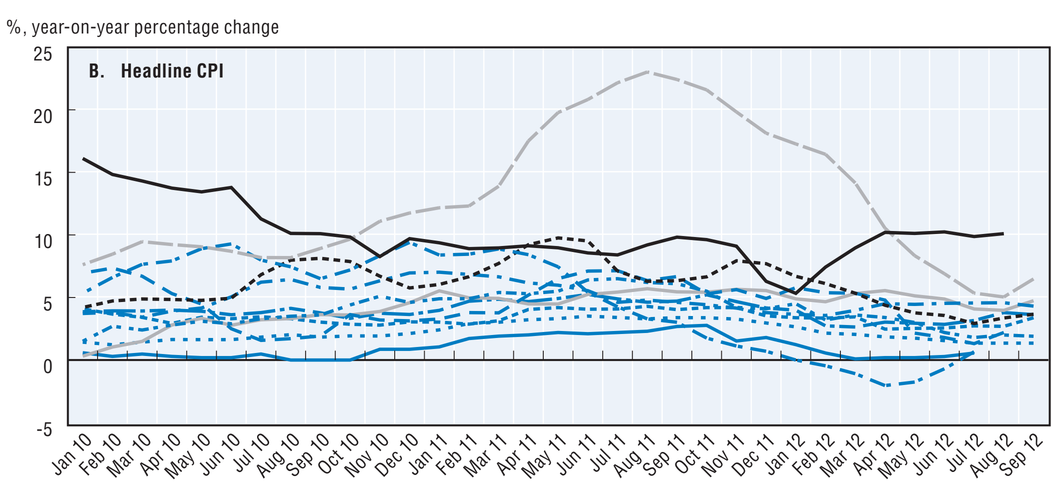
Fiscal policies in most ASEAN countries were mildly contractionary or neutral in 2011 as countries continued to wind down their fiscal stimulus programmes. As discussed in more detail later, fiscal balances are in deficit in most Southeast Asian countries. Deficits in Cambodia and the Philippines have fallen relative to GDP over the past two years, while the deficits in Malaysia remain relatively high.

Figure 1.7. **Consumer price inflation of Southeast Asia, China and India**



Notes: For Brunei core inflation refers to weighted average of Non-Food and Non-Housing, -Water, -Electricity, -Gas & -Other Fuels and Non-Transport consumer prices.
For Cambodia core inflation refers to weighted average of Non-Food and Non-Housing & -Utilities and Non-Transportation consumer prices.
For Malaysia core inflation refers to weighted average of Non-Food and Non-Housing, -Water, -Electricity, -Gas & -Other Fuels consumer prices.
For Myanmar core inflation refers to simple average of Non-Food and Non-Fuel & -Light consumer prices.
For Singapore the core inflation measure of the Monetary Authority of Singapore (MAS) monitors excludes the components of "Accommodation" and "Private Road Transport".
For Viet Nam core inflation refers to weighted average of Non-Foods & -Foodstuffs and Non-Transportation consumer prices.
For India core inflation refers to weighted average of Non-Food, -Beverages & -Tobacco and Non-Fuel & -Light consumer prices.
For China the index of core inflation refers to same period of previous year=100 and it is the simple average of non-food consumer prices.

Sources: CEIC and Datastream.



Note: For Cambodia data refer to inflation as registered in Phnom Penh.

Sources: CEIC and Datastream.

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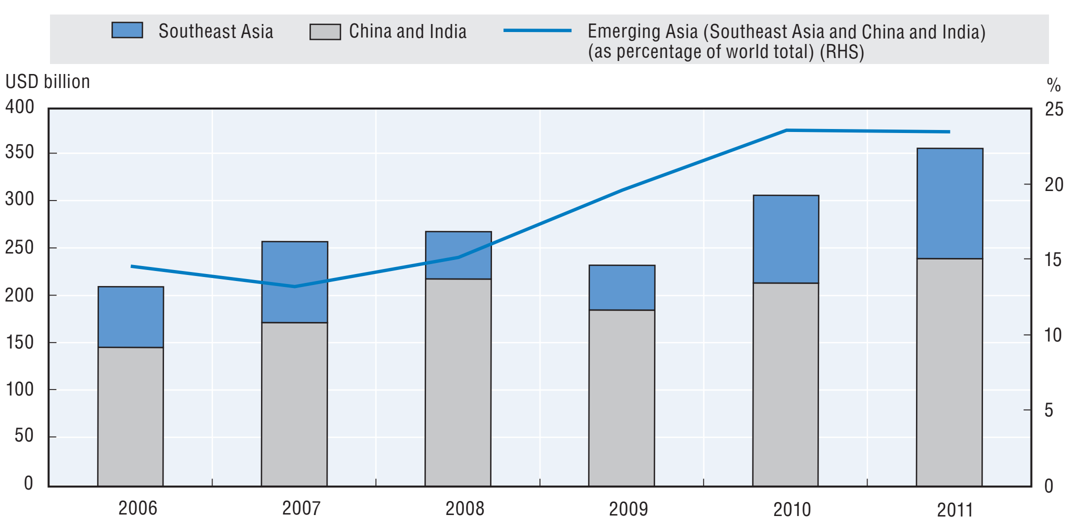
There is some room for further macroeconomic policy stimulus in Southeast Asia to support real growth but it is limited. Indonesia, Lao PDR, the Philippines and Thailand have adopted expansionary budgets for 2013, with considerable increases in infrastructure spending. However, budget consolidation is slated to continue in Cambodia and Viet Nam. Indonesia, Malaysia and Thailand should have some scope for moderate easing of monetary policy should real growth falter in the mid-term, but there may be less room for easing in the Philippines given the rise in core inflation during the second quarter of 2012. Continued inflation concerns give Singapore and Viet Nam even less room for monetary policy manoeuvres in the near term. Monetary policy is likely to remain comparatively tight for some time in Viet Nam and India, where the past surge in inflation has yet to be fully reversed.

The recovery in FDI inflows into much of Emerging Asia continued in 2011. Total FDI inflows into the region amounted to USD 357 billion in 2011 (Figure 1.8). The region accounted for 23.5% of total global FDI flows, up from about 14% just before the global financial crisis. FDI inflows reached new records in both subregions.[2] FDI inflows into the five countries of ASEAN (Indonesia, Malaysia, the Philippines, Singapore and Thailand) in 2011 were as high as or higher than before the global crisis except in the Philippines (see Box 1.2.). FDI into Indonesia in 2011 was the highest recorded in more than two decades, an indication of the marked improvement in its reputation with international investors and businesses in recent years. FDI inflows into the CLMB (Cambodia, Lao PDR, Myanmar and Brunei) countries were rising briskly before the global financial crisis but fell back in the wake of that crisis. FDI inflows into China also surged in 2011, to a record high of USD 219 billion, and recovered to USD 34.2 billion in India, after falling over the previous two years. Most of the FDI inflows into Emerging Asia come from the United States, Europe, and more advanced Asian countries, although a growing portion are coming from China and from Southeast Asian countries.

Figure 1.8. **FDI inflows in Southeast Asia, China and India**



Notes:
China includes Mainland, Chinese Taipei, Macao and Hong Kong.
Southeast Asia does not include Timor-Leste.

Source: UNCTAD World Investment Report 2012.

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Box 1.2. **Southeast Asia's improving international economic standing**

Despite its continued vulnerability to external shocks, the reputation of Southeast Asian countries with international investors and businesses has improved noticeably since the 2007 global crisis.

The improvement has been particularly striking for Indonesia and the Philippines. Indonesia's sovereign debt rating was raised to investment grade status (BBB-) by Fitch in December 2011 followed by Moody's in January 2012 (to Baa3). The Philippines sovereign debt rating was raised to BB+ by Standard and Poor's in July 2012, its highest rating since 2003 and just one step below investment grade. Thailand, Malaysia and Singapore have maintained their investment grade ratings although Viet Nam's debt is still rated below investment grade.

International perceptions of ASEAN's competitiveness have also improved. The majority of countries have moved up in the rankings on the overall global competitiveness index published by the World Economic Forum (World Economic Forum, 2011). The improvement has been greatest for Cambodia, Indonesia and the Philippines although they still lag behind Malaysia, Thailand and Singapore. Indonesia, Thailand and Viet Nam now rank in the top 15 countries in attractiveness for FDI location according to the United Nations Survey for 2011 (UNCTAD, 2010).

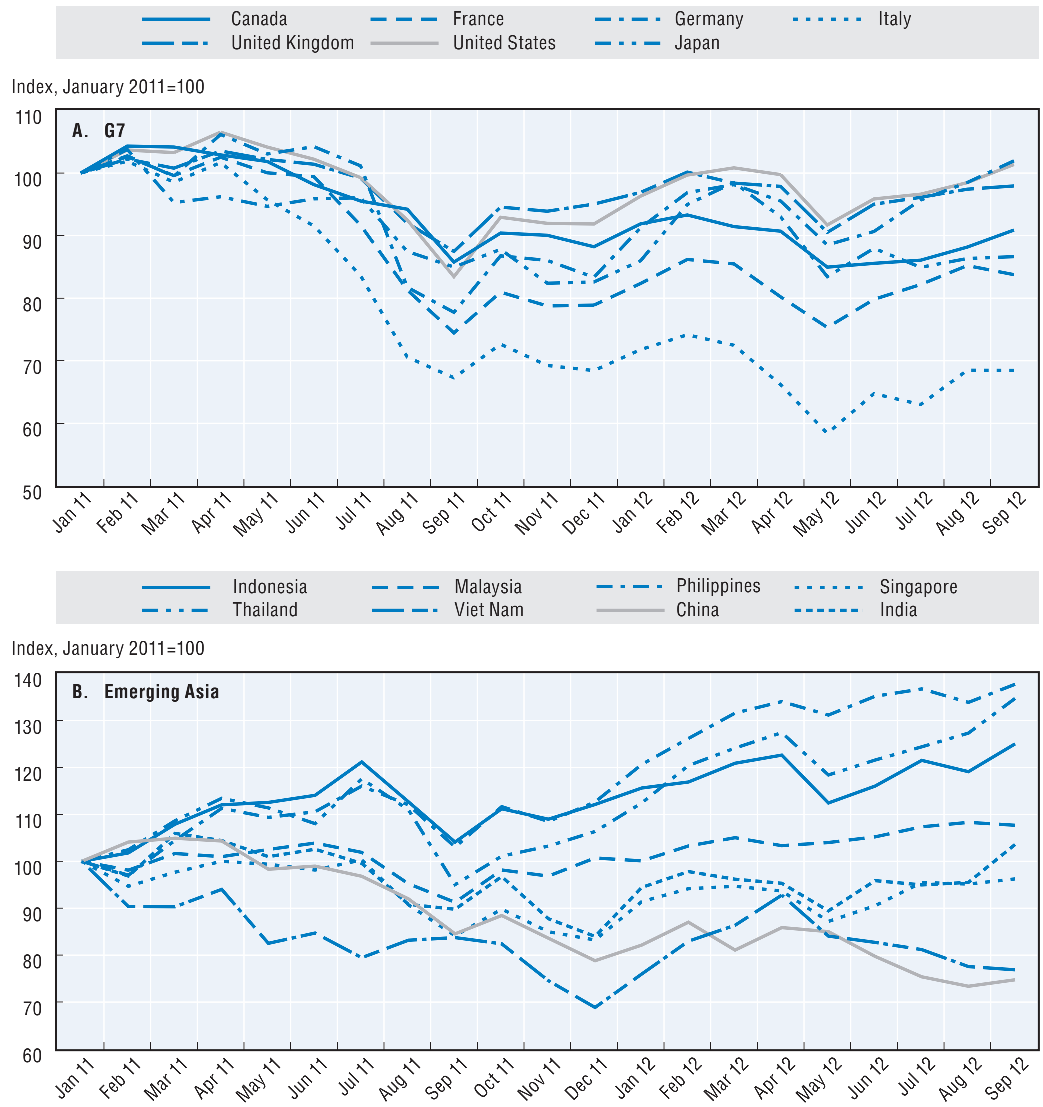
The impact of global uncertainty, in particular from the euro area, has become apparent but remains limited overall

Since the global financial crisis and the onset of the European sovereign debt crisis, there has been a sharp increase in market concerns regarding fiscal sustainability in major economies in the world. At present in the euro area, Greece faces threats of a sovereign default while larger economies such as Spain and Italy continue to face difficulties in accessing market financing. The US economy still has not fully recovered from the recession; its housing and labour markets remain weak, and fiscal uncertainties remain at the forefront, especially concerning the situation after the Presidential elections in November.

Emerging Asian financial markets have been buffered from these uncertainties but the effects seem to have been muted by the region's strong domestic fundamentals.

Stock prices generally fell as euro area anxieties rose during the summer of 2011, but, with the exception of China and Viet Nam, have since recovered to near or above their levels at the beginning of 2011 (Figure 1.9). Stocks in most ASEAN countries have outperformed those of China and, to a lesser extent, India, since the beginning of 2011. Sovereign bond spreads and credit default swap rates have also widened with global economic and financial uncertainties but the fluctuations have been much less, and the level of the spreads lower, than those recorded in 2008 (Figure 1.10).

Figure 1.9. **Stock indices in the G7 and Emerging Asia**



Source: CEIC.

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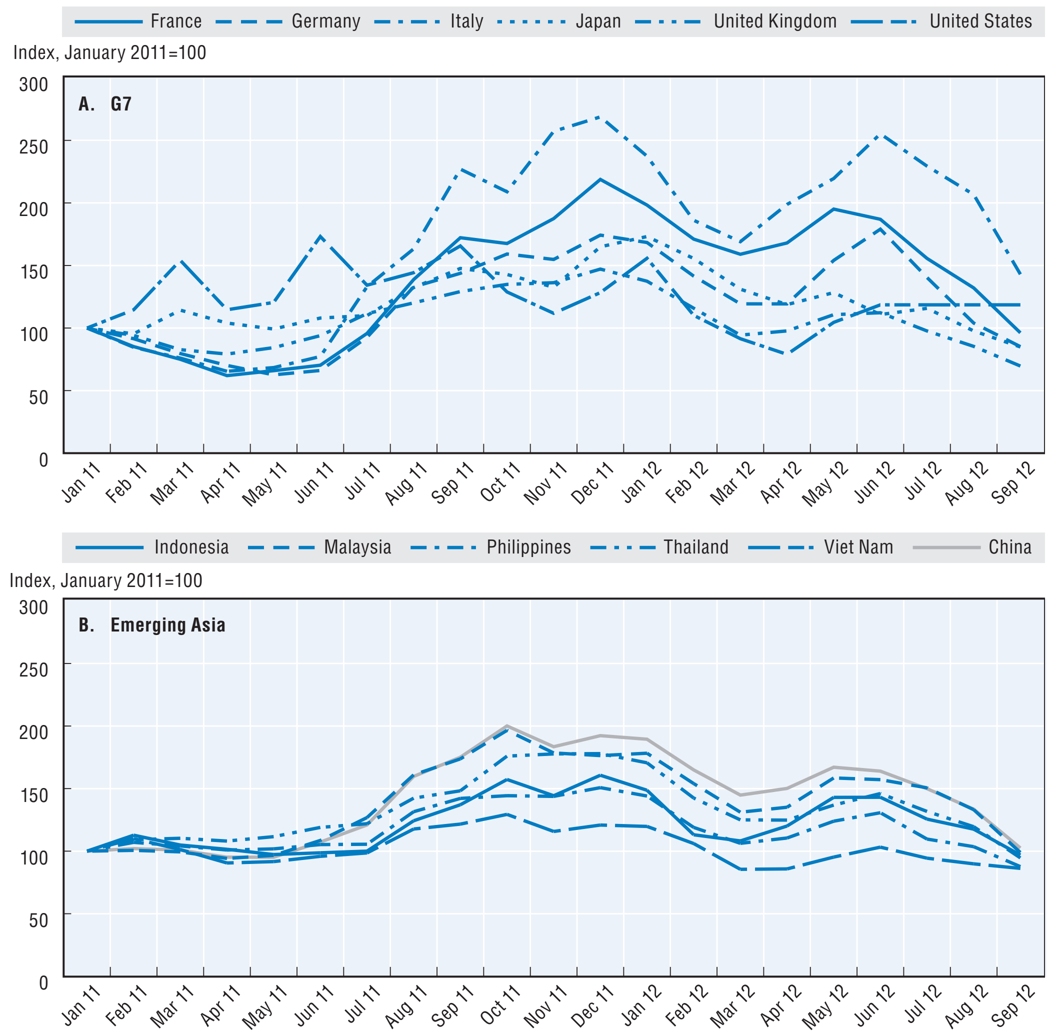
Figure 1.10. **Credit default swap premiums in the G7 and Emerging Asia**



Source: Datastream.

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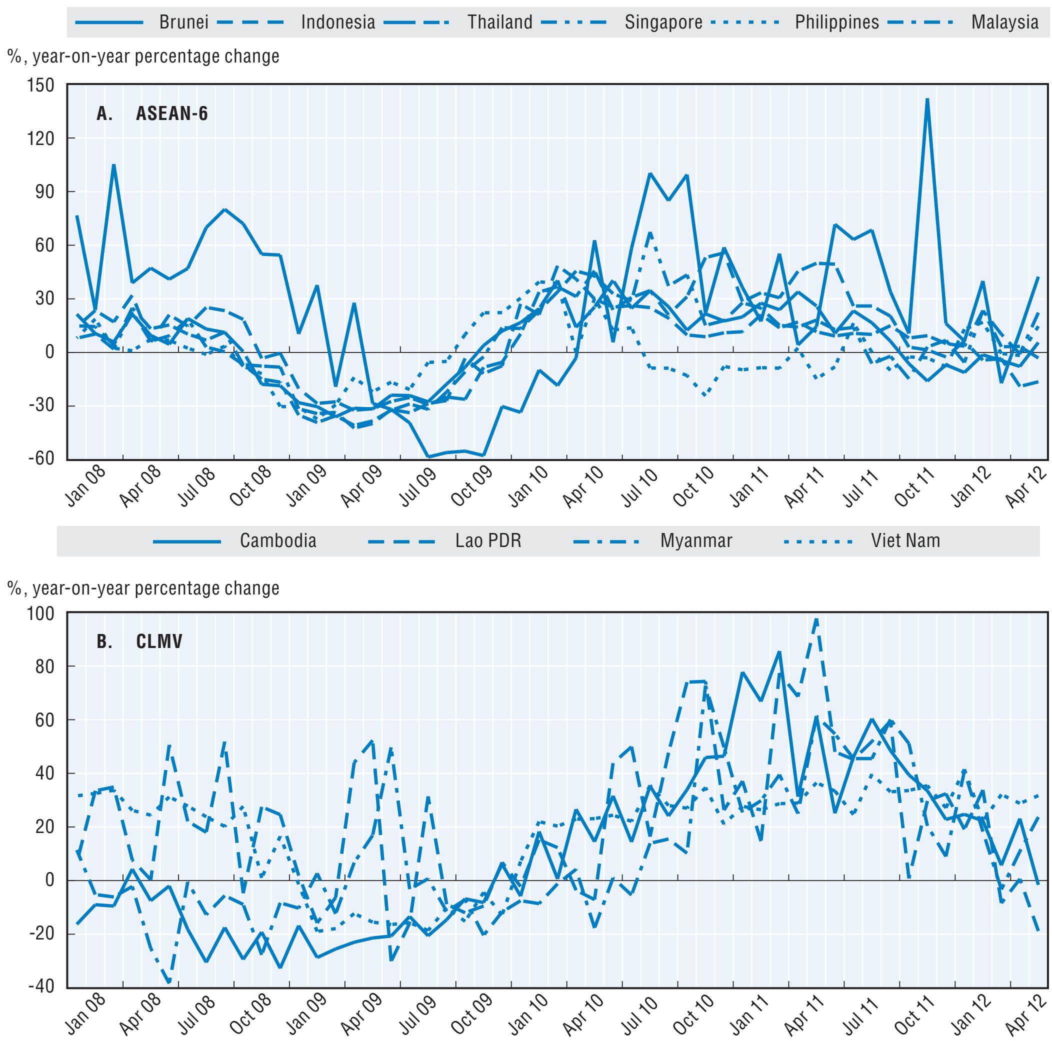
The main channel of impact has been through trade…

The impact on Southeast Asia from the slowdowns in OECD countries has been limited thus far, coming mainly through the trade channel. Slowdowns in the advanced economies have real effects on the demand for ASEAN's exports. The US, the euro area and Japan (G3) remain the key export markets for Southeast Asian countries, and a slowdown in these countries has ripple effects on Asia, with subsequent spillover effects on private investment and consumption spending. In 2009, exports to these three economies declined across all ASEAN member countries, with the largest declines coming from the relatively more open economies of Brunei (28.1%), Malaysia (27.6%) and Singapore (26.7%). In recent months, exports to the G3 have been rather volatile, with a clearer downward trend coming from the CLMV countries compared to the ASEAN-6 group of countries (Figure 1.11).

Figure 1.11. **ASEAN exports to the G3 economies**



Note: G3 economies include the United States, euro area and Japan.
Source: CEIC.

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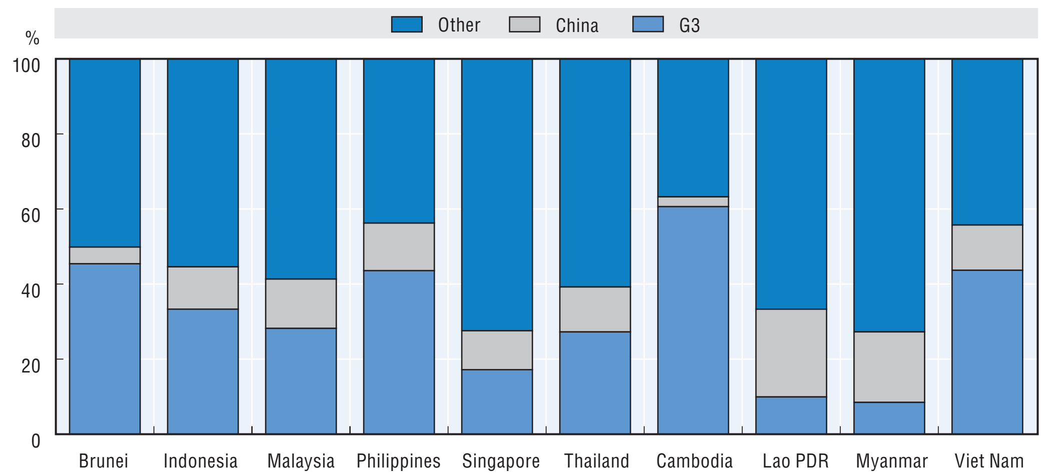
However, the degree to which the Southeast Asian region is affected may differ by country, depending on how reliant the country is on the G3 and the type of goods exported. In 2011, the G3 economies accounted for 27% of Southeast Asia's total direct exports to the world, with Cambodia having the largest share at 61% (Figure 1.12). The main products exported to the G3 are manufacturing products in almost all the Southeast Asian countries with the exception of Brunei, which exports predominantly resource-based products such as crude oil and natural gas. There are also variations in the type of manufactured products exported, with Cambodia and Viet Nam exporting mostly textile and food products and Singapore exporting mainly machinery and equipment parts. In 2009, agricultural products and resource-based products experienced the greatest decline in exports to the G3 economies from Southeast Asia, although this was compensated by higher demand for such products from China. Should current global uncertainties escalate, these products could be similarly affected.

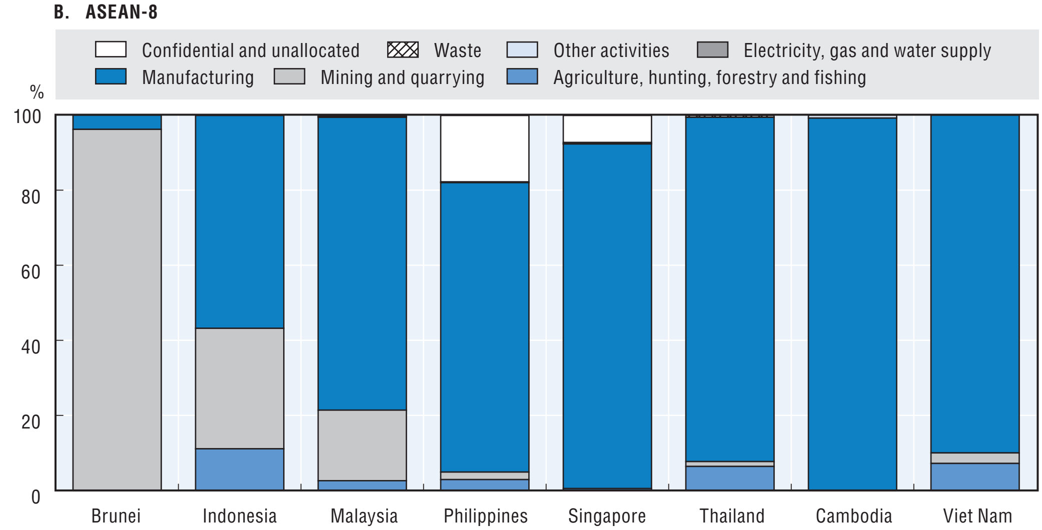
Figure 1.12. **Export structure of ASEAN to G3 economies, 2011**

A. ASEAN-10



Note: G3 economies include the United States, euro area and Japan.
Source: CEIC.

B. ASEAN-8



Notes: Brunei (2006); Cambodia and Viet Nam (2010); Indonesia, Malaysia, Philippines, Singapore and Thailand (2011). Excludes Lao PDR and Myanmar.
Source: OECD Statistics.

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A more complete assessment of trade exposure has to include indirect exports to the G3 economies, that is exports of intermediate goods that are processed in East Asian countries and subsequently exported to one of the G3. Using statistics from OECD, the indirect channel is estimated to be non-negligible for Southeast Asian countries but smaller than the direct impact (Table 1.2). Furthermore, the indirect export exposure to the G3 economies through China is larger than the indirect channels through the United States, Japan and the euro area, and has been growing over the years, indicating that Southeast Asian countries are becoming more dependent on China as a key trading partner.

Table 1.2. **Southeast Asian countries' direct and indirect trade exposure to G3**
(percentage of exports)

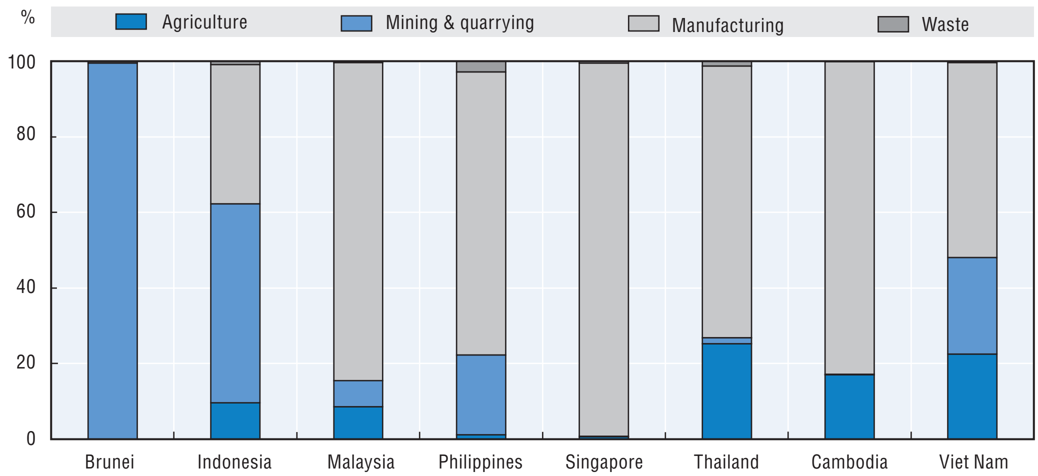
Source country	Export market	Direct export exposure	Indirect export exposure to euro area	Indirect export exposure to US	Indirect export exposure to Japan
Indonesia	Euro area	8.7		0.3	0.1
	US	8.1	0.7		0.2
	Japan	16.6	1.8	3.3	
	China	11.3	2.9	3.6	1.6
Malaysia	Euro area	8.4		0.2	0
	US	8.3	1.0		0.3
	Japan	11.5	1.3	2.3	
	China	13.1	5.0	6.1	2.8
Philippines	Euro area	10.5		0.2	0
	US	14.8	1.6		0.5
	Japan	18.5	1.4	2.6	
	China	12.7	5.5	6.7	3.0
Singapore	Euro area	7.3		0.2	0
	US	5.5	0.5		0.2
	Japan	4.5	0.1	0.2	
	China	10.4	1.0	1.3	0.6
Thailand	Euro area	7.3		0.1	0
	US	9.6	0.6		0.2
	Japan	10.5	0.7	1.2	
	China	12.0	2.3	2.8	1.3
Cambodia	Euro area	12.1		0	0
	US	34.1	0.1		0
	Japan	1.6	0	0	
	China	1.2	0.3	0.3	0.1
Viet Nam	Euro area	12.1		0.3	0.1
	US	19.7	0.6		0.2
	Japan	10.7	0.8	1.5	
	China	10.7	1.6	1.9	0.8

Note: The cut-off date for data is 15 October 2012. 2011 data for Indonesia, Malaysia, Philippines, Singapore and Thailand. 2010 data for Cambodia and Viet Nam.
Source: OECD Development Centre's estimates.

The composition of intermediate goods exports from Southeast Asian countries to China is dominated by manufacturing goods, ranging from food products to more sophisticated transport equipment parts. The large share of manufacturing products in machinery and equipment, and chemicals, especially from the ASEAN-6 economies, belies the importance of China in assembly and production in global supply chains (Figure 1.13).

Figure 1.13. **Breakdown of Southeast Asia's intermediate exports to China, 2011 or latest year available**

ASEAN-8



Within manufacturing:

%-share	IDN	MYS	PHL	SGP	THA	KHM	VNM
Food products	13.2	18.8	3.6	0.4	2.8	0.0	7.0
Textiles	0.9	0.4	0.6	0.2	1.6	4.4	8.3
Wood products	1.9	0.6	0.8	0.0	4.5	75.6	6.5
Paper products	4.6	0.2	0.4	0.4	4.0	0.0	0.2
Chemicals	12.9	18.4	6.7	43.3	39.7	1.2	15.6
Other non-metallic mineral products	0.1	0.4	0.3	0.1	0.4	0.0	1.9
Metal products	1.8	3.0	12.0	4.2	1.0	0.0	3.6
Machinery & equipment	1.2	41.8	47.8	48.0	16.9	1.5	7.6
Transport equipment	0.3	0.4	2.5	2.4	1.1	0.0	0.9
Others	0.1	0.1	0.4	0.0	0.0	0.1	0.2
Total	**36.9**	**84.2**	**75.0**	**98.9**	**71.9**	**82.9**	**51.6**

Notes: Brunei (2006); Indonesia, Cambodia and Viet Nam (2010); Malaysia, Philippines, Singapore and Thailand (2011). Excludes Lao PDR and Myanmar.

Source: OECD Statistics.

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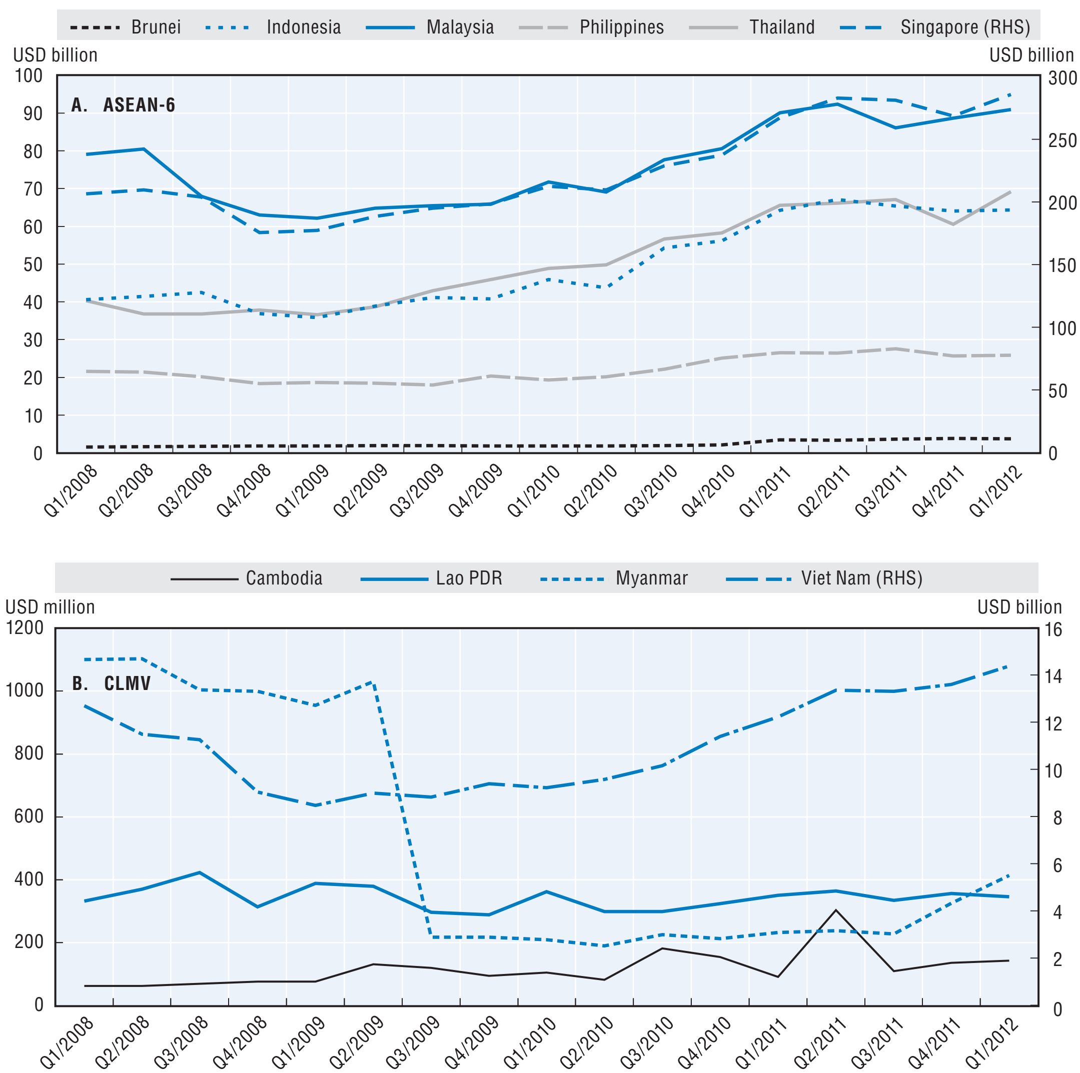
…although credit to ASEAN exporters continues to remain healthy for the moment

Another channel of impact of the external shocks from Europe and the United States is through the credit channel. Particularly in the euro area, the tight linkages in the European banking system suggest that both German and French banks have high exposure to banks in the distressed European countries such as Portugal, Ireland, Italy, Greece and Spain. The increase in risk aversion has tightened credit conditions in the euro area, which has led to a contraction in the supply of credit. A contraction in European bank lending could significantly affect trade financing for Southeast Asian exporters. The drying up of credit may also heighten the risk of loan defaults among companies, especially small and medium sized enterprises (SMEs), which have fewer resources to weather downturns.

Foreign claims statistics from the Bank of International Settlements (BIS) show that there has been some deleveraging from European, US and Japanese banks in ASEAN countries towards the end of 2011, although foreign claims have picked up slightly again in the first quarter of 2012 (Figure 1.14). Meanwhile, Asian banks have replaced G3 banks in providing credit and have thus strengthened their market presence in Asia. Current sentiments suggest that the overall supply of credit to SMEs remains healthy although banks are now more cautious in their lending strategies and are monitoring existing borrowers and their portfolio performances. While there has been a reported increase in the number of loan defaults, overall loan portfolios are still healthy. There are concerns among banks that if global uncertainties persist and the slowdown in economic activities continues, the number of non-performing loans may increase beyond the healthy range.

Figure 1.14. **Foreign claims of reporting G3 banks on Southeast Asia**



Source: BIS.

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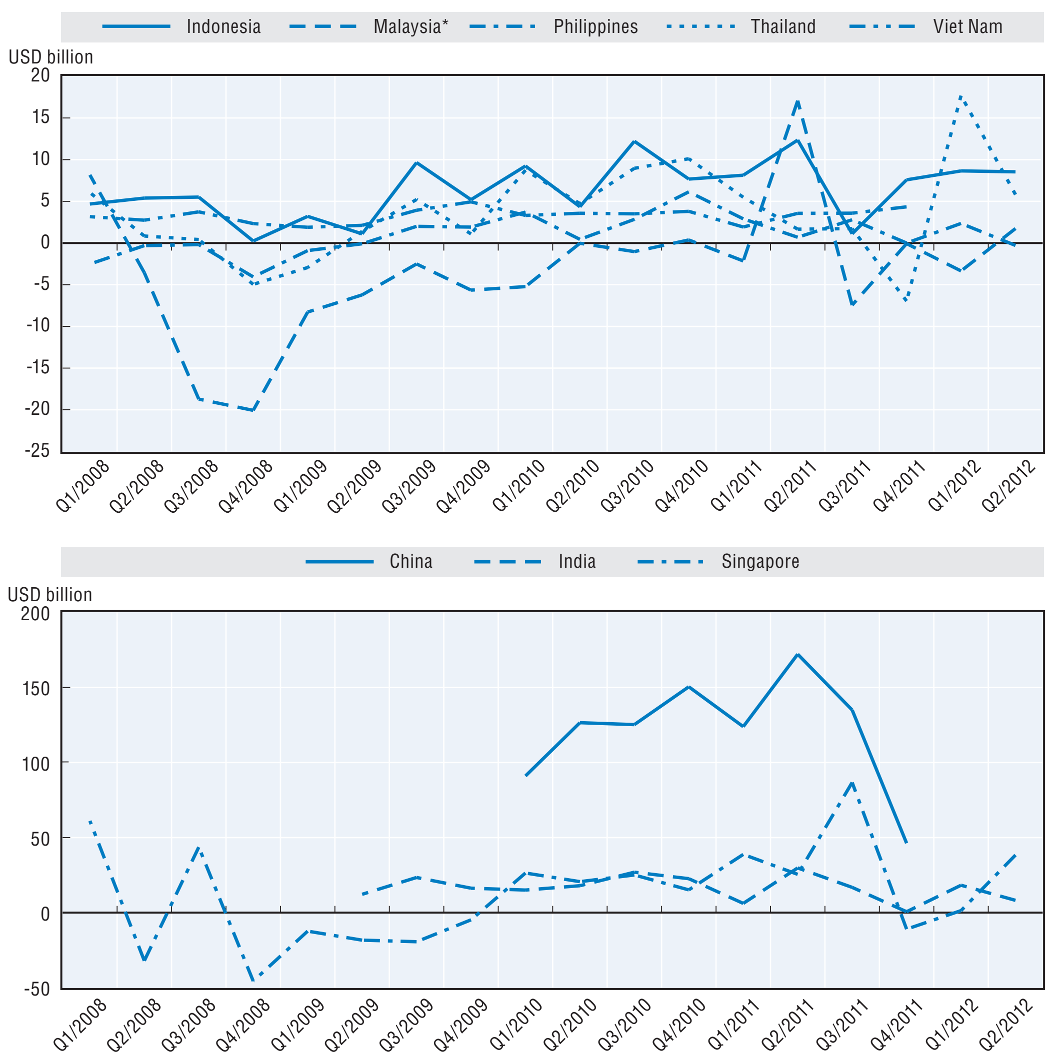
Despite increased volatility in the financial markets, Southeast Asia continues to remain an attractive destination for investment

As discussed earlier, the impact of recent ongoing global uncertainties on the financial channel has been modest, with market investors reacting through short-term indicators. Capital inflows into Southeast Asian economies have also remained manageable. Although there has been increased volatility in capital flows in the last quarter of 2011 and the first quarter of 2012, capital inflows have generally increased in the second quarter of 2012 with the exception of Thailand, which saw a decline (Figure 1.15). Singapore, in particular, has seen an increase of 50% (year-on-year) mainly due to other investment flows and by virtue of its financial hub status in the region. Nevertheless, the volatility in capital flows can be mainly attributed to portfolio and other investment flows. Foreign direct investments, which are investments into productive uses, have been rather stable over the past year, indicating that foreign investors still view the region as an attractive destination for investment (Figure 1.16).

Figure 1.15. **Capital inflows to Southeast Asia, China and India**



Note: *Net capital flows for Malaysia.

Source: CEIC.

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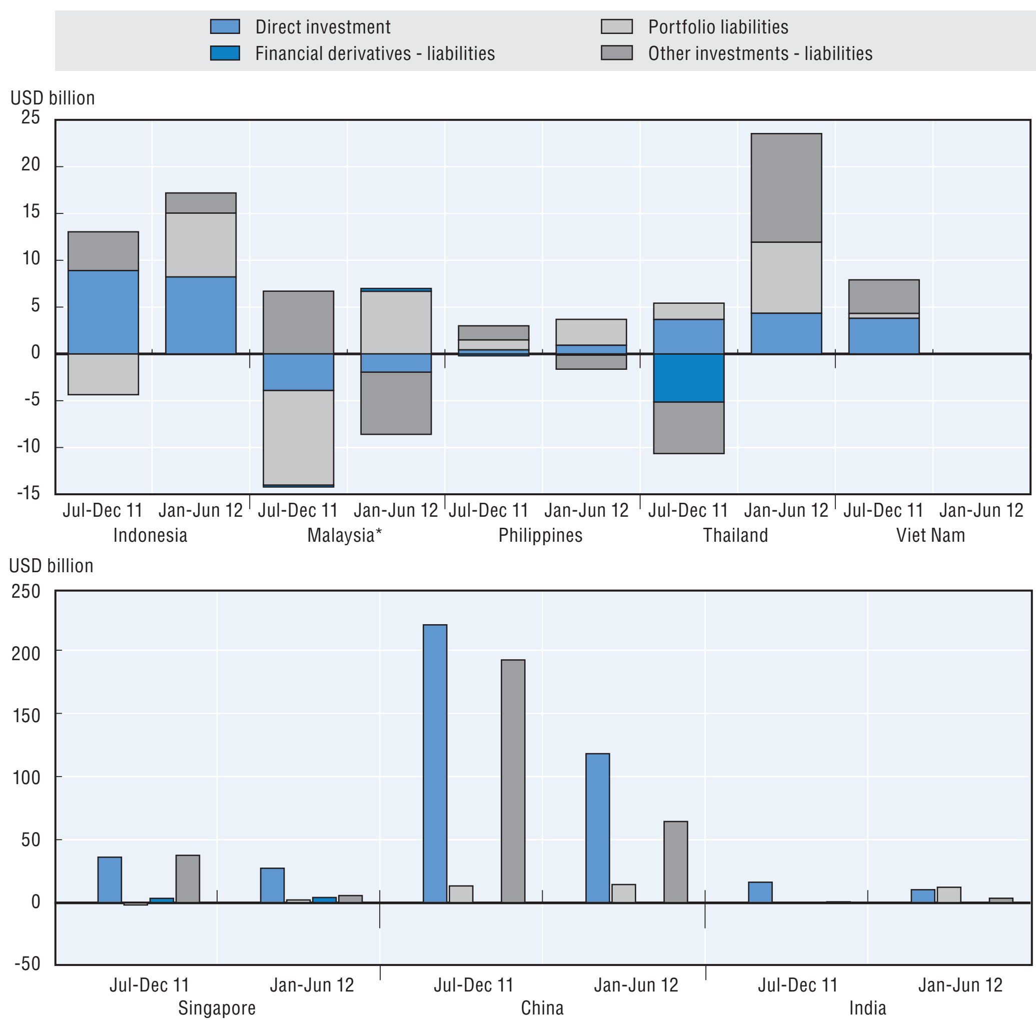
Total portfolio inflows into the ASEAN 5 (Indonesia, Malaysia, the Philippines, Singapore and Thailand) were down by nearly 42% for 2011 as a whole compared to 2010, with Singapore, Malaysia and Indonesia recording sharp declines, although net inflows rose slightly in the Philippines and Thailand. Portfolio net inflows rebounded in the first quarter of 2012 as euro area fears eased but fell back again in the second quarter when those fears re-emerged. Despite the weakening of portfolio inflows, overall balance of payments positions in the region have remained positive, leading to further accumulation of international reserves.

Figure 1.16. **Breakdown of capital inflows to Southeast Asia, China and India**



Note: *Net capital flows for Malaysia.

Source: CEIC.

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However, it is not clear which direction capital flows will take in Asia with the recent round of uncoordinated monetary easing by major central banks in the United States, the euro area and Japan. Based on the experience in the aftermath of the Lehman collapse in late 2008, a flight to the USD could occur in the event of an escalation of global uncertainties, leading to severe shortages of USD globally and prompting capital restrictions and the opening of US Fed lines of credit in several Southeast Asian countries. On the other hand, given Asia's relative resilience and fiscal strengths, capital inflows could increase from abroad from investors looking for a safe haven and higher yields. This could also prompt governments to take steps to keep easy money from flowing in and driving up their currencies or fueling speculative activities. Therefore, regardless of capital inflows or outflows, challenges remain for Southeast Asian governments in employing the required tools to manage capital flows without destabilising the domestic economy.

Box 1.3. **Myanmar comes in from the cold**

With the release of opposition leader Aung San Suu Kyi in November 2010, the establishment of a civilian dominated government in April 2011 and parliamentary elections in April 2012, Myanmar has moved to end its long political and economic isolation and has embarked on an ambitious economic reform programme to restart its economic development. The European Union and the United States have provisionally lifted most of their economic sanctions in the country, paving the way for their businesses to invest in Myanmar. Myanmar is resuming participation in major international bodies. ASEAN countries have tentatively approved the ascension of Myanmar to chair the Association in 2014, after preventing it from taking that seat in the normal rotation in past years.

The economic challenges facing the country are daunting. With per capita GDP of slightly more than USD 1 500 in purchasing power parity, Myanmar is one of the poorest countries in developing Asia and ranked 149th out of 187 countries in the 2010 United Nations Survey of Human Development. The legacy of years of state direction has left an economy dominated by inefficient state-owned enterprises while the private sector's development has been stunted. Domestic markets have been severely hampered by price controls and other rigidities and the domestic financial system is very underdeveloped. Myanmar's trade and financial relations with abroad have been distorted by protectionist measures, including a multiple exchange rate system that effectively subsidised state businesses with rates well below that which would prevail in a free exchange market. Macroeconomic management has been severely impaired by the limited development of the financial sector, with government budget deficits having to be monetised. The result has been high and volatile inflation.

The government of Myanmar has been working with international organisations on a comprehensive and ambitious economic reform plan to launch the country's economic development. Key initial measures now being developed include the following.

- A unified currency exchange rate to replace the old multiple rate has been in effect since April 2012. The rate is determined within a reference range set by the central bank based on bids received from the major banks ("managed float"). Foreign exchange controls have somewhat been relaxed as part of the currency reform.
- A draft Foreign Investment Law was first unveiled in March 2012. The draft law, which is critical to providing the legal foundation for foreign investment in the country, defines the terms on which foreign companies can invest in the country and acquire or form joint ventures with domestic firms. The draft law also provides for a five-year tax holiday and other concessions to attract foreign firms. The initial draft allowed in principle for 100% foreign ownership of domestic firms. However a subsequent revised draft, now being debated by the country's parliament, would restrict the permitted foreign ownership share in certain "strategic" sectors and limit, or even prohibit, investment in certain sectors now dominated by locally owned small and medium sized enterprises, such as agriculture and livestock, retail trade and certain services.

Box 1.3. (contd.)

- Once fully established these steps should facilitate substantial inflows of foreign investment as well as begin a longer process of reinvigorating the economy's development. That reinvigoration will require extensive infrastructure development, far-reaching reforms to state-owned enterprises that allow the private sector to eventually dominate the economy, financial reforms to create market-based institutions and markets that allocate credit efficiently, establishment of an effective monetary policy framework with strengthened monetary policy instruments, and numerous and deep structural reforms to raise productivity in the agricultural sector and unleash private sector development.

These ongoing global uncertainties continue to pose a major downside risk for the Southeast Asian economies, as their potential escalation may have significant spillovers into global financial markets, and impact the real economy through trade and credit channels.

Medium-term prospects: Greater reliance on domestic demand for growth

The results of the MPF-2013 (Box 1.4) indicate that while growth will continue to be robust over the medium term, it will be driven more by domestic demand and less by (net) exports than was the case prior to the global financial crisis (Figure 1.1). The shift in the composition of growth will be accompanied by a substantial decline in the current account surpluses in relation to GDP of the Southeast Asia region, while China's surplus will remain noticeably lower relative to GDP than in the years prior to the global financial crisis. Inflation is projected to remain moderate, or fall to moderate levels in the Lao PDR, Viet Nam and India. Government budget deficits are likely to be moderate on average in relation to GDP, and declining in some cases, leading to stable or falling public debt ratios to GDP.

Private consumption will be the dominant driver of growth in the medium term

Private consumption is likely to be especially robust over the medium term and the main contributor to overall growth in most of Emerging Asia. Consumption growth is projected to be most rapid in China (9.0% over 2013-17) and well above its average prior to the global financial crisis. Consumption growth in India is also projected to be relatively robust, averaging 6.2% over 2013-17 by MPF-2013.

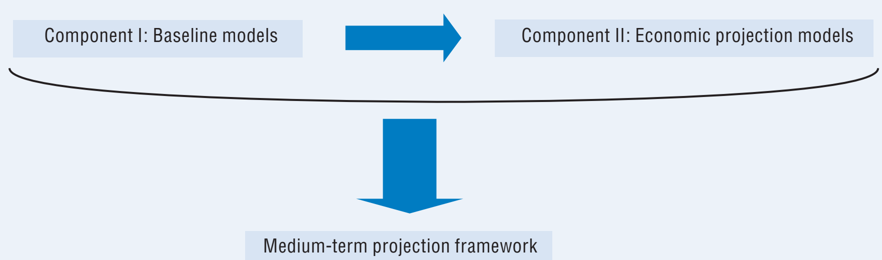
In Southeast Asia, the robust private consumption growth recorded over 2011-12 is projected to continue and in many ASEAN countries and China it will be higher than in the years 2000-07. Overall, private consumption is projected to account for more than half of total aggregate real growth over the medium term and nearly two-thirds in some cases.

Box 1.4. **Key features of the Medium-Term Projection Framework 2013**

The Medium-Term Projection Framework (MPF) is an analytical tool used to develop the medium-term projections for key macroeconomic variables for Southeast Asian countries as well as China and India.

It was developed in 2010 for six countries (Indonesia, Malaysia, the Philippines, Singapore, Thailand and Viet Nam) for the first edition of Southeast Asian Economic Outlook and coverage has been expanded to other Emerging Asian countries for this edition. MPF-2013 covers all Emerging Asian countries (ASEAN 10 countries plus China and India). The Technical model setting of the Medium-Term Projection Framework is evolving with every volume.

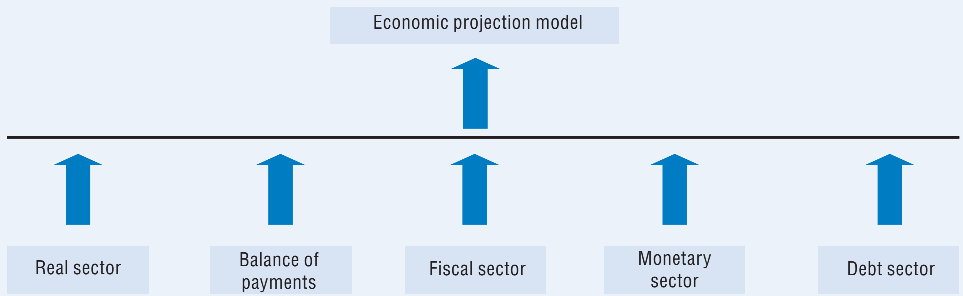
The MPF consists of two components: *i*) a **baseline ('supply side') model** that determines potential output; and *ii*) an **economic projection model** determining the path of actual GDP, its major expenditure components, along with inflation, fiscal balances, the current account balance and related key macroeconomic indicators. The path of actual GDP is determined so that its gap with potential output (as specified by the baseline model) at the beginning of the medium-term horizon is closed by the end of that projection horizon (i.e. by 2017 for this volume).



The baseline models are based on the dynamic stochastic general equilibrium (DSGE) method – a new Keynesian framework that consists of a dynamic Investment-Savings (IS) relation that determines the response of actual GDP to exogenous changes in demand, the near-term relation between inflation and the output gap ('Phillips Curve') and monetary policy responses to changes in GDP and inflation ('Taylor Rule'). Equilibrium dynamics are driven by three exogenous shocks: total factor productivity (TFP), demand and monetary shocks. Due to the availability and quality of data, filtering approaches are used for Brunei, Cambodia, Lao PDR and Myanmar in baseline model instead of DSGE approach.

The economic projection models are medium-term demand driven economic forecasting models that comprise a set of equations describing the five main sectors of the economy: the real sector, the monetary sector, the fiscal sector, the balance of payments sector and debt sector. The medium-term paths of the key demand variables in the real sector are based on error correction models. For Brunei, Cambodia, Lao PDR and Myanmar, simpler versions of the projection models are used due to the availability and quality of data.

Box 1.4. (contd.)



The projections from the MPF-2013 are based on the latest information available on government fiscal policies, development plans and other relevant policies as well as assumptions about growth outside the region (oil and other commodity prices), and other external conditions. Thus the projections discussed in the text should be regarded as "best guesses" about the broad trends in economic conditions likely to result from planned economic policies as they were known at the time the projections were finalised. Changes in government policies or in external conditions from those assumed for the projections would produce different projected outcomes. The cut-off date of data for MPF-2013 is 1 November 2012.

For further technical details about the methodology of the Medium-Term Projection Framework, please see www.oecd.org/dev/asiapacific/mpf.

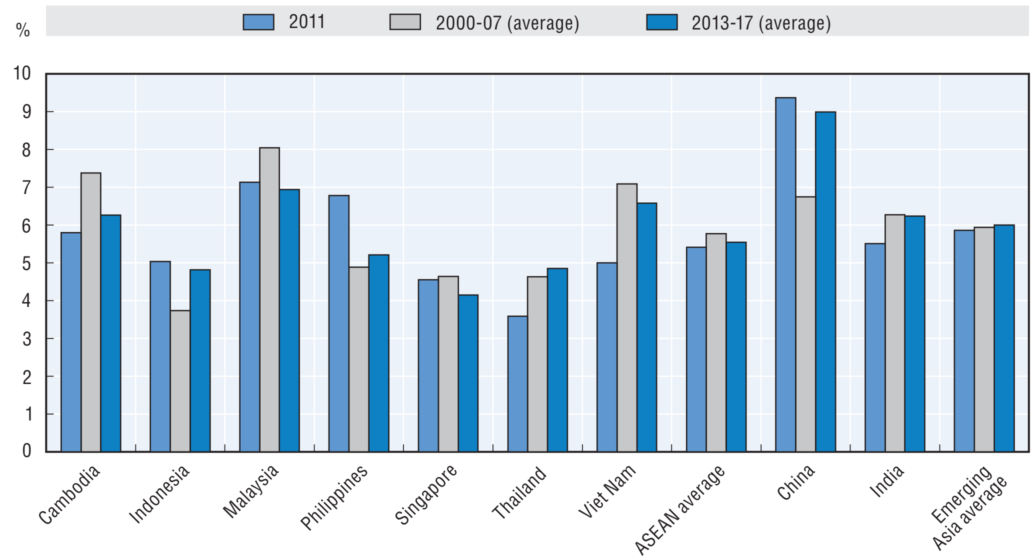
Source: OECD Development Centre.

A combination of cyclical factors, government policies and longer term shifts in economic structure that have supported consumption growth over the past several years are likely to continue to underpin its growth over the medium term. The employment growth and falling unemployment during the recovery from the global financial crisis have helped to boost consumer confidence and the ability of households to spend. Wage growth, further reductions in unemployment and movement of workers now in the informal sector into higher paying jobs in the formal sector as labour markets tighten further should continue to support robust consumption over the medium term.

Government policies are becoming increasingly supportive of private consumption. Partly to offset the effects of rising commodity prices beginning in late 2010, a number of Southeast Asian governments have instituted or increased income support to poorer segments of the population. In Indonesia, the conditional cash payments to poor households instituted in 2009 are gradually being extended to encompass all eligible (2.9 million households) recipients by 2013. Cash payments and/or subsidies to poorer households have also been increased in the Philippines and Malaysia, and the government of Singapore has increased its "in-work" income supplement for low wage workers as well as support for those who are unable to work. Consumption will be further supported in Malaysia and Thailand by increases in wages of public workers and in statutory minimum wage rates for the private sector beginning in 2013.

Furthermore, increasing government spending on health and social safety-net programmes in much of ASEAN will continue to encourage consumption spending by freeing up household resources and by reducing their need for precautionary savings (OECD, 2011a)

Figure 1.17. **Private consumption of Southeast Asia, China and India**
(percentage change)



Note: ASEAN average includes Cambodia, Indonesia, Malaysia, Philippines, Singapore, Thailand, Viet Nam. Emerging Asia average includes seven countries of ASEAN, China and India.
Source: OECD Development Centre, MPF-2013.
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At the end of 2008, China launched a government-funded project called "home appliances going to the countryside" which aimed to expand sales of household electrical appliances in rural areas at prices 13% lower than those in cities. According to statistics from the Ministry of Commerce of China, in 2011, the sales of household electrical appliances across the country amounted to 92.48 million units, creating direct consumption of more than CNY 342 billion (USD 54.4 billion). These incentive policies have provided dramatic strength for numerous enterprises to get through difficulties. However, the market contracted sharply in some regions after the expiration of this policy at the end of 2011.

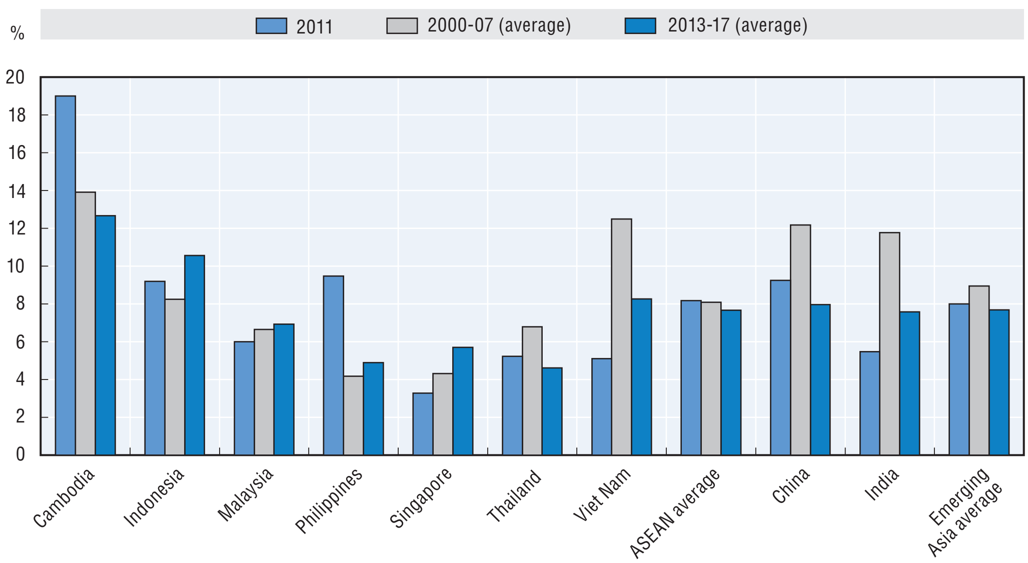
Macroeconomic policies have also helped to support consumption by cushioning the effects of shocks to real growth and by maintaining, in most cases, low and fairly stable inflation rates. Surges in inflation in Viet Nam in 2008 and again in 2010 depressed consumption growth by eroding household purchasing power but the projected reduction in inflation over 2013-17 should help to sustain consumption spending at a robust and more stable pace.

Strong consumption growth is also being favoured by the structural economic changes brought about by the rising middle classes in ASEAN, China and India that are discussed later. Movement of households from poverty to middle-income levels has boosted spending on household durables and automobiles as well as education and health services. The need for precautionary savings to insure against destitution from economic setbacks diminishes as household incomes rise into the middle-class ranges. Growth of the middle class has also fostered the development of consumer credit facilities, which in turn give households greater scope for spending. Rapid growth of consumer credit has been an important factor supporting consumption growth particularly in higher income Southeast Asian countries, notably Malaysia.

The environment for private investment has improved

Despite the unwinding of public infrastructure spending in the stimulus packages of a number of countries, growth in investment is projected to continue to be strong in the Emerging Asian region. Investment growth is projected to be robust for many Southeast Asian countries, according to the MPF-2013.

Figure 1.18. **Gross fixed capital formation of Southeast Asia, China and India**
(percentage change)



Note: ASEAN average includes Cambodia, Indonesia, Malaysia, Philippines, Singapore, Thailand, Viet Nam. Emerging Asia average includes seven countries of ASEAN, China and India.
Source: OECD Development Centre, MPF-2013.
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In many ASEAN countries, investment growth should be as or more rapid over the next five years than over the five years leading up to the global financial crisis. However investment growth in China, where overall growth has been exceptionally dependent on capital formation for much of the reform period, is projected to be noticeably slower over the next five years as policies and other factors favouring greater reliance on consumption take hold. Investment growth in India is also projected to be slower over 2013-17 than during 2000-07, owing in part to constraints on the government's budget and uncertainties over prospects for further reforms. Government infrastructure spending is slated to be an important contributor to overall investment growth in a number of Southeast Asian countries. Indonesia's Master Plan for the Acceleration and Expansion of Economic Development (MP3EI—see Chapter 2, Structural Policy Country Note on Indonesia) calls for outlays totalling IDR 368.6 trillion (Indonesian rupiah) (about USD 50 billion) through 2020 for 110 projects in the six main economic "corridors" targeted for development. In Malaysia, the government's Economic Transformation Programme (ETP) to develop higher value added industries and infrastructure in partnership with the private sector mandates spending of USD 58 billion through 2020, including a USD 11.9 billion project to develop the mass transit system of the capital region. Government outlays to support investment to upgrade infrastructure in the Philippines through public-private partnerships are slated to total PHP 740 billion (Philippine peso) (USD 17.2 billion) through 2016, about one-third of which is to be spent in 2012. Extensive infrastructure spending is planned in Thailand, Lao PDR and Cambodia to repair damage from the recent flooding and to improve flood control and other infrastructure needed to reduce damage from future floods.

Private investment will be key to sustaining robust growth in overall investment. The environment for private investment in ASEAN has improved in important respects in recent years as some of the factors that were depressing investment before the global crisis have eased. Low inflation and improving fiscal positions in most ASEAN countries and China have helped to limit macroeconomic volatility that tends to depress private investment. Recovery from the global financial crisis and the strong financial conditions of domestic banks have revived domestic credit expansion and helped to ease lending terms. Improvements in infrastructure from the spending in the recent fiscal stimulus packages and that planned over the medium term will help to address the often serious bottlenecks and other limitations that have been a serious impediment to private investment before the crisis. Evidence suggests that infrastructure investment, particularly in transport and communications infrastructure, has a strong positive impact on private investment.

The ASEAN region's strong macroeconomic and financial conditions are an important comparative advantage in attracting FDI. As discussed below, this comparative advantage should help to sustain strong FDI inflows into the region that will be an important contributor to domestic investment. Inflows from OECD countries should pick up once the euro crisis eases and growth in the United States recovers. ASEAN countries are also likely to benefit from the growing outflows of FDI from China and from intra-regional FDI flows.

Within Southeast Asia, Malaysia and Indonesia appear well positioned for strong FDI inflows over the medium term, given the recent strength in those inflows and their relatively favourable or improved (in the case of Indonesia) competitiveness and credit ratings. China is also likely to continue to be a strong attractor of FDI inflows, and a larger portion of those inflows is likely to go into domestically oriented sectors. Inflows into the CLMV countries as well as Brunei are likely to be boosted by the growing amount of FDI outflows from China and the more advanced economies in ASEAN, and in Myanmar by the lifting of sanctions. There is also upside potential for FDI inflows into the Philippines and India, whose performance has tended to lag behind that of the rest of Emerging Asia, if planned improvements in infrastructure investment and reforms to improve the regulatory and business environment are successfully undertaken.

Current account surpluses of larger Southeast Asian countries will narrow

The large current account surpluses of Southeast Asia and China, which have fuelled disputes over trade and exchange rate policies, are projected to decline considerably over the next five years as domestic demand assumes the dominant role in driving real growth and export growth slows somewhat while import growth picks up.

In the near term, the current account surplus of larger Southeast Asian countries continued to narrow during 2013-17. The decline in 2012 is largely attributable to Malaysia, Singapore and Thailand. Some of the decline in surplus is cyclical, owing to the weakening of external demand from OECD countries in 2011, but there has been a fairly clear downward trend in the surplus over the past several years. This downward trend has been accompanied by and is related to the even more marked fall in China's current account surplus over the past several years. China's surplus will fall to 1.9% of

GDP by 2017, its lowest level in more than ten years. The overall current account surplus of Emerging Asia has been further reduced by the rise in India's current account deficit, which reached 3.2% of GDP in 2011.

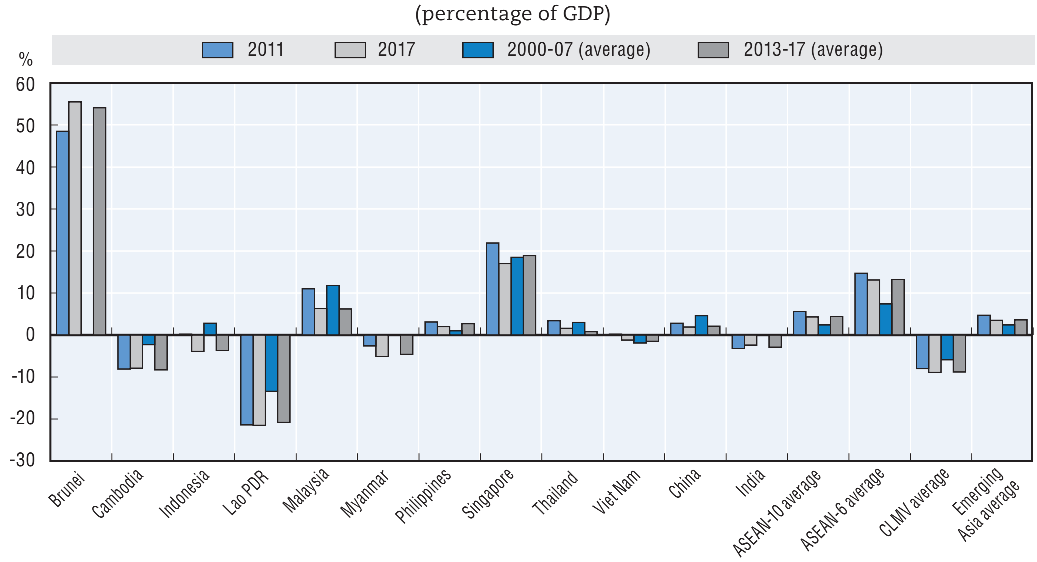
In the medium term, except for Indonesia which is projected to record a small deficit relative to GDP by 2017, many ASEAN-6 countries such as Malaysia, the Philippines, Singapore and Thailand will remain in current account surplus while the CLMV countries remain in deficit. China's current account surplus is also projected to remain modest in relation to GDP, at 1.9% of GDP by 2017 compared to 4.6% in the eight years prior to the global financial crisis. India's current account is projected to remain in deficit in the medium term.

The reduction in current account surpluses reflects a marked slowing of growth in exports of goods and services, amid robust growth in imports. Export growth for many ASEAN countries is projected to fall well below the average rate recorded over 2000-07. Export growth is expected to slow even more for China and also to slow markedly for India.

The slowdown in exports of Emerging Asia is partly a reflection of weakness in demand from outside the region, particularly the OECD. This weakness in external demand should gradually abate over the medium term, allowing a mild revival in Emerging Asian exports by 2017, although their pace will in most cases still be below that of the years leading up to the 2007 crisis. Export growth will also be moderated by continued gradual appreciation in the real exchange rate of the currencies of most Southeast Asian countries as well as China.

Figure 1.19. **Current account balance of Southeast Asia, China and India**

(percentage of GDP)



Notes: ASEAN-6 average includes Brunei, Indonesia, Malaysia, the Philippines, Singapore and Thailand.
CLMV average includes Cambodia, Lao PDR, Myanmar and Viet Nam.
Emerging Asia average includes all ASEAN countries and China and India.
Owing to data availability country averages for 2000-07 do not include Brunei and Myanmar.

Source: OECD Development Centre, MPF-2013.

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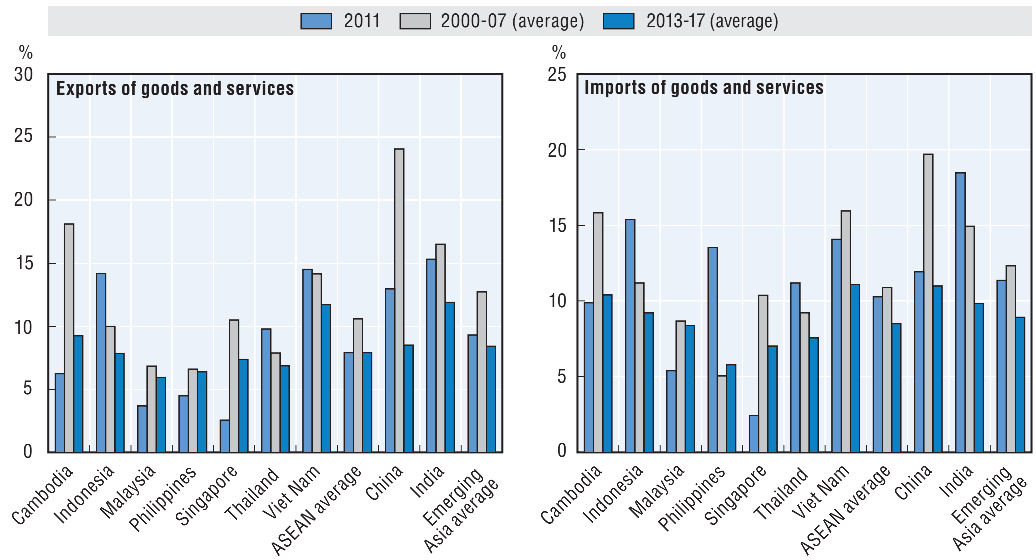
Figure 1.20. **Exports and imports of goods and services of Southeast Asia, China and India**

(percentage change)



Note: ASEAN average includes Cambodia, Indonesia, Malaysia, Philippines, Singapore, Thailand, Viet Nam. Emerging Asia average includes seven countries of ASEAN, China and India.

Source: OECD Development Centre, MPF-2013.

StatLink http://dx.doi.org/10.1787/888932773749

Despite the decline in current account surpluses, most Southeast Asian countries as well as China are projected to continue to record large surpluses in their balance of payments. For reasons given in the next section, portfolio net capital inflows into these countries are likely to remain strong and may increase further over the medium term and be accompanied by continued strong FDI inflows. Southeast Asian countries and China are projected to continue to increase their international reserves. Reserve levels in these countries will remain high relative to their trade and GDP, ranging from 6 months of imports in Indonesia, Malaysia, Singapore, and Viet Nam (as well as India), around 12 months in the Philippines and Thailand, and nearly 20 months in China.

Strong growth will be underpinned by effective macroeconomic policies

The favourable outlook for growth and the external accounts is based on the continued effectiveness of macroeconomic policies. The projections assume that monetary policies will continue to sustain low inflation consistent with central bank targets in many ASEAN countries as well as China, and to progressively reduce inflation rates in India, Viet Nam and, to a lesser extent, the Lao PDR, where they have been comparatively high.

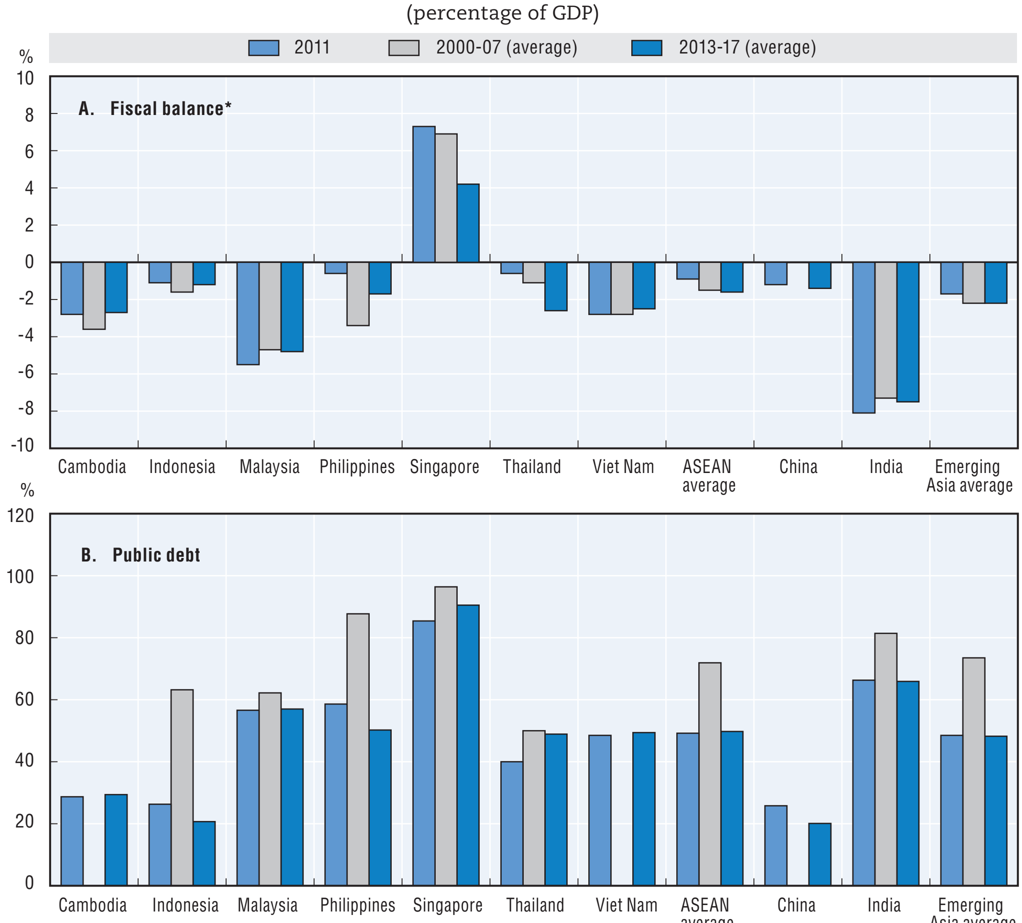
According to officially announced budget plans, most countries in the region will continue to reduce their fiscal deficits, although at a somewhat slower pace than in 2009-10 (Figure 1.21). Malaysia, which suffered a downgrade in its international credit rating in 2010 because of a surge in its budget deficit, is slated to reduce the deficit to 4.8% of GDP over 2013-17, compared to about 5.5% in 2011. Except for Thailand, where government reconstruction spending will temporarily interrupt fiscal consolidation, budget deficits are projected to fall in the the region. The deficits of China and India will remain in the medium term.

Assuming that budget plans are successfully implemented, Southeast Asian countries and China will be in enviable fiscal positions. Their projected budget deficits relative to GDP are well below those expected to be achieved in the United States and most of the rest of the OECD. In most of Southeast Asia and China, primary budget balances are projected to be only in small deficit over the medium term. This together with favourable debt-dynamics (real interest rates that are below the growth rate of GDP) will lead to declines in public debt to GDP ratios that are already comparatively low in many of the countries. Public debt ratios are projected to fall significantly in Indonesia and China and to be below 60% of GDP in most ASEAN countries by 2017 (except for Singapore) – levels that are again well below those projected for the OECD and other major emerging market economies.

Budget consolidation in most of the Emerging Asian countries is projected to be accomplished with little or no increase in revenues relative to GDP. As discussed in the next section, Southeast Asian countries could potentially improve their mobilisation of fiscal revenues, which would make it easier to finance increased spending where needed on infrastructure and on health and other social services.

Figure 1.21. **Public finances of Southeast Asia, China and India**

(percentage of GDP)



Notes: * Fiscal balance of general government.
ASEAN average includes Cambodia, Indonesia, Malaysia, Philippines, Singapore, Thailand, Viet Nam.
Emerging Asia average includes seven countries of ASEAN, China and India.
2000-07 Emerging Asia average for fiscal balance does not include China, owing to data availability.
2000-07 country averages for public debt do not include Cambodia, Viet Nam and China, owing to data availability.

Source: OECD Development Centre, MPF-2013.

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The economic outlook is subject to both upside and downside risks

The medium-term outlook for Emerging Asia could be less favourable than the projections imply for a number of reasons concerning both the external environment and the success of the countries themselves in their development policies.

- Prolongation of the tensions in the euro area and/or weakness in the United States recovery would moderate the projected strong real growth in Emerging Asia somewhat but probably not drastically.
- Renewed pressures on food, oil and other commodity prices could re-emerge in the near term as a result of the severe drought in major farming regions of the United States and political tensions surrounding Middle East oil producers. These pressures are likely to be further reinforced once recoveries in the United States and Europe gain momentum. Rising commodity prices could add to inflationary pressures in Emerging Asia and limit countries' scope for monetary easing to counter shocks to external demand. Increasing commodity prices could also complicate budget consolidation efforts in those countries where commodity subsidies are now comparatively large.
- Particularly so long as interest rates remain at historically low levels in the United States and much of Europe, Southeast Asian countries and China are likely to experience strong capital inflows but also fluctuations in these inflows as international risk appetites vary. Strong capital inflows into some ASEAN countries pose a risk of igniting or aggravating domestic asset price bubbles and could complicate monetary policy management. The strong financial conditions of domestic banks and recent reforms to strengthen prudential policies should help to limit risks to domestic financial stability but the surges will need to be carefully managed.

Economic reforms and other policies within the region present both upside and downside risks. The robust growth projections for much of the region are predicated on the success of planned infrastructure investments in alleviating transportation, power and other bottlenecks that have hampered industrial development and depressed productivity in the past. Widespread delays in these projects, particularly in Indonesia, the Philippines and India, could lead to lower growth than projected. However the benefits to productivity and growth from timely and successful implementation of the projects could be greater than now projected. Emerging Asian countries also need to successfully implement planned reforms to regulatory and other policies to improve the business environment.

Key policy challenges to sustaining healthy growth in the medium term

Southeast Asian countries' success in realising their favourable medium-term growth and development prospects will depend on meeting several key challenges.

- Management of capital inflows is likely to continue to be an important issue. Further development and regional integration of domestic capital markets will help to better reap the benefits from those flows and reduce the risks they can pose to domestic economic stability.
- Managing the extensive dollarisation is the challenge for CLMV countries together with further strengthening of the financial sector.

- Fiscal capacities need to be reformed and strengthened to improve revenue mobilisation and the overall efficiency of tax systems and to adapt to the changes stemming from the growth of the middle class.
- Emerging Asian countries are being transformed into middle-class economies at a faster rate than in any other world region. The transformation into middle class dominated societies creates both opportunities and challenges for governments in the region.

Management of the effects of capital inflows will be an increasing challenge

Southeast Asian countries and China are likely to continue to have potential risks of volatility of capital inflows in the medium term, depending on the external economic environment. Capital inflows provide considerable benefits to ASEAN countries: they add to resources available for domestic investment; they provide a source of finance for government borrowing; they help to diversify the investor base for domestic equities and bonds; they contribute to the development of domestic financial markets and improvement in their efficiency; and they (through FDI) provide a channel for the transmission of foreign technology and other expertise to the domestic economy.

However, large and variable capital inflows also can create significant problems for the receiving country (OECD, 2011a). Surges in capital inflows ("hot money") can raise a country's real exchange rate above its longer term equilibrium level, which, if prolonged, can damage competitiveness and lead to misallocation of domestic resources. Sudden reversals of large capital inflows can destabilise domestic financial markets and potentially undermine the financial soundness of banks and other financial institutions. Prolonged surges in capital inflows may also aggravate or even spark unsustainable booms in domestic asset prices ("bubbles") and/or in domestic credit that are followed by contractions that depress economic growth. For example, large foreign investment in Singapore's real estate sector has led authorities to intervene on a number of occasions to prevent prices from rising to unsustainable levels. Concerns have also arisen about the recent property market boom in Myanmar, which is being driven to some extent by investments from Singapore.[3]

Historical evidence suggests that capital inflow surges can lead to domestic credit bubbles

Emerging Asia has been subject to periodic credit booms that have not infrequently given way to credit contractions and economic instability. These episodes have sometimes, but not always, been preceded or accompanied by capital inflows well above their underlying longer term trend – "capital bonanzas". Such capital flow bonanzas can fuel asset price bubbles through portfolio inflows into stock markets or though lending for real estate purposes by the domestic banking sector which in turn borrows from abroad. There is evidence suggesting that such bonanzas raise the risk of macroeconomic instability and financial crises in emerging economies (Reinhart and Reinhart, 2008).

Recent empirical analysis of credit boom episodes in the Asia Pacific region further supports this conclusion but also suggests that not all capital flows pose equal risks (see Box 1.5; Molnar and Tanaka, 2012). The analysis examined credit booms and capital inflow surges in 38 emerging and developed economies in the Asia Pacific region from 1970 to 2010. Credit booms were identified as periods in which the ratio of credit increases to GDP credit growth exceeded its longer term trend by a certain fraction. Capital flow bonanzas were identified as capital inflows into a country that exceeded the global trend in those flows.[4]

Box 1.5. **Estimating the influence of capital bonanzas on credit booms**

The analysis examined credit booms and capital inflow surges in emerging and developed economies in the Asia Pacific region. Following earlier literature, the historical trends in credit and in capital flows are estimated using a filtering approach. In order to test the robustness of the empirical results, alternative sets of credit booms were defined as 5, 10, 20 and 30 percentage points' growth above the historical trend. The above definitions resulted in 144, 84, 29 and 14 credit boom spells for Asia-Pacific countries over 1970-2010 applying the 5, 10, 20 and 30 percentage point thresholds, respectively.

Earlier studies have used the underlying trend in individual countries' capital inflows as the reference for capital bonanzas. This approach is most appropriate if all countries have the same propensity to experience a sudden surge in inflows or a sudden withdrawal of capital. However, this may not be realistic for developing countries in the Asia-Pacific region, given the diversity in their economic circumstances. Therefore, in this analysis, the deviation from the global trend in capital flows is used instead of a trend based on countries' own historical data. This also allows for gauging to what extent countries are able to reap the benefits of global capital flows relative to other countries. To highlight differences between different magnitudes of flows, surges of 1, 2 and 3 standard deviations above the global trend are computed for all countries.

The effect of capital flow bonanzas on the likelihood that a credit boom will occur was estimated using a probit statistical model, controlling for other macroeconomic conditions that also may affect this likelihood, notably interest rates in the receiving country and measures of the global risk appetite, the depth of domestic financial markets and competitive pressures in the domestic banking market. Intuitively, domestic growth and falling interest rates (which decrease the cost of capital) would be conditions conducive to credit booms. In addition, the global risk appetite and capital inflows, in particular cross-border lending, may also play a role.

As a first step to assess what drives credit growth in Asia and the Pacific, the impact of various types of capital flow bonanzas on domestic credit growth was examined using a fixed effects model with country and year effects. Capital flow bonanzas entered as independent variables were alternatively entered as net portfolio inflows, FDI inflows, and cross border lending by banks and non-financial firms during each episode. Cross-border lending was further differentiated into new lending by foreign banks and other firms and reductions in borrowing by domestic entities from those firms. The control variables included the growth rate of the economy, the change in long-term interest rates, the trade openness of the economy (measured as share of trade in GDP) and financial depth (measured as loans outstanding to GDP).[6]

The results show that among the different types of capital flows, only cross-border lending by foreign banks and other foreign firms significantly affects the growth of domestic credit and this effect is positive. Nevertheless, this is not a robust finding as it only holds for bonanzas defined as inflows 2 and 3 standard deviations above the global trend and only when long-term interest changes are controlled for. Moreover, when total cross-border lending to domestic banks by both domestic and foreign entities is used, the same positive impact of cross-border lending on domestic credit growth was not found. Surprisingly, very large (3 standard deviations above the global trend) portfolio capital inflows have a negative impact on domestic credit growth. This somewhat puzzling finding may be attributable to the fact that portfolio inflows may partly finance firms' fund needs and hence reduce the demand for bank loans.

Source: OECD Development Centre and Molnar and Tanaka (2012).

Table 1.3. **Estimated impact of capital inflow bonanzas on the probability of domestic credit booms in Asia**

(Probit estimation)

	Credit boom at least 5 ppt above historical trend	Credit boom at least 10 ppt above historical trend	Credit boom at least 20 ppt above historical trend	Credit boom at least 5 ppt above historical trend	Credit boom at least 10 ppt above historical trend	Credit boom at least 20 ppt above historical trend	Credit boom at least 5 ppt above historical trend	Credit boom at least 10 ppt above historical trend	Credit boom at least 20 ppt above historical trend
	(Left-hand side variable: binary variable indicating the start of a boom)								
Surge in inward credit by foreigners at least 1 std above global trend	0.0861*	0.011	0.0268						
	[1.746]	[0.347]	[1.530]						
Surge in inward credit by foreigners at least 2 std above global trend				0.204***	0.147***	0.0704***			
				[3.032]	[3.008]	[2.693]			
Surge in inward credit by foreigners at least 3 std above global trend							0.203**	0.0866	0.0611*
							[2.449]	[1.520]	[1.875]
Change in the interest rate differential (lagged)	0.00116	-0.0000695	0.0000116	0.000804	-0.000243	-0.000122	0.000839	-0.000216	-0.000116
	[1.080]	[-0.0997]	[0.0567]	[0.758]	[-0.350]	[-0.588]	[0.779]	[-0.299]	[-0.477]
Change in the OECD output gap (lagged)	0.0107	0.00751	0.000675	0.0116	0.00937	0.00153	0.011	0.0088	0.000661
	[1.005]	[1.044]	[0.219]	[1.107]	[1.312]	[0.505]	[1.044]	[1.201]	[0.211]
Lagged growth rate	0.0162	-0.0152	0.0311	-0.0214	-0.0472	0.0231	-0.0228	-0.0348	0.0217
	[0.136]	[-0.191]	[1.423]	[-0.183]	[-0.568]	[1.095]	[-0.194]	[-0.427]	[0.894]
Bank credit to GDP ratio	-0.000560**	-0.000393*	-0.0000566	-0.000539**	-0.000372*	-0.000049	-0.000605**	-0.000421**	-0.000107
	[-1.984]	[-1.893]	[-0.610]	[-1.988]	[-1.898]	[-0.580]	[-2.195]	[-2.044]	[-1.029]
Observations	**534**	**558**	**564**	**570**	**595**	**602**	**582**	**608**	**616**
z-statistics in brackets									

Notes: Significance levels:* significant at 10%, ** significant at 5%, *** significant at 1%.
Reported coefficients are the marginal effects (i.e. the change in probability of the left-hand side variable if the explanatory variable increases by one unit).
Source: OECD Development Centre and Molnar and Tanaka (2012).

The results of Table 1.3 indicate that foreign capital inflows are an important factor behind domestic credit booms. Increasing cross-border lending by foreigners tends to increase the probability of the start of large credit booms (defined as at least 20 percentage points above the historical trend). The higher foreign cross-border lending was in the previous year, the more likely smaller credit booms (5 and 10 percentage points above the historical trend) are to start. The results also imply that smaller foreign cross-border lending episodes (those 1 standard deviation above the global trend) tend to trigger smaller credit booms (those 5 percentage points above the historical trend), while large and very large foreign cross-border lending episodes result in larger credit booms. When borrowing from abroad by domestic financial institutions is taken into account, even smaller capital inflow bonanzas appear to trigger very large credit booms. This suggests that borrowing from abroad by domestic banks may be a sign of a start of a domestic credit boom.

Several other factors also significantly affect the likelihood of a credit boom emerging:[5]

- Countries with shallower financial depth (measured by the ratio of domestic assets to GDP) tend to be more prone to credit booms.
- Limited competition in the domestic banking sector (as indicated by a comparatively large spread between deposit and lending rates) is also conducive to credit booms.

However, neither the growth rate of the domestic economy nor the state of the business cycle in OECD countries (measured as the output gap for the OECD) appear to affect the likelihood of credit booms independently from the influence of capital inflow bonanzas.

Greater development of capital markets in the region could help to mitigate adverse effects of capital inflows

Governments have several policy options for limiting credit booms and other risks from capital inflows.

- They can use capital controls to limit inflow surges or to influence their composition to favour FDI inflows and other investments that are less volatile. Such measures can be effective in the short term but they tend to become progressively less effective over time, as investors find other means (licit and illicit) to evade them (OECD 2011a). The measures can lead foreign investors to use offshore vehicles that are outside the regulatory jurisdiction of the receiving country and which are less easily monitored.
- Governments frequently use foreign exchange market intervention to limit exchange rate appreciation above the level warranted (in their judgement) by long-term fundamentals. Such intervention needs to be sterilised by offsetting open market sales in domestic financial markets if it is not to lead to excess credit expansion and inflation. However, sterilisation can be difficult to achieve when domestic financial markets are not well developed.
- Over the longer term, strengthening of domestic financial markets and institutions through prudential reforms, improved governance of financial institutions and development of efficient financial markets are the key to containing risks from capital inflows and fully realising their benefits.
- Reduction in barriers to foreign direct investment, such as ceilings on foreign ownership shares of domestic businesses and prohibitions on foreign investment, can raise the share of FDI in overall capital flows. These barriers are still quite considerable in ASEAN and other developing Asian economies (OECD, 2011a).

Emerging Asian countries have made considerable progress since the global crisis in strengthening the financial soundness and governance of their banking systems. Most of the countries are well on their way to conforming to the stronger prudential norms specified by Basel III (OECD 2011a). Capital adequacy ratios are already above those specified by Basel III in many cases and other key indicators of financial soundness, such as non-performing loan ratio and loan-loss provisions, compare favourably with those in (most) other emerging markets and many developed economies. These measures, provided they are persistently and effectively enforced, should considerably reduce the risks capital inflows into the domestic banking system will undermine financial stability, as they did in the 1997 Asian crisis.

China continues to advance on its broad and ambitious programme of financial reforms. The authorities have pushed forward the coverage of financial institutions and services in rural areas. By the end of 2011, the number of village and township banks had totalled 726, efficiently improving rural financial services in remote areas. The implementation of new capital regulatory standards is being steadily implemented.[7]

Over the longer term, further development of domestic capital markets is very important to realising the benefits of capital inflows and containing their risks. Deeper capital markets dampen the volatility in prices arising from fluctuations in foreign (and domestic) investors' demands for domestic equities and fixed income instruments. More efficient capital markets are less susceptible to mispricing of assets and their risks and to speculative bubbles.

Stock markets in Emerging Asia have developed considerably over the past 30 years, The stock markets in many of these countries compare favourably in overall development and efficiency with those in other emerging markets, although they are less developed than the major markets in the OECD. Since 1990, market liquidity (share-turnover) has more than doubled and markets have become noticeably broader. Nearly two-thirds of international flows into emerging equity markets go to countries in the emerging Asian region (Purfield et al., 2006).

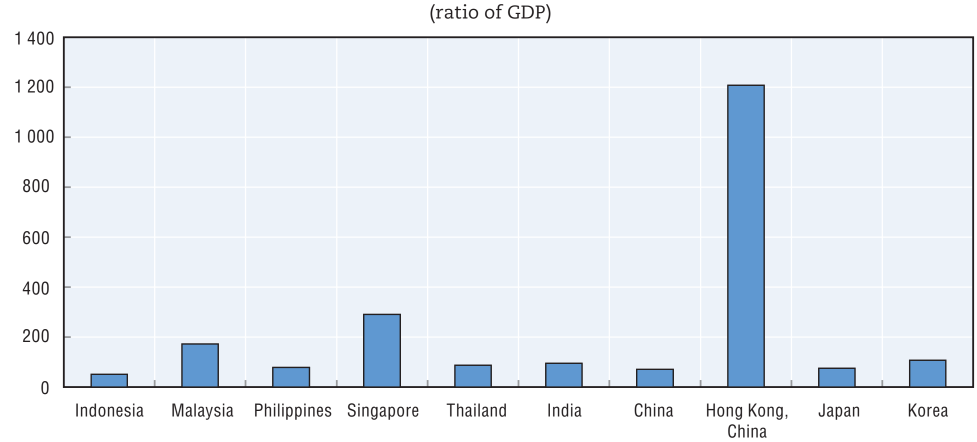
India's stock market has been the biggest beneficiary of financial reforms in that country and its development has helped to catalyse financial innovations in other areas. Notably, the experience gained in reforms to the stock market helped in the establishment of a currency futures market in 2008 (OECD, 2011b).

The growth in the Chinese stock market over the past decade has been especially impressive. As of March 2012, the Shanghai and Shenzhen Stock Exchanges were ranked among the top 15 stock exchanges in the world in terms of market capitalisation. The annual growth in the number of accounts opened by investors has averaged 15.32 million since 2008, with both individual investors and, in particular, institutional investors experiencing rapid growth. By the end of 2011, more than 1 100 domestic enterprises were allowed to issue overseas-listed foreign shares. More and more qualified foreign institutional investors (QFII) were invested in the Chinese market. From December 2011 to May 2012, 46 overseas financial institutions had obtained licences to operate as QFII.

There is, however, considerable variation in the development of stock markets in the region. The markets in Malaysia and Singapore are among the most efficient in the world (Purfield et al., 2006). Neither Brunei nor Myanmar (yet) have stock exchanges and exchanges in Lao PDR and Cambodia were opened in 2010. Equity markets in Indonesia and the Philippines are less developed than in the most advanced Asian developing countries, not only in their overall size (Figure 1.22) but also in terms of their liquidity and breadth. Despite its large overall size, the Chinese stock market is also less developed than the more advanced markets in terms of the diversity of their issuers (which are still dominated by state-owned companies) and their liquidity and breadth.

Figure 1.22. **Stock market capitalisation in Asia, 2010**

(ratio of GDP)



Notes: China is the sum of the Shanghai and Shenzhen exchanges. Japan is the sum of the Tokyo and Osaka exchanges. India is the Bombay exchange.

Source: World Federation of Exchanges.

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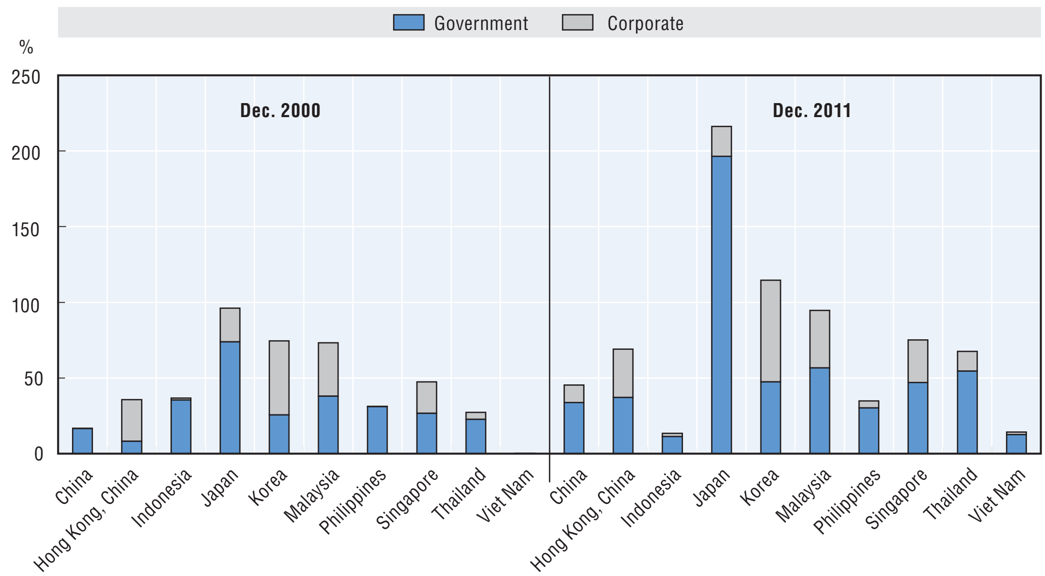
Development of equity markets in Emerging Asia has been hampered by weaknesses in corporate governance, in regulatory norms concerning disclosure and predatory market practices such as insider trading (especially their enforcement) and in corporate governance. Stock market development in smaller ASEAN economies is also impeded by the limited scale that can be achieved from the listing of domestic companies.

Further development of corporate bond markets would help reduce risks from capital inflows

Bond market development in Emerging Asia became a key policy priority after the 1997 crisis, which exposed the dangers posed by near-exclusive reliance on banks for domestic financing. Limited bond market development, particularly the private (corporate) segment has contributed to dependence on capital inflows as domestic savers have tended to place funds in foreign financial markets, especially in the OECD, which then are relent to domestic borrowers.[8] As discussed further below, a wide range of policy initiatives have been taken in individual countries and at the regional level to develop these markets.

There has been significant progress toward this goal in Southeast Asia as well as China and India but the progress has been uneven. There has been some growth in the size of domestic bond markets relative to GDP in Malaysia, Singapore, Thailand, Viet Nam and China. However, except for China (since 2005), most of the growth has been in the government bond market (Figure 1.23). The overall bond market in Indonesia has shrunk in size compared to 2000. The ASEAN 6 countries still account for only 1.3% of total world bonds outstanding, China for 3.3%, and India 1%. These figures are well short of these countries' share of world GDP (ADB, 2012a) and not much different from their share before the Asian crisis. Brazil alone accounts for a larger share of world bonds than the six ASEAN countries.

Figure 1.23. **Bonds outstanding in Asia**
(percentage of GDP)



Source: Asia Bonds Online.
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Corporate bond markets are particularly underdeveloped in Southeast Asia, leaving their private sectors more dependent on bank financing than comparable emerging economies in other regions. The corporate bond market is still very small, both in absolute size and relative to GDP, in Indonesia, the Philippines, Thailand and Viet Nam. Malaysia and Singapore have the largest and most developed markets in the region, but they are still less than one-tenth the size of the corporate market in Japan. None of the CLMV countries except Viet Nam yet has a significant corporate bond market.

China's corporate bond market was virtually negligible until recently and although it has grown very rapidly since private firms were allowed to issue medium-term notes in 2008, it is still small in relation to the overall economy. Although much larger in absolute size than the markets in Southeast Asia, China's total outstanding corporate bonds (about USD 852 billion at the end of 2011) is only 11.4% of its GDP. The Chinese government has been committed to giving corporate bonds a bigger role to divert risk from the banking system, which provides 75% of the nation's credit. However, according to Chinabond, the nation's bond clearing house, more than 68% of bond investors are banks.

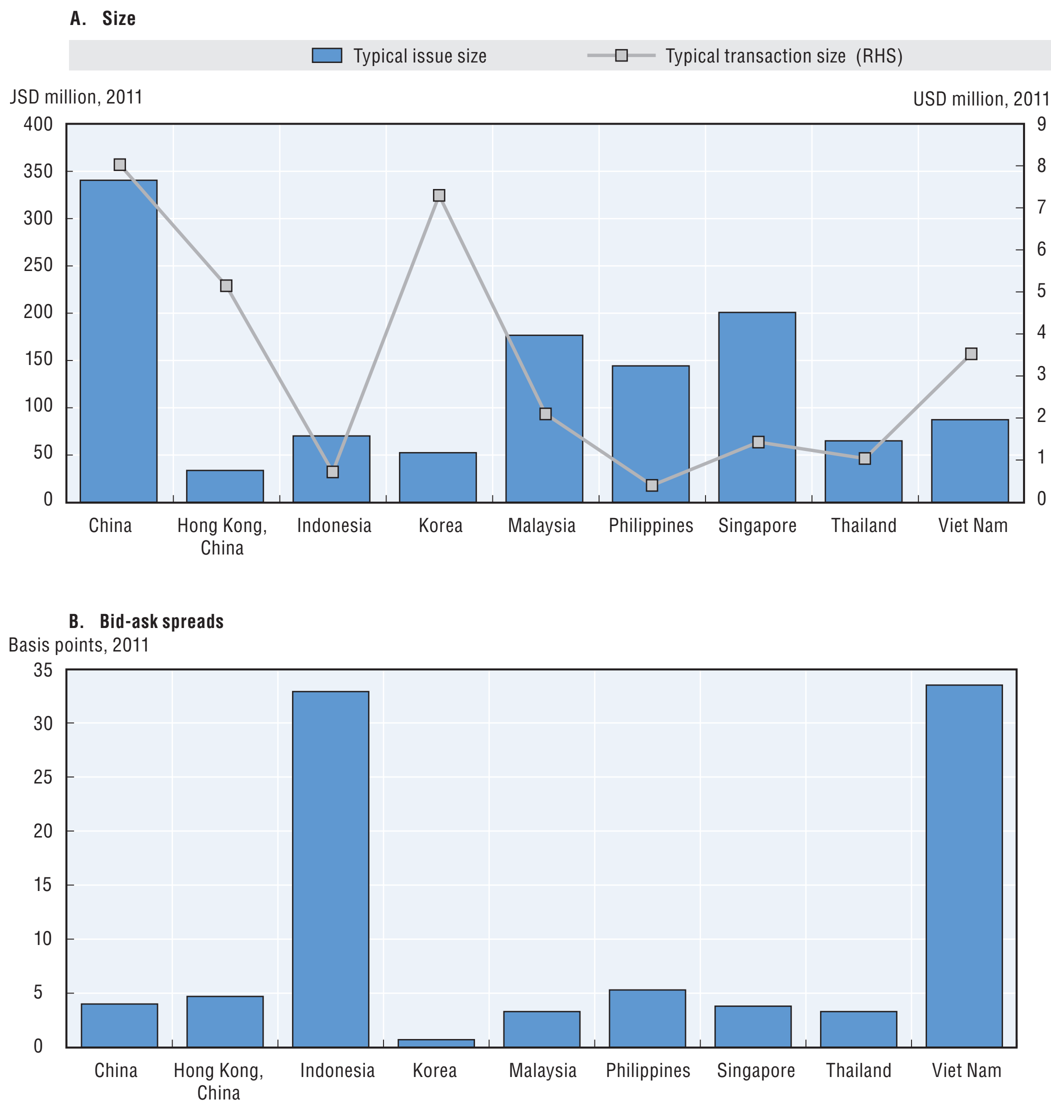
The limited development of corporate bond markets in the Emerging Asia region is also manifest in other performance dimensions. Market liquidity, as measured by bid-ask spreads and turnover, is comparatively low (Figure 1.24). Issuers are relatively concentrated and the average size of issues in relation to the issuers portfolio ("significance") is relatively high. The portion of issues at long maturities (greater than 10 years) is small in most cases. These indicators are noticeably better for the most advanced markets, in Malaysia and Singapore, but they are still generally less favourable compared to the corporate bond markets in the United States, the larger European countries, and a number of emerging economies in Latin America.

The limited development of the corporate bond markets in Emerging Asia is partly attributable to macroeconomic and structural characteristics that affect corporate bond markets in all countries but whose overall configuration in Asia has tended to limit their size (see Eichengreen and Luengnaruemitchai, 2006).

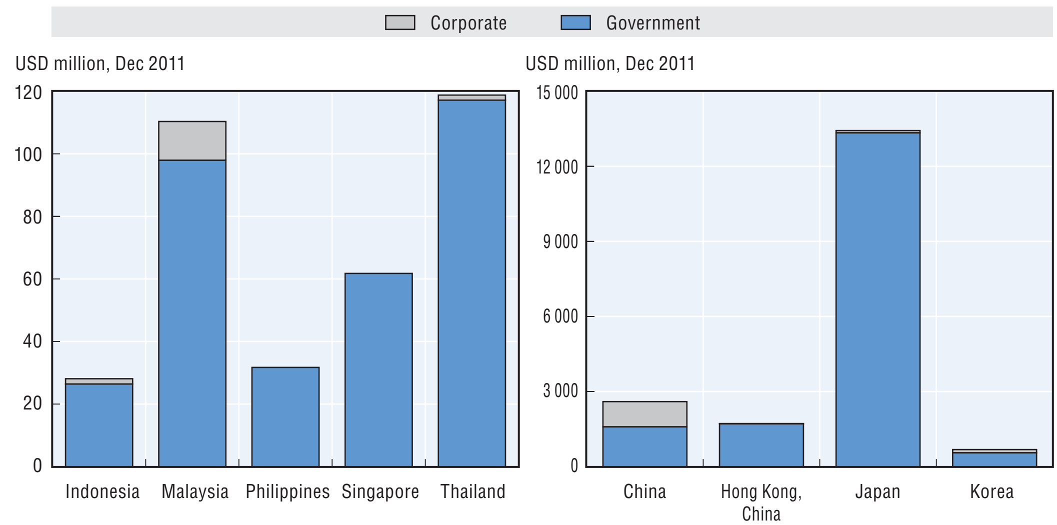
- The limited size of some of the ASEAN economies has made it difficult to reach the scale required for greatest bond market efficiency. The optimal scale of corporate bond markets is greater than that for equity or government bond markets (Goswami and Sharma, 2011). Some evidence suggests that in developing Asia, only the markets in Malaysia and China have reached the minimum aggregate size needed (USD 100-200 billion) for greatest efficiency (McCauley and Remolona, 2000; see also Siackhachanh, 2012). There are also scale economies to bond issuance at the firm level (from fixed costs of meeting necessary reporting and other requirements for issue) that very few corporations in smaller economies are likely to be able to fully exploit.
- The prominence of foreign-invested firms in most ASEAN countries and in China has limited the issuer base for domestic corporate bond markets. Foreign-invested firms typically finance their expansion from offshore or from internal funds. The decline in private and public investment spending in the aftermath of the Asian financial crisis accentuated this tendency by reducing the need for external funding funds. (Felman et al., 2011).
- The investor base for domestic corporate bonds has been restricted by the relative underdevelopment of insurance companies, pension funds and other institutional investors, which are the dominant holders of corporate bonds in OECD countries. Institutional investors have been major drivers of growth in the more developed bond markets of several Latin American countries, notably Chile.
- Fiscal prudence, in terms of generally low budget deficits, although it has contributed to sustaining macroeconomic stability (which by itself should be favourable to bond markets), has also restrained the growth of government bond market, which has tended indirectly to impede development of the corporate market.[9]

Development of the corporate bond markets in Emerging Asia has also been constrained by limited development of key market infrastructure and by inadequacies in legal and regulatory regimes that are common to developing countries. For example, benchmark yield curves, which are necessary to allow corporate markets to extend to longer maturities, have only recently been developed in Malaysia, Thailand, Singapore and China, and are not yet developed in the Philippines and Indonesia. Overly stringent restrictions on firms permitted to issue bonds (in China) and on the permitted investments by insurance companies and pension funds in some countries (in China and the Philippines) have also tended to limit development of corporate bond markets.[10] In India, the floor on the portion of holdings by banks and insurance companies that must be invested in government bonds indirectly limits their capacity to hold other assets, including corporate bonds (OECD, 2011b)

Figure 1.24. **Bond market indicators in Asia**



C. Trading volume



D. Turnover ratio

Source: Asia Bonds Online.

StatLink http://dx.doi.org/10.1787/888932773825

Significant progress has been made in improving the underpinnings of corporate bond markets

Individual Southeast Asian countries as well as China and India have made considerable progress over the past decade in strengthening the key elements required for well-developed corporate bond markets. A number of countries have taken steps to broaden the investor and issuer bases for corporate bonds by relaxing restrictions on domestic corporations and institutional investors and by making it easier for foreigners to participate. India and China have increased ceilings on holdings of domestic financial assets by foreign institutional investors on a number of occasions.[11] Singapore has streamlined disclosure and other requirements for listing and taxation in order to encourage foreign corporations to issue bonds in the domestic market. Thailand now allows foreign governments and financial institutions to issue local currency denominated bonds onshore.

Box 1.6. **Regional initiatives to develop East Asian bond markets**

Beginning in 2003, a series of initiatives to develop bond markets have been taken at the regional level to better develop bond markets in the ASEAN and other East Asian emerging economies. These efforts have been concentrated in the Asian Bond Market Initiative (ABMI) established in 2003 by the ASEAN+3 finance ministers and the Executives Meeting of East Asia – Pacific Central Banks (EMEAP). These initiatives have focused on developing national bond markets through investments by regional funds and through initiatives to develop national and regional bond market infrastructure. Working groups under the ABMI have been formed to examine the feasibility of and measures toward: creation of new securitised bond instruments; establishment of a regional bond guarantee agency; the strengthening of national ratings agencies; and creation of regional settlement and clearance systems and a regional credit rating agency. Efforts have also been underway since 2001 by the Association of Asian Credit Rating Agencies to harmonise standards and procedures across countries (Spiegel, 2009).

The first Asian bond market fund (ABF-1) was launched under the EMEAP in 2003 with total initial funds of USD 1 billion. These funds were used to purchase dollar denominated sovereign bonds issued by governments of the ASEAN 5 and China; Hong Kong, China; and the Republic of Korea. In 2004, a second fund (ABF-2), with initial funding of USD 2 billion, was created to invest in local currency bonds of the same eight countries. These funds have also helped to spur reforms to reduce impediments to cross-border investments in ASEAN countries arising from tax, accounting and other differences in laws and regulations (Bhattacharyay, 2011).

The regional efforts have gained further momentum in the wake of the global financial crisis. In 2008, a second ABMI roadmap was issued calling for improving local currency bond market issuance and the investor base and for strengthening market infrastructure and regulatory frameworks (Spiegel, 2009). In 2011, Asian Finance Ministers approved the creation of a regional Credit Guarantee and Investment Facility (CGIF) with USD 700 million of initial funding from the Republic of Korea, Japan and China; and the ASEAN Infrastructure Fund to finance infrastructure investment across ASEAN, with USD 495.2 million of funds, managed by a company based in Malaysia. The CGIF is intended to facilitate issuance of longer-maturity bonds in local markets by issuers with good but below AAA rating; and to facilitate cross-border issues by companies with investment grade rating even if their home country has a below investment grade sovereign credit rating (Siackhachanh, 2012).

Malaysia has enjoyed distinctive success in developing its bond market through innovations to facilitate issues that conform to Islamic norms. Islamic bonds outstanding now amount to 28% of GDP or nearly two-thirds of total outstanding corporate bonds, and Malaysia has assumed the dominant position in the market for this type of bond (Felman et al., 2011).

Key components of bond market infrastructure have been modernised and in certain areas are now in line with international best practices. In particular, trading takes place on a delivery-versus-payment basis, which minimises settlement risk (Gray et al., 2011). All of the Southeast Asian markets as well as those of China and India have well developed networks of market makers (typically banks or securities companies, depending on the country) and inter-dealer trading arrangements. Regulatory authorities and central banks in some countries have broadened the range of collateral acceptable in interbank transactions or for borrowing from the central bank in order to improve liquidity.[12]

Countries have also been strengthening legal and regulatory rules critical to corporate bond markets. These include stronger disclosure requirements in the capital markets and measures to better protect minority shareholders (in China and Thailand), corporate governance reforms (particularly in China) and reforms to bankruptcy codes (in Indonesia, Thailand, the Philippines and China) (Goswami and Sharma, 2011). The reformed provisions generally conform to international norms on paper, although their enforcement has not infrequently been uneven.

The individual country reforms have been encouraged and facilitated by extensive efforts that have been undertaken at the regional level of ASEAN and of the ASEAN + 3 (Box 1.6). These regional initiatives have directly stimulated development of the overall bond market and corporate bond markets through the Asian bond funds and through efforts to develop best practices and harmonised standards for national bond markets in the region. The initiatives are also working to lay foundations that would allow for a region wide bond market if and when regional financial integration and other economic conditions necessary for such a market are established.

Conditions are favourable for an acceleration of corporate bond market development

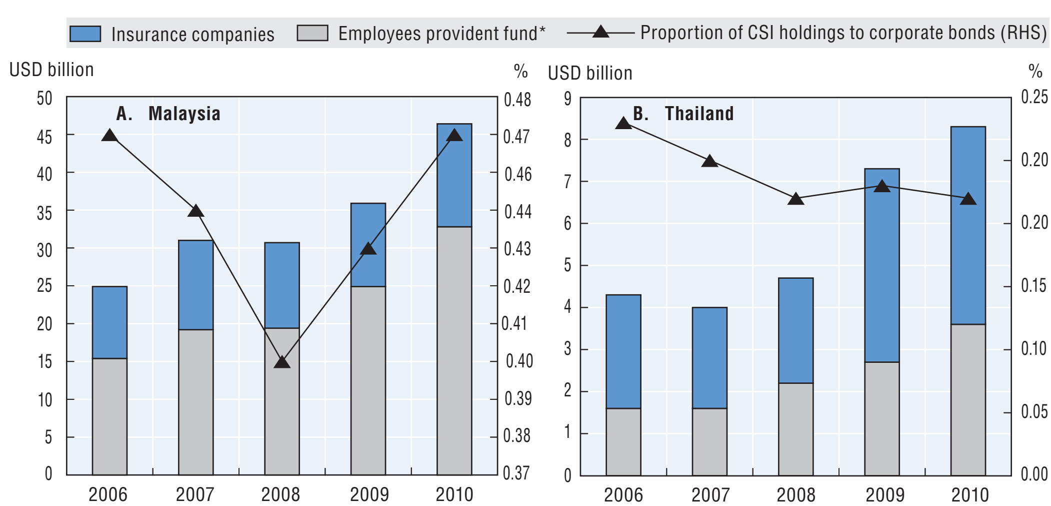
Issuance in Emerging Asian bond markets has accelerated since the global financial crisis. The corporate market has grown fastest in China but there has been a noticeable pickup in growth of the Southeast Asian markets as well. This acceleration is partly attributable to a decline in business access to bank credit during the crisis and to a shift in international investment funds away from Europe and into emerging markets to take advantage of the higher returns available in the latter. Both of these factors are likely to at least diminish as recoveries in the once uncertainties about Europe and the growth in the United States ease.

However, a number of more durable factors suggest that Southeast Asian corporate bond markets may be on the verge of an acceleration in their development. Emerging market debt is still underweighted in the portfolios of major investment funds in the OECD, suggesting that its share is likely to continue to trend upward. Southeast Asian bond markets are in a good position to benefit from this trend given the recent improvement of the international credit ratings of Indonesia and the Philippines, and the continued relatively favourable standings of the other ASEAN 5. Mutual funds have been growing rapidly, especially in China, India and Malaysia. While mutual fund investments are still concentrated in government debt in most countries, they are likely to further diversify into corporate debt over time. This has already been occurring in Malaysia, where holdings of corporate bonds by insurance companies and pension funds have nearly doubled since 2006 and now amount to 46% of total corporate bonds outstanding (Figure 1.25).

Policies in a number of areas will be important to ensuring that ASEAN bond markets realise the potential benefits from these favourable forces.

- Strengthening of clearing, depository and settlement systems, in part through further development of central securities depositories (CSDs), which are now in place in Malaysia, Singapore and Thailand, would help to reduce market risks and costs. Given the comparatively small size of the markets in a number of ASEAN countries, development of linkages across countries for key market infrastructure components, through cross-country clearing and settlement arrangements and by linking CSDs to international counterparts could have considerable benefits (Gray et al., 2011).
- Enforcement of disclosure standards could be strengthened, particularly in the less advanced Southeast Asian markets and in China. Bringing country standards in line with the international financial reporting standards (IFRS) issued by the Board of the International Account Standards Committee, as Southeast Asian countries are committed to do by 2012, will be important to achieving more transparent disclosure.
- Harmonisation of standards and procedures used by country rating agencies, which is now being studied under the EMEAP, would further help to integrate regional bond markets and to help make up for their limited scale in most of the individual countries.
- Although a long-term objective, progressive development of derivatives markets will be important to improving the capacities of market makers and achieving broader, more liquid, and less volatile markets. Rudimentary derivatives markets, mainly for futures and options, have been established in China, India, Malaysia and Singapore but with limits on access and other restrictions. The derivatives markets' array of instruments needs to be broadened over time as regulatory and financial institutions' capacities to manage their risks improve.

Figure 1.25. **Corporate bonds held in Malaysia and Thailand, by institutional investors**



Note: * Pension fund for Thailand.
Source: Asia Bond Monitor, April 2012.

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Caution needs to be maintained in using direct controls to limit or influence the structure of capital inflows. Capital controls that are maintained for prolonged periods tend to inhibit development of domestic financial markets (Eichengreen and Luengnaruemitchai, 2006). Prolonged application of capital controls is especially likely to be counterproductive for ASEAN markets given that need for foreign participation to sustain sufficient scale.

Cambodia, Lao PDR and Viet Nam face challenges from their extensive dollarisation

Extensive use of multiple currencies for transactions, which has become known as "dollarisation", is common in developing countries. Most often, dollarisation is manifest by the circulation of currency and the use of bank deposits denominated in United States dollars alongside the official currency controlled by a country's central bank.[13] In some countries, the dollar is legally permitted to be used in private transactions although it is not officially legal tender ("semi-official" dollarisation); while in others the dollar's use is either restricted or illegal and largely confined to the informal economy or "black markets" ("unofficial dollarisation"). Dollarisation most often arises when the purchasing power of the domestic currency becomes very unstable and unpredictable (Box 1.7).

Box 1.7. **Economic conditions behind dollarisation**

Generally, dollarisation develops in economies when the purchasing power of the official currency becomes very unstable to the point that use of a more stable alternative is preferable despite the generally higher transaction costs involved. Countries with extensive dollarisation tend to be relatively open developing and transitional economies with a recent history of high inflation and unstable foreign exchange values for their currencies. In such countries, individuals and businesses often prefer to use foreign currencies to pay for their imports owing to lack of confidence in the stability of their national currency. Use of the foreign currency in such circumstances can provide a more stable and predictable cost of imported goods than use of the official currency. Additionally, underdeveloped financial and banking systems, weak legal and institutional structures, and political and economic instability also contribute to the likelihood that dollarisation will become extensive (Menon, 2007).

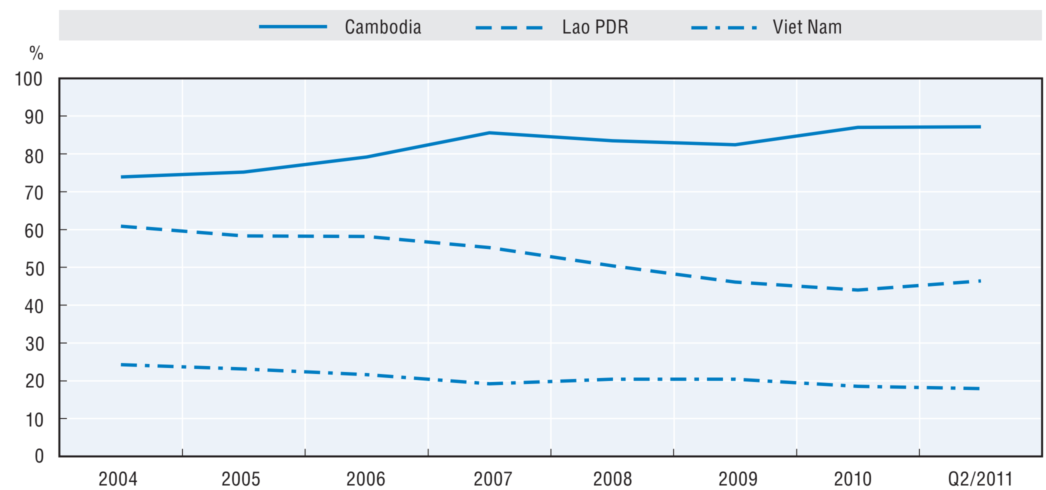
In Southeast Asia, dollarisation is most extensive in Cambodia, followed by the Lao PDR and Viet Nam. Foreign currency deposits amount to nearly 90% of M2 in Cambodia versus 50% and 20% respectively in the Lao PDR and Viet Nam (Figure 1.26). Foreign currency deposits are almost entirely denominated in USD in Cambodia and Viet Nam and in USD and Thai bhat in the Lao PDR. Households in Viet Nam also hold substantial amounts of gold.[14]

In Cambodia, the USD has been widely used as a medium of exchange, store of wealth, and unit of account. Dollarisation began in the early 1990s as large amounts of foreign aid and other foreign assistance and FDI – which reached nearly USD 2 billion in 2009 – made dollar currency and deposits widely available. Local currency is typically used for trade in the countryside for agricultural products and for the payment of taxes and public utility bills. Over 95% of banking system deposits are denominated in the USD. A substantial amount of USD currency is also used, although monetary statistics do not report their level.

Dollarisation in the Lao PDR was dominated by the Thai baht until the Asian financial crisis in 1997-98. Foreign currency deposits as a share of M2 rose from 20% in 1991 to nearly 80% in 1999. After that crisis, the USD became the dominant foreign currency in the country. Dollarisation has been driven by two main forces. First, a series of large depreciations in the value of the Lao kip have led to a flight from the local currency in circulation. Second, the huge cross-border trade arising from the Lao PDR's geographic and cultural proximity to Thailand has fostered the holding of large amounts of Thai baht denominated currency and other financial assets in the Lao economy. This tendency has been further reinforced by the high degree of openness of the economy, the deregulation of current and capital account transactions, and remittances from Lao living abroad. Greater macroeconomic stability that has been achieved since the Asian financial crisis has led to a gradual decline in dollarisation, although it remains high.

Figure 1.26. **Dollarisation in Cambodia, Lao PDR and Viet Nam**

(Ratio of foreign currency deposits to M2)



Source: IMF, ADB and national sources.

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Dollarisation in Viet Nam started with the transition towards a market economy that began in the wake of the hyperinflation of 1986–88. Dollarisation, and the rise in domestic gold holdings, was initially driven by the loss of confidence in the local currency arising from a long period of volatile and high inflation. In addition, low levels of domestic saving together with the difficulty of raising funds in local currency at longer maturities have encouraged borrowing from abroad, leading to extensive dollarisation of liabilities.

Holdings of dollar deposits soared from 9.4% of M2 in 1988 to 41.2% in 1991. In 1989, successful monetary reforms, comprising price controls, unification of the exchange rate regime, and introduction of foreign currency deposits, brought a dramatic decline in inflation rate to 35%. Since then, authorities have been more successful in their exchange rate policy and in controlling money expansion and inflation. Dollarisation fell back from the 1991 peak to 22.4% in 1997 and has declined gradually further since then.

Dollarisation has had some benefits but has complicated monetary policy

Dollarisation can bring some benefits. Dollarisation allows individuals and businesses to at least partly avoid risks from high inflation and other instabilities in macroeconomic policies and thereby somewhat reduce the costs they impose on the economy. Dollarisation can reduce incentives for governments to run unsustainable fiscal deficits since the governments cannot as easily finance budget shortfalls by printing money.

However, the benefits of dollarisation come with considerable cost that makes dollarisation a "second best" response to situations of great macroeconomic instability. Dollarisation reduces the revenues accruing to the government through its issue of domestic currency and base money ("seignorage"). It also limits the power of central banks as the lender of last resort given that they issue only one of the several currencies that the public is willing to hold.

The use of multiple currencies can result in economic authorities losing control over monetary and exchange rate policies. The ability of the private sector to switch between the local currency and the dollar or other foreign currencies makes it more difficult for central banks to control the money supply through their determination of base money, reserve requirements and/or policy interest rates. The demand for local money is also likely to become less stable, making the effect of changes in the domestic money supply on the economy less predictable. Consequently, the burden for macroeconomic stabilisation falls increasingly on fiscal policy. The instability in the demand for local money is also likely to lead to greater volatility in the exchange rate of the local currency.

Largely for these reasons, the adjustment to major external shocks can be more prolonged and painful when dollarisation is extensive. For instance, the 1997 Asian financial crisis involved a collapse in confidence in the currencies of the countries most affected that led to very large and prolonged contractions in domestic output, consumption and investment. The potential fall in the exchange rate and the resulting contraction in economic activity from a comparable loss in confidence in the domestic currency could be especially great for Cambodia, Lao PDR and Viet Nam, given their extensive dollarisation.

The experiences of the three countries in conducting monetary policy illustrate the complications posed by dollarisation. In Cambodia, where the monetary system is dominated by cash transactions, monetary policy has aimed at price stabilisation since the establishment of the National Bank of Cambodia (NBC) in 1994. Broad money (M2) and bank deposits have gradually grown, reflecting the robust economy and improved market confidence in the banking system. However, the share of the domestic currency, the riel, in bank deposits and lending has stayed quite low. Since the economy is highly dollarised, the NBC cannot effectively control the supply of riel money. Instead, the NBC uses open-market-operations (OMO) through auctions of dollars to maintain the foreign exchange rate on a path that preserves domestic price stability. Since 2005, the NBC has been the sole conductor of dollar auctions with the objective of achieving better money supply management. The NBC has built a track record of maintaining the exchange rate at a level that contributes to price stability. Through its dollar auctions, the bank has been able to keep market exchange rates close to its targets. However the use of the exchange rate as the monetary policy intermediate target has been complicated by its vulnerability to seasonal fluctuations.

In the Lao PDR, dollarisation has helped to limit capital flight from the economy and has fostered development of the domestic financial system by allowing residents to deposit their foreign currency in domestic banks. Nonetheless, lower demand for domestic money and the very limited financial intermediation in the economy has meant that financing the budget by borrowing from the central bank has become more costly in terms of inflation. During the Asian financial crisis in 1997-98, the Lao PDR experienced difficulty as the kip rapidly depreciated in response to the high inflation during that period. Moreover, the economy has been vulnerable to solvency and liquidity risks due to currency mismatches and sudden losses in business confidence. As in Cambodia, de-dollarisation would help to improve the effectiveness of macroeconomic policies but is only achievable over the longer run through restoration of confidence in the domestic currency and greater stability in its exchange rate in relation to the US dollar and the Thai baht.

In Viet Nam, dollarisation also has helped to deepen financial markets and foster credit expansion in an economy with a relatively low national saving rate. However, high dollarisation has created risks in the financial system in terms of currency mismatches as well as weakening the ability of the State Bank of Viet Nam (SBV) to respond to economic shocks through changes in the money supply and the exchange rate. Additionally, it has been difficult to reverse dollarisation in long-term USD-denominated assets and banks' USD deposits and loans.

The effectiveness of macroeconomic policies in all three countries would be improved if dollarisation could be reduced to much lower levels. Achievement of this objective, however, is a long-term goal that can only be accomplished by restoring confidence in the stability of the domestic currency, which, given past history, is likely to take some time. A number of policies to manage the consequences of dollarisation in the medium term while encouraging its reduction over the longer term are needed.

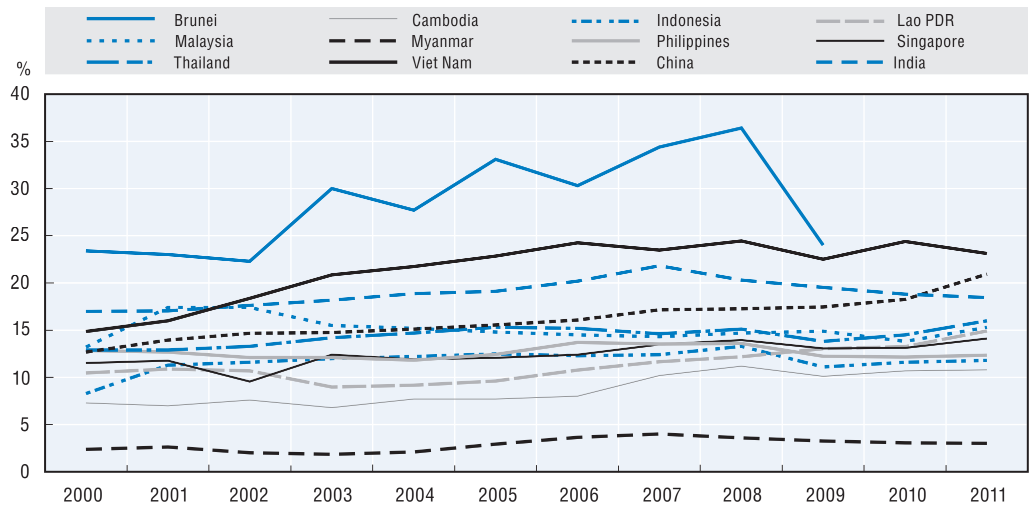
- In principle, the central bank could promote greater use of the domestic currency through the banking system, for example by providing bank refinancing in national currency for domestic operations. Development of markets for local currency denominated financial assets would also help to encourage a shift away from foreign currencies.
- The authorities could pursue greater stability in the exchange rate between the local and foreign currencies in order to improve the stability of the purchasing power of the former. However, this could require substantial official reserves of foreign currency.
- Improvement in payment systems is required to encourage transactions in domestic currency by reducing transaction costs and by supporting local currency markets in the formal financial system.
- Regional monetary co-operation and integration can help foster de-dollarisation by establishing payment mechanisms that reduce demand for USD.

Fiscal capacities need to be strengthened through better revenue mobilisation

Southeast Asian countries as well as China and India face formidable challenges in the medium term to their fiscal capacities to sustain robust growth driven by domestic demand while fostering continued growth of the middle class and poverty reduction. Improving the mobilisation of government revenues will be an important key to meeting these challenges. Tax structures need to be adapted to the structural economic changes middle-class development is bringing and to sustain the international competitiveness of the region's industries. Institutional capacities to collect revenues need to be strengthened to ensure that revenues are raised with as little as possible loss of economic efficiency.

Figure 1.27. **Trends in total tax revenue in Southeast Asia, China and India**

(total tax revenue to GDP)



Note: Data refer to revenues of central government, except for China and India, where data refer to general government.

Source: CEIC, ADB Key Indicators 2012 and IMF WEO database.

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The ratio of total taxes to GDP averages about 14% of GDP for Southeast Asia as a whole (Figure 1.27). This average of Southeast Asia is well below the ratio of 21% of GDP for China and also somewhat below that of 18.5% for India (including taxes raised by India's state governments). The tax ratios vary considerably across Southeast Asia, with the ratios for Cambodia, Lao PDR, Indonesia and the Philippines being roughly two-thirds of that for Thailand and about half that of Viet Nam, the country with the highest ratio. For some countries, a significant portion of these revenues are derived from non-tax sources: non-tax revenues primarily from sales of oil and other minerals amount to nearly one-third of total revenues for Brunei and one-quarter of revenues for Malaysia and Indonesia.

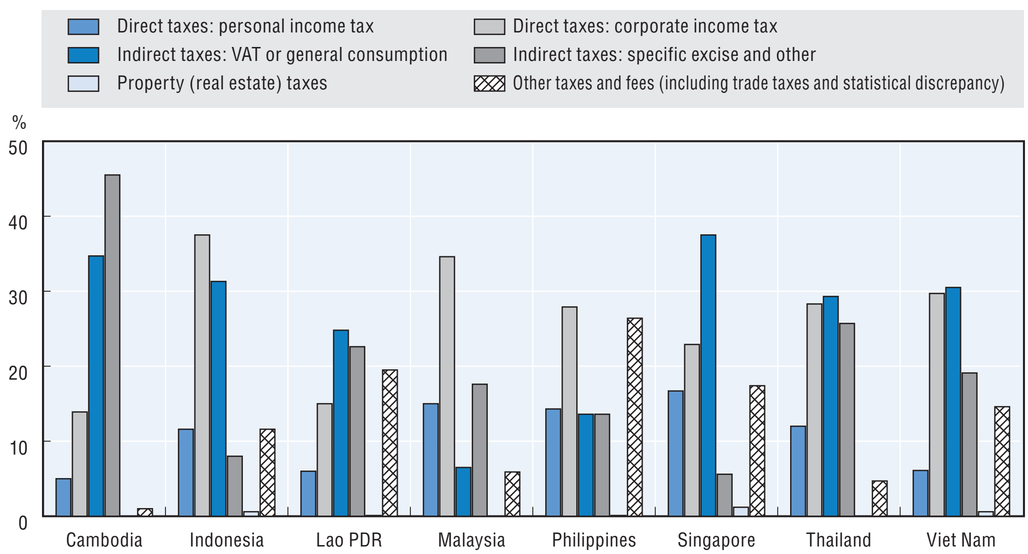
Both revenue and tax ratios to GDP are considerably lower for Emerging Asian countries than those found in OECD countries, where tax revenues average nearly 33% of GDP. This pattern is consistent with the broader tendency for government revenues as a share of GDP to rise as per capita incomes increase. However, the tax ratios for at least some Southeast Asian countries appear to be lower than their income levels might suggest. The tax ratios for Indonesia and the Philippines are noticeably below the median ratio of about 16.5% of GDP for lower middle-income developing countries (IMF, 2011a), although the ratios for Thailand, Viet Nam, India and China are above the median. The tax ratios for Malaysia and Singapore are also below the median for their income group (upper-middle income and high income respectively).

Tax revenue ratios to GDP have remained roughly unchanged on average over the past decade in most of the Southeast Asian countries. However there has been a rising trend in the ratio in Cambodia, China and Viet Nam, due in large part to major reforms these countries undertook beginning in the late 1990s.

The structure of tax revenues in Southeast Asia and other Asian developing countries is broadly consistent with that of developing economies generally, although again there is considerable variation across the region. The main sources of tax revenue come from direct taxes on personal and corporate income and indirect taxes from value added or general sales taxes and excise taxes on specific goods (Figure 1.28). Social insurance contributions for old-age pensions, which make up roughly a quarter of total tax revenues in the OECD, are either not yet instituted or are relatively limited in developing Southeast Asia, China and India. Revenues from customs duties, although they have declined over time owing to the liberalisation of international trade, still account for a significant portion of total revenue in many countries, particularly in Cambodia, the Philippines, Thailand, Viet Nam and India, where they amount to 1-3% of GDP. Real property taxes are generally a small portion of total tax revenues.

Figure 1.28. **Structure of tax revenues in Southeast Asia**

(percentage of total tax revenues)



Source: CEIC and OECD Development Centre staff calculations.

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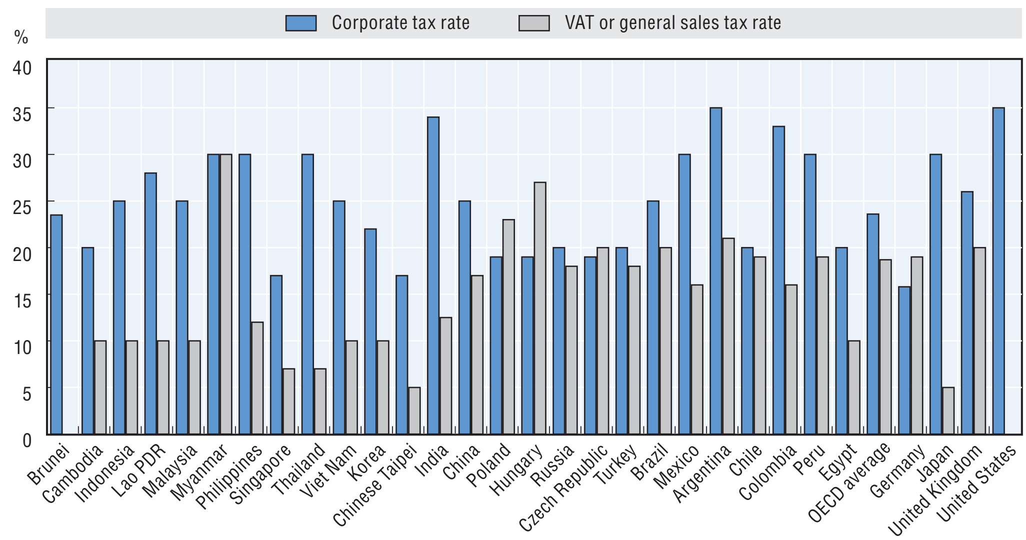
Southeast Asian countries tend to be more reliant on indirect tax revenues and less reliant on direct taxes on corporate and personal income than OECD countries. Total direct taxes are less than total indirect taxes in most of the region and in China, whereas they are more than twice indirect taxes in the OECD. Malaysia and the Philippines are exceptions to the Southeast Asian pattern, the former in large part because of corporate tax revenues on oil companies.

An even more distinctive feature of the Emerging Asian tax systems is the dominance of corporate taxes in direct tax revenues. Corporate income taxes make up the bulk of direct tax revenue in all the Southeast Asia countries as well as China and India. In the OECD, corporate income taxes are generally no more than half, and often much less than half of total direct tax revenues.

Value added tax (VAT) rates in Emerging Asian countries are generally no higher and in some cases lower than those in other Asian developing countries (Figure 1.29). The statutory value added tax rate in the majority of Southeast Asian countries is 10%, with the Philippines slightly higher at 12% and Singapore and Thailand lower at 7%. Most of these rates are lower than that of India (12.5%) and well below the 17% applied in China.

Many developing countries in Latin America and lower income countries in Europe also apply higher rates than those in Southeast Asia.

Figure 1.29. **Corporate and value added tax rates in Asia and other selected countries**



Notes: In the case of corporate tax rates, where a progressive (as opposed to flat) rate structure applies, the top marginal rate is shown (e.g. Thailand, China).

In the case of VAT or general sales tax rates, where multiple rates are applied, the top rate is shown (e.g. Malaysia, Myanmar).

Sources: OECD and www.taxrates.cc.

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Statutory corporate income tax rates range between 25% and 30% in most of Emerging Asia, slightly above the average for OECD countries but roughly in line with other developing countries. The statutory rates in the Philippines (30%) and India (an average rate of 34%) are high by international standards while that of Singapore is relatively low.[15] However as discussed further below, statutory corporate tax rates are not particularly indicative of average corporate tax burdens because of extensive exemptions and preferences in corporate tax codes.

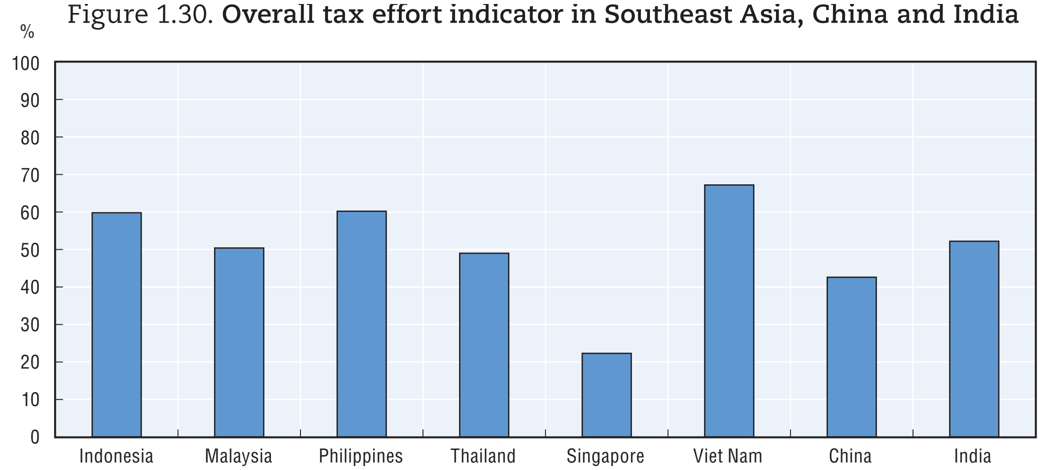
Tax systems are underperforming in revenue generation

Emerging Asia faces two sets of obstacles in mobilising government tax revenues: a policy gap and a compliance gap. First, the scope of tax policies is constrained by the relatively low incomes of most of the population and the earlier stage of development of the business sector compared to more advanced economies, creating what is known as a policy gap. Personal income taxes are typically levied on only a small fraction of the population, those with the highest incomes, since they would impose unacceptable burdens on lower income households and would be too expensive to collect relative to their potential yield. Similar considerations limit the scope for collecting corporate income and other business taxes. The use of tax exemptions, preferences and subsidies for policy goals, such as poverty reduction or to promote “infant industries” – although hardly unique to developing countries – further limits tax bases. Second, collection of tax revenues that are legally due is limited by the early stage of development and other institutional weaknesses in tax administration and law enforcement and by the large amount of economic activity carried out in the informal sector, facilitating widespread tax evasion and smuggling – the so-called compliance gap.

Highly open economies, such as those of many Emerging Asian countries, can face particularly acute constraints on tax policy scope and collection. Most taxes, but particularly business taxes, raise costs in export industries and can, if too high relative to competitor countries, discourage direct investment inflows. This competition for FDI has led to the proliferation of tax holidays, exemptions from certain taxes, and other tax preferences for foreign and domestically owned export businesses, in developing countries. Collection of taxes on the domestic activities of foreign multinational companies can be difficult given the capabilities of these countries to book profits offshore through transfer pricing and other devices.

Existing tax systems in many Emerging Asian countries are underperforming in terms of revenues they are generating. The net result of tax policy and compliance gaps is that tax revenues collected are nearly always lower than those that would theoretically be collected if legislated tax rates were applied uniformly and fully collected. A number of studies have attempted to empirically measure the maximum tax revenues that could be collected in order to compute the ratio of actual tax revenues to this theoretical maximum (see IMF, 2011b). This ratio provides a rough indication of the effectiveness of country tax systems in mobilising revenues. The ratio tends to be lowest for least developed lower income countries and to rise with per capita income (although the relation is only very rough).

Figure 1.30. **Overall tax effort indicator in Southeast Asia, China and India**



Source: OECD Development Centre's estimates based on IMF data.

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In Asia, overall tax "effort" by this measure is the lowest in China and the highest in Viet Nam (IMF, 2011b; see also Pessino and Fenochietto, 2010). All of these ratios except that for Viet Nam are below the median (63%) for lower middle-income developing countries. The ratios for Malaysia and Singapore are also below the median for countries in their income group. These measures are far from conclusive – there are many legitimate reasons why countries may not raise all the revenue that they theoretically could from their taxes.

Reforms in several areas could substantially improve revenue mobilisation

Emerging Asian countries have taken a variety of policy initiatives over the past decade to improve the effectiveness of their tax systems. Viet Nam made major reforms to its tax structure in the late 1990s as part of its preparation for membership in the

World Trade Organization, introducing a value added tax and reformed enterprise tax system. These reforms were responsible for much of the impressive increase in revenues that followed, from 15% of GDP in 2000 to 23% in 2011. The Philippines introduced a major reform of its value added tax system in the middle of the last decade (Botman et al., 2008). China has undertaken broad reforms to its tax system under the 11th five-year plan (2006-10), including: moving from a production to a consumption based value added tax; unification of the corporate tax regimes for domestic and foreign companies; and unification of the rural and urban tax regimes (through abolition of the agriculture tax). As discussed below, further reforms to the VAT are planned for the 12th five-year plan over 2011-15.

There has been less change in tax structures over the past decade in other Emerging Asian countries. In 2009, the government of India outlined a blueprint for overhauling the tax system, including a lowering of the corporate tax rate to 25% and streamlining of the personal income tax regime. However, most of the reforms have not yet been implemented and their adoption has been further complicated by controversy over the government's proposal to change the rules for taxation of domestic investment transactions by foreign companies. Reforms in other countries have focused on improving collection through strengthened tax administration systems. Indonesia reorganised its tax organs beginning in 2007 to better target key different segments of the taxpayer population and managed to achieve a four-fold increase in registered taxpayers.

Most ASEAN countries are considering or have incorporated significant fiscal reforms in their medium-term development plans. The incorporation of major tax reductions with no specified termination date in the stimulus packages adopted by Indonesia and the Philippines in the wake of the 2007 global financial crisis has increased the need for tax reform in these countries. The Indonesian government has set of goal of achieving a revenue to GDP ratio of above 14% by 2014 (IMF, 2011a). The government of Thailand has been evaluating a range of reforms to personal and corporate income taxes and to consumption taxes, although no specific plan has yet been decided upon.

Three areas of tax reforms have particular potential to improve revenue mobilisation and the overall efficiency of the tax systems in many ASEAN countries.

First, reforms to the VAT have great potential for substantial increases in revenue in many ASEAN countries. Broadening the VAT base and improving revenue collection could raise revenues equal to several percentage points of GDP in Indonesia, Malaysia and the Philippines.[16] The "productivity" of the VAT systems in terms of the revenue actually raised compared to the revenue that would be raised if the statutory rate were applied to the entire (consumption) base is quite low in these countries, both in absolute terms and relative to the median of countries in their income group. For example, the ratio of realised to potential VAT revenue is only about 20% in the Philippines and 56% in Indonesia (IMF, 2011a).[17] The large number of important sectors that are either exempt from the VAT or which receive preferential rates are substantially responsible for these low rates. For example, Indonesia's present VAT excludes mining and drilling activities, along with most of the financial, transport, and hotel and restaurant sectors.

Studies suggest that base broadening and improved collection could raise considerable revenues at existing statutory rates in these countries. Raising Indonesia's VAT yield to full realisation would add on the order of 2 percentage points of GDP to total tax revenues while raising it only to the average of lower middle-income countries could raise as much as 1% of GDP in additional revenues.[18] Analogous calculations suggest that

Malaysia and the Philippines could generate even larger revenue increases by raising VAT efficiency.

Increases in the statutory VAT rates in those countries where they are now comparatively low would raise substantial further revenues. Raising the statutory VAT rates in Thailand and Singapore to the 10% that is most common in Southeast Asia could raise more than 2 percentage points of GDP in new revenues with no change in the tax base. An increase in the VAT is currently being considered in Thailand, although no decision has yet been taken.

Reforms to VAT regimes to harmonise treatment across sectors and improve efficiency in collection could also bring substantial other benefits. At the beginning of 2012, China began an ambitious new phase in its reform of its VAT system, aimed at extending that system to transport and other services in place of the business tax on those sectors. The programme began with an experimental pilot programme in Shanghai, followed by Beijing beginning 1 September 2012, and will ultimately be extended to the entire country. Achievement of a fully integrated VAT system, similar to those in many OECD countries, has the potential to significantly reduce economic distortions and burdens imposed by a fragmented system. Initial results from the pilot programme suggest that many businesses have experienced reduced burdens due to better ability to account for VAT charges in inputs and other factors.[19]

The scope for further increases in corporate tax rates is constrained but efficiency could be improved considerably

Southeast Asian economies probably have little if any scope for increasing corporate tax revenues through higher rates given their openness, the importance of foreign multinationals in their export sectors, and increasingly fierce international competition. Indeed, these forces, which have already helped spur reductions in corporate income tax rates in many higher income countries, may make it difficult to keep corporate tax revenues growing in line with the overall economy.

The potential to increase revenues, as well as overall economic efficiency, by increasing the productivity of the corporate tax system is considerable. Corporate tax systems in ASEAN and many other developing countries contain extensive exemptions and preferences that, probably even more than with the VAT, greatly reduce revenues collected relative to the maximum that could be realised if the tax were applied uniformly. ASEAN countries are hardly unique in granting such preferences but in some cases have been more generous in doing compared to the average of other developing countries in the region. One estimate suggests, for example, that Indonesia could raise additional corporate tax revenues of around half a percentage point of GDP by raising the productivity of its corporate income tax to the average of Asia-Pacific developing economies (IMF, 2011b).

Tax preferences to attract foreign businesses and investments are especially inefficient in a regional context

The low productivity of corporate tax systems owes much to the extensive use by developing economies, especially those most dependent on international trade, of tax and other preferences to attract foreign businesses and other forms of FDI. These preferences take a wide range of forms, including "tax holidays" exempting foreign businesses in a country from various taxes for a certain period of time, exemptions from import duties, preferential tax rates after the holiday expires, and exemption from or expedited treatment from government regulations. These tax concessions are typically applied to firms locating in special economic zones or free trade areas established to encourage inward FDI and export businesses.

Tax and other preferences for foreign businesses in special economic zones were a central element of China's development strategy during the first two decades of the reform period (Naughten, 2007). They have been used extensively by most Emerging Asian countries, particularly those most open to international trade.

Despite their widespread use, tax and other concessions for foreign firms and domestic exporters tend to be of low cost effectiveness in terms of the benefits relative to the tax revenues forgone, for several reasons.

- The preferences tend to be poorly targeted since firms that would have located in the countries typically receive the same concessions as those for whom the concessions were decisive in their choice of location. Moreover, foreign firms for whom the concessions are decisive may well relocate once concessions in the tax holidays expire.
- Foreign investment tax preferences can lead to misallocation of resources by disadvantaging domestic firms not eligible for the preferences and firms that produce for the domestic market versus those that produce for export.
- The tax preferences can be very expensive in terms of forgone revenues, both from the corporate income tax as well as from VAT and other taxes. Recent estimates suggest such preferences in the Philippines may sacrifice as much as 1-2% of GDP in lost tax revenues (Botman et al., 2008).

The effectiveness of investment tax preferences has been substantially further eroded by competition among Asian countries in their provision. An individual country is unlikely to be able to gain any durable improvement in its relative competitiveness through such means since its competitors are likely to match its concessions. This seems to have happened in Emerging Asia, where investment tax preferences are comparable across competitor countries, providing little or no advantage in attracting investment.

Investment tax preferences may have been more cost effective at earlier stages of development as a (second-best) policy to compensate foreign firms for imperfections in underdeveloped domestic markets and inefficiencies in government regulation. However, Southeast Asian countries as well as China and India have advanced to the point where direct policies to address such imperfections are likely to be preferable to using tax concessions as compensation.

These considerations suggest that it would be useful for Emerging Asian countries to review their systems of investment tax and other preferences with a view to reducing their scope over time. Such reduction could help to compensate for a further lowering of corporate statutory tax rates that may be necessary, especially in the Philippines and Thailand where the rates are now somewhat above those in most of the rest of the region, as well as to raise overall tax revenues (Botman et al., 2008). Reduction in investment tax preferences is likely to be most feasible if done in a regional context and in consultation with other developing Asian competitors to limit the disincentives from unproductive tax competition.

There should be scope to raise revenues from personal income, real property and environmental taxes

In addition to reforms of the main tax sources, a number of other taxes are relatively under-used in some or all ASEAN countries. Consideration could be given to expanding their use, either to increase overall tax revenues or to finance reductions in corporate or other taxes where they are now comparatively high.

As noted above, personal income taxes in developing countries are generally lower than in OECD countries in large part because the tax cannot be imposed on much of the population without undue hardship. However, the scope for greater reliance on personal income taxes should increase as per capita incomes rise. Comparison of personal income tax yields relative to GDP across ASEAN countries suggests that those of Malaysia and Singapore are somewhat low in relation to GDP than their income levels might otherwise suggest. The ratios in these two countries are well below that of China (3.4% of GDP in 2009) and about equal to that of India, both of which have lower per capita incomes. There may also be scope to raise personal income tax revenues in Thailand. Since many other considerations affect the optimal level of a given type of tax, this argument does not mean that these countries necessarily should raise their income tax revenues but it does suggest that they have the capacity to do so.

Real estate taxes have the advantage of posing relatively limited distortions to the economy owing to the immobility of their base. However, overall revenues from real estate taxes are generally very low in most developing countries, often under 0.1% of GDP and infrequently exceed 0.5% of GDP (IMF, 2011b). The low revenue yield is due in large part to poorly defined property rights, difficulties in valuing real property, and weak enforcement. These difficulties are likely to be greatest for rural areas; and more urbanised economies, notably Singapore, not infrequently have above average shares of real estate taxes in overall taxes.

Real estate taxes can be and often are much more important in the tax base of local governments. Expansion of real estate taxes for local governments would allow these authorities to expand services and could help to reduce gaps in fiscal resources among regions. Country experiences suggest that difficulties in real estate taxation can be reduced over time by improving capacities of local tax administrations and through adaptation of valuation and other tax mechanisms (e.g. use of unit land taxes as in Viet Nam) (IMF, 2011b). Efforts to improve the capacity for real estate taxation could help to increase local government revenues especially in the Philippines and Thailand, where they are now little utilised compared to some other Southeast Asian countries.

Finally, environmental tax instruments (ETIs) are at a very early stage of development in Emerging Asian countries. The countries tend to use subsidies rather than taxes to encourage environmentally beneficial behaviour. Only Singapore and Thailand have gasoline taxes. Use of ETIs in Southeast Asian and other Asian developing countries is constrained by a number of factors (OECD, 2011a).

- Tax administrations are less developed than in OECD countries, which limits the ability to impose and collect the taxes.
- Pollution and environmental standards, which are necessary to the effective design of ETIs, are being developed but are still incomplete.
- Concerns over the burden of ETIs on poor households and certain industries and on international competitiveness have limited their use and partly account for the greater use of subsidies.

There are signs of movement toward greater use of ETIs in Emerging Asia. Viet Nam instituted a broader environmental tax in 2011, applying to fuels and lubricants as well as certain pesticides and herbicides, preservatives, disinfectants and plastic bags (OECD, 2011a). In October, 2011, China's State Council issued guidelines for environmental policy reforms, including study of the possible future implementation of an environmental tax.[20]

Expansion of the use of ETIs over time as tax administration capacities are improved could raise modest but significant revenues. OECD countries raise an average of about 1.6% of GDP from environmental levies and some of the lower income OECD countries, notably Chile, raise more than 1% of GDP from these taxes. Use of environmental taxes, combined with reduction or elimination of subsidies that encourage use of environmentally damaging substances, would also bring considerable benefits in fostering greener growth.

Better targeted subsidies would also improve fiscal capacities

Most Emerging Asian countries provide considerable direct or indirect price subsidies to households for the purchase of food and other basic commodities and services. The subsidies usually go directly to households but in some cases are indirect, most often through subsidies to energy producers to compensate for controls on prices below world levels. The subsidies are functionally equivalent to taxes with negative rates ("negative taxes").

Subsidies are most extensively applied to food and energy but they are also used to support other expenditures, including for education and health. The total cost of the subsidies is substantial. In Southeast Asia they range from around 1% of GDP and 5% of total government revenues in the Philippines and Thailand to nearly 5% of GDP and 25% of overall revenues in Indonesia and Malaysia. Total subsidies in India, including those implicit in price ceilings on energy and other regulations, amounted to nearly 9% of GDP in 2008 (OECD, 2011a). The cost of subsidies has grown considerably over time. In Malaysia, they are now more than ten times larger in relation to total government revenues than they were in the early 1990s (ADB, 2012b). The cost of fuel and energy subsidies in Indonesia for 2012 has been projected to be nearly double that in 2010 (Ardiansyah, 2012).

Subsidies have typically been instituted as a means of income support for poorer households. However, they are often an inefficient means of achieving their goals for three reasons.

- Price and other direct subsidies for the purchase of goods and services usually apply to all households and thus much of the benefits go to better off households. Targeted subsidies tend to be inaccurate as it is often very difficult to identify those who are most burdened by the commodity being subsidised.
- The cost to the government budget of price subsidies on basic commodities can be highly volatile and unpredictable owing to variations in world commodity prices. Increases in the cost of subsidies when international commodity prices surge, as they did during 2010 and the first half of 2011, can undermine efforts to maintain fiscal discipline.
- Price subsidies distort resource allocation and in some cases encourage economically undesirable behaviour, such as the overuse of products detrimental to environmental quality or other social goals.

Price subsidies for fuel and energy are particularly problematic for all three of these reasons. Fuel and energy subsidies in Indonesia and Malaysia, where they are most heavily used, amounted to nearly than 10% of total tax revenues in 2010, and are also important in Thailand, where they amount to nearly 2% of revenues (OECD, 2011a). Fuel and energy subsidies have been a major driver of the overall increase in the cost of subsidies in Indonesia and Malaysia.

While intended to help poor households, fuel and energy subsidies tend to be especially badly targeted, in part because they indirectly subsidise automobile and other purchases that are affordable only by better off households. The World Bank has estimated that in sub-Saharan Africa, where such subsidies are also used extensively, households in the highest quintile of the income distribution receive on average nearly six times as much from fuel subsidies as households in the bottom quintile.[21] The government of Indonesia has estimated that nearly 70% of its fuel subsidies go to the upper two income quintiles.[22] In India, more than half of subsidies for irrigation and for fertilisers have gone to medium and large scale farms; and households below the official poverty line receive only a small portion of food subsidies (OECD, 2011b).

Fuel and energy price subsidies are also detrimental to government efforts to improve environmental quality and to promote greener growth. Many of the major cities in the Emerging Asian region are suffering from severe air pollution arising in substantial part from the burning of kerosene and other household fuels and from automobiles. Fuel and energy price subsidies have encouraged overuse of these fuels compared to less polluting alternatives. In Malaysia, for example, per capita consumption of fuels is nearly 4.5 times that in Thailand, where fuel price subsidies are considerably less.

Rationalisation of price subsidies in Southeast Asian countries would significantly reduce their burden on government revenues while better promoting government goals. Rationalisation can be best achieved by reforms in two areas.

- Food and other non-fuel subsidies should be replaced where possible by direct cash payments to the most needy households. This would allow a reduction in total subsidies without adverse consequences to those the subsidies are supposed to help.
- Fuel and energy subsidies should be reduced over time and ideally eliminated. Lower income households could be compensated for the additional burden of higher fuel/energy costs through direct cash payments (not based on fuel consumption) or, in the case of lower income households above the poverty line, by reductions in income taxes.

In 2010, India's government began a new reform of its energy pricing and subsidy regimes by deregulating the price of gasoline and by allowing state-owned companies to sell natural gas from new fields at market-determined prices. The government also raised the administered price for diesel, LPG, kerosene and declared its intention to deregulate their pricing at a future date. In that same year, the government of Malaysia began a promising effort to reform its subsidies regime by beginning a phased five-year reduction of subsidies on gasoline, cooking gas, electricity and road tolls, that was projected to save a cumulative total of USD 33 billion. The effort included measures to improve the targeting of remaining subsidies on poorer households, including cash rebates to motorcycle and small car owners. However the initiative was subsequently suspended. Indonesia's proposed budget for fiscal year 2012 includes measures to raise fuel prices and thereby reduce fuel subsidies, but the Parliament has so far rejected the plan.

Emerging Asia's expanding middle class: opportunities and challenges

Emerging Asia is being transformed into middle-class economies at a faster rate than in any other world region. The transformation into middle-class dominated societies creates both opportunities and challenges for governments in the region. Middle-class development can enhance growth by spurring technological innovation, accumulation of human capital, financial development, and improvement in government services.

However, realisation of these benefits is not automatic. In ASEAN as well as China and India, the development paradigm needs to place less emphasis on development of export industries and more emphasis on developing industries and services to meet the needs of the growing middle class.

- Policies need to foster development of competitive higher technology and higher value-added industries
- Human capital development through improved access to education and strengthened vocational and other skills training will be crucial.
- Countries need to improve the utilisation of their labour resources, in part by addressing youth unemployment and by addressing development gaps between regions.
- Reforms to migration policies at both the individual country and regional level would help to strengthen the benefits from migration to both sending and host countries and to reduce conflicts between the interests of migrant and domestic workers.

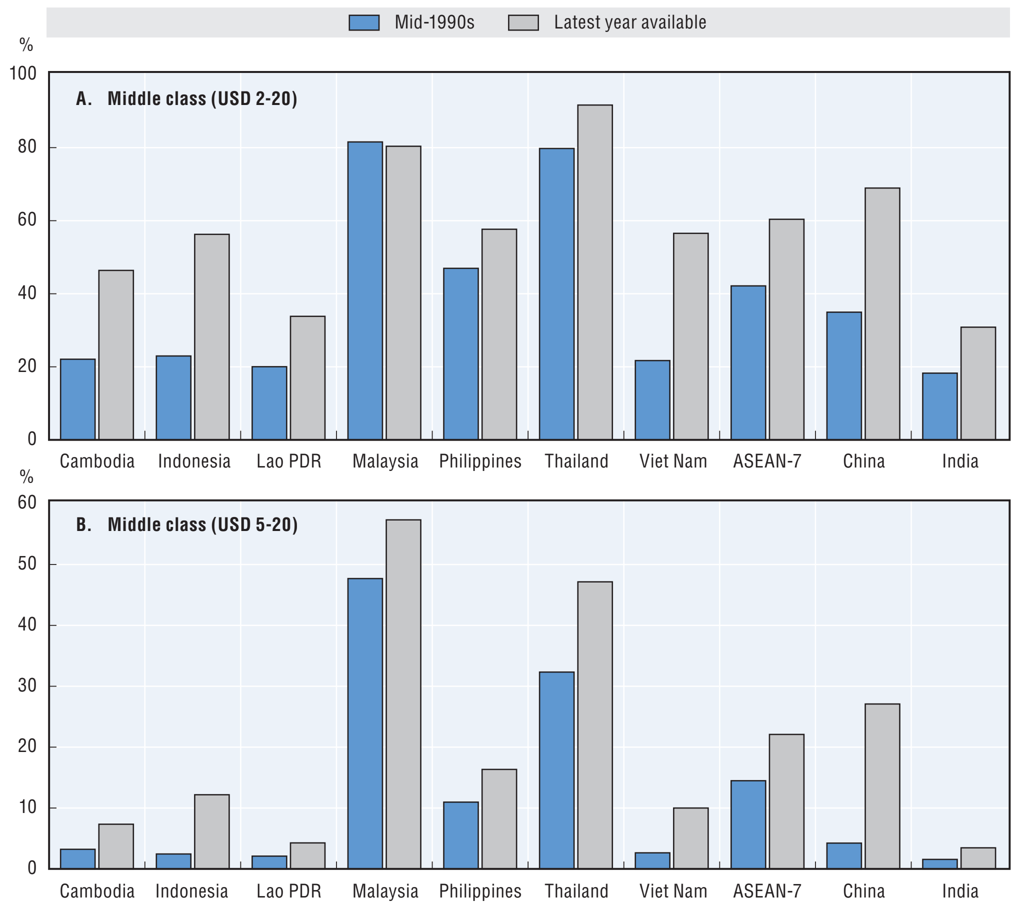
Middle-class growth in the region has been among the most rapid in Asia and has boosted consumption growth

Rapid growth in Southeast Asia and other developing Asian economies over the past two decades has produced a remarkable expansion in the middle class and decline in poverty. In 1990, according to survey data, only one-fifth of the population of the developing Asian region as a whole had "middle-class incomes", defined as USD 2 to USD 20 per person per day in purchasing power parity (PPP) (Box 1.8). Four-fifths of all households had poor or near-poor (poverty) incomes of less than USD 2 per person per day in PPP. By 2005, the middle-class portion had risen to 56% while the portion of those in poverty had fallen to just above 40% (Chun, 2010).

China has led the Asian region in middle-class growth but Southeast Asian countries have not been far behind. The portion of the population in China with incomes between USD 2 and USD 20 per person per day in PPP rose from 35.0% in 1996 to 68.9% in 2008, while the middle class in the seven largest Southeast Asian developing countries increased from 42.2% to 60.4% over the same period[23] (Figure 1.31). The middle class has also increased noticeably in India, although less rapidly than in China or Southeast Asia, and remains lower at just over 30.9% in 2009.

Middle-class expansion has been accompanied by a dramatic fall in poverty: nearly 65 million fewer people are now in poverty in the seven Southeast Asian countries than in the mid-1990s, and more than 400 million fewer in China. In the case of India, the number of poor has risen by an estimated 54 million people even though the proportion of poor to the total population has fallen, owing to its comparatively rapid overall population growth. The size of the middle class in Emerging Asia is still less than that in other major developing regions except for sub-Saharan Africa, but the gap has closed significantly over time.

Figure 1.31. **Size of the middle class in Southeast Asia, China and India**
(percentage of total population)



Notes: ASEAN-7 includes Cambodia, Indonesia, Lao PDR, Malaysia, the Philippines, Thailand and Viet Nam.
Mid-1990s: Cambodia, 1994; Indonesia, 1996; Lao PDR, 1997; Malaysia, 1995; the Philippines, 1994; Thailand, 1996; Viet Nam, 1998; China, 1996; India, 1993.

Latest: Cambodia, 2008; Indonesia, 2011; Lao PDR, 2008; Malaysia, 2009; the Philippines, 2009; Thailand, 2009; Viet Nam, 2008; China, 2008; India, 2009.

In the case of Indonesia, China and India the latest figures of the size of the middle class are estimates combining the separate urban and rural distributions, weighted by share of urban/rural to total population.

Source: World Bank; OECD Development Centre staff estimates.

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Box 1.8. **Defining the middle class in developing economies**

The middle class is typically thought of as the portion of the population that is neither very poor nor very wealthy by the standards of a country and whose spending and working characteristics differ from those of the poor and the wealthy. In OECD countries, the middle class is most often defined as most or all of the group between the lowest one-fifth of the income distribution and the highest one-fifth, corresponding to household income of approximately USD 20 000 to USD 100 000 per year, and within comparable ranges in PPP terms in other OECD countries.

In most developing countries, very few of the population have incomes above even the lower bound of the middle-class range in OECD countries. Yet there is a middle class in a meaningful sense in that it has distinctive characteristics that separate it from higher and lower income segments and whose members tend to think of themselves as middle-class.

Box 1.8. (contd.)

Different approaches to defining the middle class

A number of approaches have been taken to defining the middle class in developing countries, depending on the issue being analysed. Some studies have taken a relative approach, defining the middle class as those households within several intermediate deciles or quintiles within the income distribution. This approach can be used to analyse the growth and characteristics of this intermediate in comparison with lower and higher income groups in a specific country. However, partly because spending patterns and other characteristics tend to vary as income changes, this approach is less useful in comparing the middle classes across countries.

An alternative approach that is better suited to such analyses is to take an absolute approach by defining the middle class in terms of a range of incomes, in PPP terms, that is the same across countries. The discussion here follows recent studies by the Asian Development Bank and others in defining the middle-class income range as between USD 2 per-person/day and USD 20 per-person/day in PPP terms. By this definition, as noted in the main text, the middle class in lower income countries is essentially that portion of the population that is not poor (i.e. income below USD 2 per-person/day). Some other studies (see, for example, Banerjee and Duflo, 2008; and Easterly, 2001) have used somewhat narrower or wider income bands to define the middle class but these alternative definitions do not fundamentally alter the conclusions discussed here. Notably, defining the middle class as the portion of the population with incomes of between USD 5 and USD 20 per-person/day would imply considerably smaller middle classes. For example, the middle-class shares in China and India by this narrower definition would be about 27.1% and 3.5%, respectively, of the population instead of the 68.9% and 30.9%, respectively, under the broader definition used in the text. The middle-class share of the population in Southeast Asia would also be considerably smaller under the narrower definition. The broader definition may somewhat overstate the true portion of the population with characteristics distinct from those of the poor but the narrower definition is probably as likely to understate middle class size. Moreover, all of the main conclusions – about the rapid growth in the middle class, its relation to aggregate growth in per capita income, and about its different spending patterns and preferences in relation to poorer households remain valid under the narrower definition.

Data for measuring the middle class

The basic data for measuring the middle class in developing countries come from household surveys of income and expenditure taken in individual countries. Where complete, these provide estimates of the portion of households in each income group and the mean or median income of that group. In some cases, survey data on household expenditure are more available than household income and are used as a proxy for household income. Not all surveys report mean or median household income and in those cases corresponding figures taken from national income data can be used to construct the distribution. Even where survey data of the mean/median income figures exist, they often (especially for Asian developing countries) differ significantly from the corresponding national income accounts figures, most often leading to higher estimates of middle-class size and mean/median income than do the corresponding survey estimates (See Chun, 2010).

Source: Chun, 2010; Kharas, 2010.

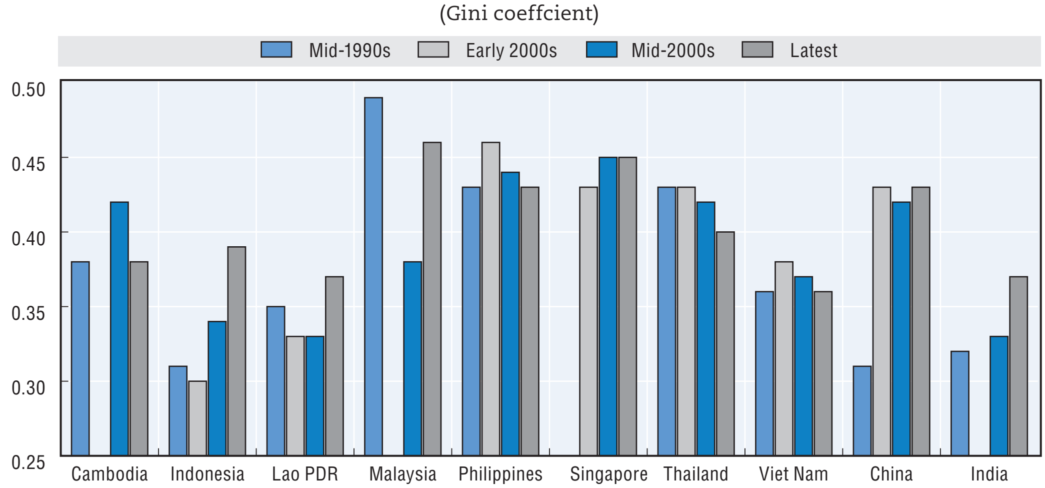
Not surprisingly, middle-class population shares are generally greatest in those developing Asian countries with the highest levels of per capita income, notably, in Southeast Asia, Malaysia and Thailand. The positive relation between middle-class size and per capita income is also reflected in the gaps in middle-class development between rural and urban areas. In China, where rural per capita income is about 36% of urban per capita income, the middle class in rural areas makes up 44% of the population compared to 89% in urban areas. Per capita income and the middle-class portion are likewise lower in rural compared to urban areas in India and Indonesia. Urban areas account for the bulk of the middle class in China and India (three-quarters and four-fifths respectively) but nearly half the middle class in India live in rural areas. However, the middle-class portion of the population has risen more rapidly in rural compared to urban areas in China and Indonesia.

The middle-class portion of the population in Southeast Asia has grown most rapidly in Cambodia, Viet Nam, Lao PDR and Indonesia, countries that had the lowest portions in 1999, and least rapidly in the countries where it was initially the highest (Malaysia and Thailand). Aggregate GDP growth accounts for most of the growth in the middle class, as illustrated by the fact that the countries recording the greatest increases in the middle-class portion have in most cases also had relatively rapid growth in per capita GDP (notably China and Viet Nam). However, there are exceptions to this pattern: India has also had relatively rapid growth in per capita GDP but relatively slower growth in its middle class; while Indonesia and Lao PDR rank higher in terms of middle-class growth than they do in per capita GDP growth.[24]

The impact of the expansion of the middle class on income distribution varies by countries. Since the early and mid 2000s, income distribution has became more equal in Cambodia, the Philippines, Thailand and Viet Nam as the middle class has expanded (Figure 1.32). On the other hand, albeit to a varying degree, income inequality has increased in Indonesia, the Lao PDR, Malaysia, Singapore, China and India. The case of China and India is especially striking as the Gini coefficient has increased considerably from 0.31 and 0.32 in the mid-1990s to 0.43 and 0.37 respectively.

Figure 1.32. **Income inequality in Southeast Asia, China and India**

(Gini coeffcient)



Notes: Mid-1990s: Cambodia, 1994; Indonesia, 1996; Lao PDR, 1997; Malaysia, 1995; Philippines, 1994; Thailand, 1996; Viet Nam, 1993; China, 1995; India, 1994.

Early-2000s: Indonesia, 2002; Lao PDR, 2002; Philippines, 2000; Singapore, 2000; Thailand, 2000; Viet Nam, 2002; China, 2002.
Mid-2000s: Cambodia, 2004; Indonesia, 2005; Lao PDR, 2002; Malaysia, 2004; Philippines, 2006; Singapore, 2005; Thailand, 2006; Viet Nam, 2004.

Latest: Cambodia, 2008; Indonesia, 2011; Lao PDR, 2008; Malaysia, 2009; Philippines, 2009; Thailand, 2009; Viet Nam, 2008; China, 2008; India, 2010.

Sources: World Bank World Development Indicators, ADB Asian Development Outlook 2012, Department of Statistics Singapore.

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Despite the rapid increase, the bulk of the middle class in most ASEAN countries is still concentrated near the bottom of the middle-class income range of between USD 2 and USD 4 per person per day. The share of the middle class in the lowest income segment is about 58% for developing ASEAN as a whole (excluding Myanmar), close to that for China (55%) but considerably higher for India (80%). The shares are highest in Cambodia, Lao PDR and Viet Nam, the ASEAN countries with the lowest overall per capita incomes, but nearly as high in Indonesia. These shares have fallen only slightly since the mid-1990s for Emerging Asia as a whole. However, China and Malaysia have recorded noticeably greater declines in the vulnerable portions of their middle classes. In India, the share of the middle-class group with an income between USD 2 and USD 4 per person per day decreased only by around 5%.

Households in the lowest income segment are particularly vulnerable to falling back into poverty when major shocks to the overall economy occur. Nearly 10% of Indonesia's middle class fell back into poverty in the immediate aftermath of the 1997 Asian crisis (ADB, 2010). Although in China the risk of downward mobility for the middle class belonging to lower income brackets has eased according to Zhang et al. (2011), it is still not negligible. As for India, the majority of the middle class is at risk of falling back into poverty in the event of a major economic shock.

Given their favourable growth outlook, developing Asia, including ASEAN, China, and India, should continue to see their middle classes continue to grow and become wealthier and more secure, while poverty rates continue to decline. Longer term projections (Chun, 2010) suggest that by 2030, the total portion of the population in the middle-class income range could constitute at least 75% of the population in most of developing Southeast Asia, and India, and the majority of the population in Cambodia and Lao PDR. A significant segment of the population with above middle-income levels (above USD 20 per person per day) is likely to have emerged by 2030, especially in China, Malaysia, Thailand and Viet Nam. The portion of the population in the most vulnerable middle-class segment is projected to fall considerably, to around 20% of the population for the seven developing Southeast Asian countries and to virtually disappear in China. However, by 2030 the percentage of the population at the lower end of the daily consumption range of USD 2 to USD 20 is expected to stay relatively high, around 40%, in India.

Middle-class growth has important economic implications

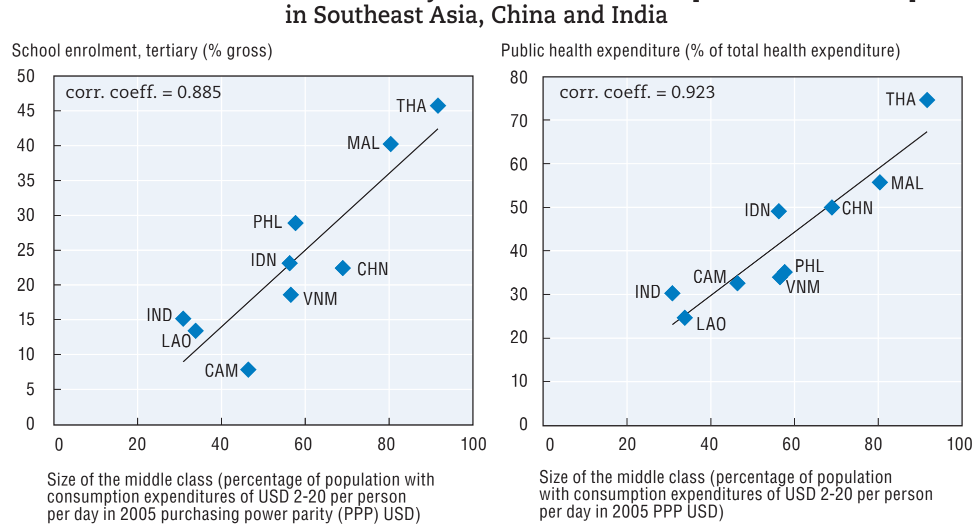
The middle class in developing countries differs significantly from the poor and the very wealthy in terms of their economic behaviour as well as their political preferences and views. Middle-class households in rural areas tend to be less occupied in farming and other agricultural activities and more likely to work in non-farm rural industries and on very small businesses operated solely by the proprietor or employing a few family members and on a part-time basis (Banerjee and Duflo, 2008). Middle-class workers in urban areas tend to be concentrated in manufacturing establishments and in salaried work in companies, including foreign companies, and in the public sector.

These differences are having significant effects on the economies of ASEAN and other developing Asian economies as well as important implications for government policies.

Middle-class development is already affecting the structure of demand in these countries. Middle-class households, particularly those in the higher portion of the middle-income range, tend to devote a larger portion of their income to purchases of major consumer durables – such as automobiles and motorcycles, televisions, refrigerators and air conditioners – than do poor households (ADB, 2010; Banerjee and Duflo, 2008). For example, less than 1% of poor households own an automobile in China, India and the Philippines, but the portion rises to about 1.2%, 3.0% and 18.5%, respectively for households with incomes between USD 4 and USD 20 per person/day. Nearly four-fifths of households in China and India, and nearly one-third in the Philippines own a refrigerator, compared to less than one-sixth of poor households. The higher portion of refrigerators and household durables is partly a reflection of the fact that middle-class households typically have larger residences, in terms of rooms and square metres, than poor households.

Increased demand for consumer durables and other consumer goods from the middle class is also helping to spur innovations in at least two ways. First, middle-class households tend not only to spend more on consumer goods than poorer ones but also to purchase a greater variety of goods. This increased variety encourages product innovation and technological upgrading. Second, the growth of developing country middle classes has spurred the development of less expensive versions of durables and other consumer products ("frugal innovation", ADB, 2010) that until recently have been affordable only in more advanced economies. An example is the introduction of the "Nano" automobile in India by the Indian firm TATA Motors, whose price of about USD 2 500 is well below the lowest cost automobiles typically sold in OECD countries. Other examples include an inexpensive battery operated refrigerator developed at General Electric's facility in Bangalore, India; and a cheap lithium ion battery developed by a Chinese company. These innovations are fostered by scale economies arising from the large and growing middle-class markets and are complemented by innovations in management, marketing and distribution to adapt to and take advantage of the particular characteristics of the middle class in developing countries.

Figure 1.33. **Middle class size versus tertiary school enrolment and public health-care spending in Southeast Asia, China and India**



Notes: Latest year available: Cambodia, 2008; Indonesia, 2011; Lao PDR, 2008; Malaysia, 2009; the Philippines, 2009; Thailand, 2009; Viet Nam, 2008; China, 2008; India, 2009.

In the case of Indonesia, China and India the latest figures for the size of the middle class are estimates combining the separate urban and rural distributions, weighted by share of urban/rural to total population.

Source: OECD Development Centre.

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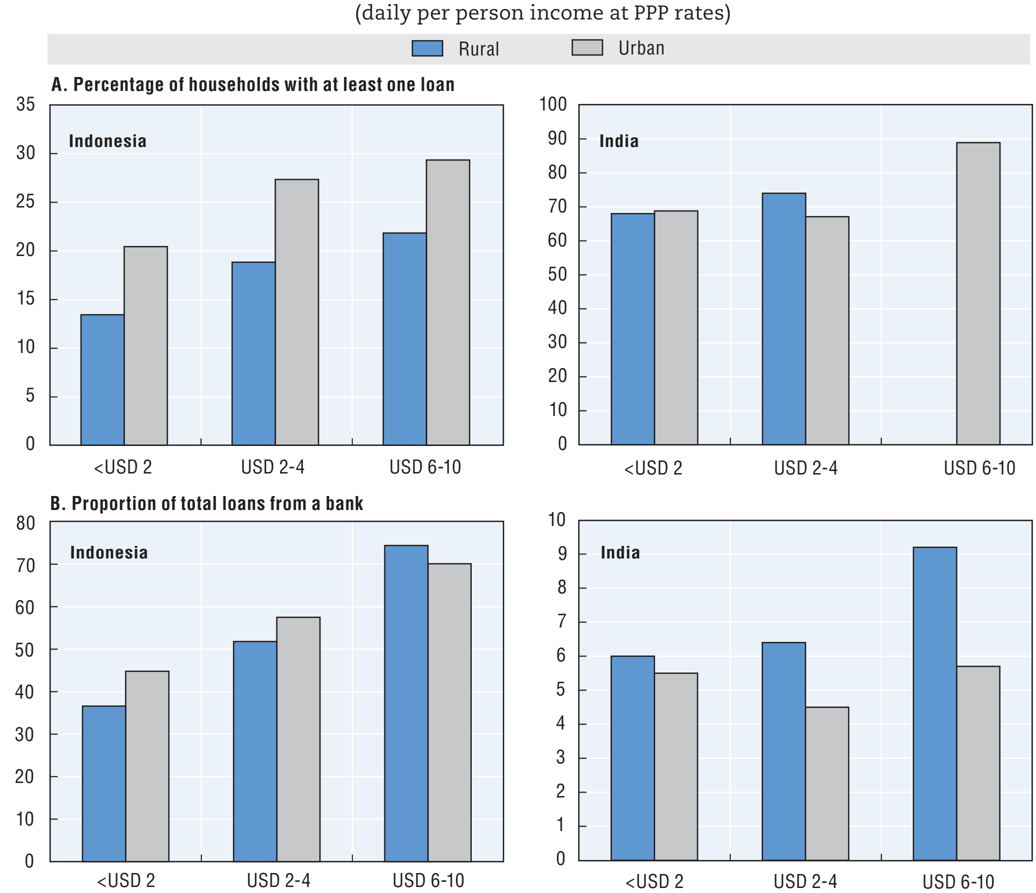
Middle-class households tend to spend a higher portion of their income on education and health services, and to purchase more sophisticated education and health services, than do poorer households (Figure 1.33). The higher education spending is probably partly a reflection of the higher education attainment, in terms of years of schooling and incidence of university degrees of middle-class adults compared to adults in poorer households.

Middle-class growth is spurring the development and broadening of financial instruments and services in ASEAN and other Asian developing countries. Savings of middle-class households tend to be larger in both absolute terms and as a share of income than those of poorer households. Data from India and Indonesia indicate that middle-class households are somewhat more likely to have a bank loan than poor households (Banerjee and Duflo, 2008) (Figure 1.34). Moreover, middle-class portfolios are more diversified than those of the poor, and become increasingly diversified as their income rises. For example, about 19% of households with incomes of USD 4 to USD 20 in China, and 7.6% in India, own stocks, while the portion owning life insurance assets is 18.8% and 72.6% respectively in these two countries (ADB, 2010). These compare to the 10% of households in China that hold stocks or life insurance assets; in India, only 2% of households in this bracket hold stocks although 57% hold life insurance assets. Middle-income households are also more likely to have some debt and to have access to some consumer and housing finance.

Figure 1.34. **Household borrowing in Indonesia and India, by income segment**

(daily per person income at PPP rates)



Source: Banerjee, A. V and E. Duflo (2008), "What is middle class about the middle classes around the world?", *Journal of Economic Perspectives*, American Economic Association, Vol 22(2) pages 3-28, Spring, www.ncbi.nlm.nih.gov/pmc/articles/PMC2638076/pdf/nihms-84073.pdf.

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Middle-class households not only spend more on education and other human capital development in their effort to rise economically, they are also more likely to migrate in search of opportunities outside their home area. Much of this migration takes place internally, with, for example, workers from rural areas going to cities to seek employment in construction and other lower skilled activities (notably in China). However, inter-country differences in wage levels, geographic proximity in some cases and skill shortages in higher income Asian countries have led to substantial transnational worker migration within ASEAN and with other East Asian countries. Migrants, mainly from other Asian countries, made up nearly 12% of the total workforce of Malaysia in 2005 and nearly 28% of the workforce in Singapore. Nearly three-quarters of a million Philippine workers, amounting to about 2% of the overall workforce, were employed outside the country in 2004, about 38% in Asia and 50% in the Middle East (Asis, 2006).

The growth of the middle class in developing countries implies a need for government services to facilitate its increased demand for higher quality goods and services. Greater and more sophisticated health and education services are likely to require at least partial government support of universities to train professionals and to develop hospital and school infrastructure. Larger houses and apartments equipped with refrigerators and other electrical appliances increase demand for electricity and clean water and waste treatment facilities. Roadways and related infrastructure need to be improved and expanded to accommodate the growing population of automobiles and other motor vehicles.

Middle-class growth is also changing priorities for social safety-net development and, to some extent, making that development more feasible. Middle-class households are more likely to demand and benefit from institutionalised social security and medical insurance systems, and less likely to need direct cash assistance and subsidies that are mainly directed at poor households.

The middle class's need for government services along with its relatively higher education attainment has helped to spur the public's demand for greater efficiency and accountability in the provision of public services. In a number of countries, the growing middle class has been an important impetus to citizen activism and other pressures for economic reform to improve the quality of government. For example, in India this involvement has helped to improve governance and the quality of services for the poor as well as the middle class (Chakrabarti, 2009).

The increased educational and job-skill attainment, the impetus to innovation from greater and more diverse consumption, and pressures for improved governance arising from middle-class expansion can be beneficial to aggregate productivity growth and could thereby increase potential economic growth.[25] Empirical evidence is so far inconclusive as to whether middle-class development has been an independent driver of economic growth. However, evidence does suggest that middle-class development and real growth are driven by similar factors and implies that middle-class development and real growth are mutually reinforcing (ADB, 2010).

Sustaining further development of Southeast Asia's middle class will require a shift in policies

Emerging Asian economies face significant challenges in coming years in fostering continued robust growth in the middle class that reinforces and does not hinder other central policy goals. Middle-class development needs to be accompanied by continued reductions in poverty and a reasonably wide distribution of the gains from growth to all segments of the population if the social consensus underpinning growth enhancing policies is to be sustained.

Achievement of these goals cannot be taken for granted. Historical experiences indicate that as countries reach middle-income levels, the "easier" productivity gains from shifting workers from agriculture to higher productivity activities in industry and from acquiring existing technologies begin to wane. Continued robust growth requires structural changes – to improve the quality of the labour force, remedy imperfections in markets, improve the business environment and foster innovation – that can be difficult to make. Failure to make these changes can lead to a faltering real growth and development ("middle-income trap") (Kohli and Mukherjeei, 2011).[26]

In Southeast Asia, sustaining middle-class development entails less emphasis than in the past on development of export industries employing very low wage workers. Greater emphasis is needed on policies to foster more knowledge based growth, greater reliance on domestic demand, and to develop services sectors. Policies will also have to address problems from increasing environmental pressures, urban congestion, greater longevity and changing lifestyles typically associated with middle-class growth.

Sustaining and in some cases boosting "healthy" labour productivity growth that is accompanied by increasing real wages and fosters further employment gains is critical to continuing the rise in incomes. ASEAN countries have achieved impressive growth in labour productivity since the 1997 crisis. However productivity growth in recent years has lagged behind that of China and India, particularly for the higher income ASEAN countries (ILO, 2010). Continued strong labour productivity growth will depend critically on the region's success in improving its competitiveness in higher technology and knowledge-intensive industries so that it can move up the value added chain. Infrastructure development is clearly critical to the capacity of ASEAN countries to move up the value-added chain into higher productivity industries that can support further middle-class development. Earlier editions of this Outlook detailed the extensive efforts that ASEAN countries have been making to improve their transport and other infrastructure. Several of the fiscal stimulus packages adopted by ASEAN countries in the wake of the 2007 global financial crisis contained substantial investments in infrastructure (OECD, 2011a). Accelerated infrastructure development is a key element of the medium-term development plans in most Southeast Asian countries. This development needs to include infrastructure improvements to better connect rural and poorer provinces to the overall economy in order to ensure that they share in the poverty reduction and middle-class development. Achieving these objectives will require substantial investment expenditures in coming years but also improvement in regulatory and other institutional conditions to ensure adequate funding and the efficient allocation of infrastructure investment.

Strengthening both the quality and availability of education is clearly essential to further poverty reduction, increasing middle-class incomes and reducing the vulnerability of the lowest income segments to economic shocks. Education is key to ensuring the supply of skilled workers that is needed to allow countries to move up the value added chain, which in turn is essential to continued upgrading of worker productivity. Strengthening education requires an across-the-board effort at all levels – primary, secondary, and higher education, in both rural and urban areas – in order to sustain mobility from the poor to the middle class and within the middle class. Measures to improve formal education need to be accompanied by policies to foster effective worker training and retraining and to help workers acquire new skills as the demands of the economy change ("life-long learning").

Conclusion

The success of the ASEAN economies in sustaining strong growth over the past year despite slowing external demand is a reflection of the underlying strength in their macroeconomic and financial fundamentals. Low inflation, moderate fiscal deficits, and strong financial conditions of banks have limited the shock to financial markets from the euro area crisis and have provided room for monetary and fiscal policies to counter the external shocks.

Real growth should continue to be robust over the medium term but its character is likely to be significantly different from that prior to the global financial crisis.

- Growth will be driven more by domestic demand and less by exports.
- Consumption is likely to be especially robust while investment growth is supported by an improving environment for private investment and, in some cases, by strong government infrastructure investment.
- Current account surpluses should be well below the average level recorded in the decade following the 1997 Asian financial crisis.

The medium-term outlook is partly a reflection of the profound economic changes that are occurring as a result of the rising middle class in ASEAN countries, China and India. The transformation into middle-class economies is shifting demand toward consumer durables and services, requiring a greater share of resources devoted to domestic needs compared to exports. The development of the middle class is also increasing the demand for government support for education, health and social insurance, which will require reforms to government institutions and provisions to improve the efficiency with which services are provided.

The growth in the middle class along with the continued exposure of ASEAN economies to external shocks poses important challenges to economic policy over the medium term.

- To sustain healthy middle-class growth and avoid the "middle-income trap", the development paradigm needs to place less emphasis on export sectors than in the past and more on moving up the value added chain and on developing human resources and improving their utilisation.
- Fiscal capacities need to be strengthened through tax and related reforms in order to ensure that governments can raise the revenues needed to achieve their goals while limiting distortions to the economy.
- Further development of domestic financial markets, particularly corporate bond markets, and their gradual regional integration, will be the key in the long term to successful management of capital inflows and realisation of their benefits.
- Several of the CLMV countries will also need to manage the effects of dollarisation in the medium term while creating conditions for gradual de-dollarisation over the longer term.

Notes

1. Malaysia's government has also budgeted a one-time cash payment to lower and middle-income households while the government of Thailand has instituted tax breaks for first-time buyers of homes and cash rebates for first-time purchasers of automobiles.
2. UNCTAD, *World Investment Report 2012: Towards a New Generation of Investment Policies*, www.unctad-docs.org/files/UNCTAD-WIR2012-Chapter-II-en.pdf.
3. "Myanmar's real estate boom: too much, too soon?" *Wall Street Daily*, 15 March 2012, www.wallstreetdaily.com/2012/03/15/video-myanmar-real-estate/.
4. The trend in domestic credit is obtained by filtering historical credit ratios (credit-to-GDP) by the Hodrick-Prescott filter. In order to examine the robustness of the results, alternative sets of credit boom episodes are identified using thresholds of 5, 10, 20 and 30 percentage points above historical trend. The above definitions resulted in 144, 84, 29 and 14 credit boom spells for Asia-Pacific countries over 1970-2010 applying the 5, 10, 20 and 30 percentage point thresholds.
5. Falling domestic interest rates appear to trigger credit booms only in certain model specifications for instance, when capital inflows are specified as change in inflows or past year inflows, but not when episodes of capital inflows are applied. This may suggest that the triggering impact of capital inflow episodes is so large that there is no additional room for domestic interest rates to play a role beyond that effect.
6. As domestic credit growth itself may have an impact of many of these macroeconomic variables, the macroeconomic control variables were entered with a lag to mitigate the simultaneity problem.
7. China Banking Regulatory Commission, www.cbrc.gov.cn/EngdocView.do?docID=244086DD999546F9AF02480C521583B1.
8. See García-Herrero et al., 2009. Financial integration within ASEAN is much less developed than trade integration. Intra-regional portfolio flows in the region have been found to be significantly less than those that would be expected from standard "gravity" models (see Morgan and Lamberte, 2012).
9. For example, corporate bond markets require a benchmark yield curve to be fully developed, which is usually based on yields of government bonds.
10. In China until quite recently, only the very strongest companies were permitted to issue bonds and private companies were excluded from the market. The State Planning Commission, which was transformed into the National Development and Reform Commission (NDRC) in [ ], was responsible for approving company bond issues for most of China's reform period. In [ ], the China Securities Regulatory Commission (CSRC) was given responsibility for regulating the issue as well as trading of bonds listed on the two exchanges, but the NDRC retained responsibility for issues by non-listed companies.
11. In January 2009, the government of India raised the ceiling on foreign institutional investors holdings of domestically issued corporate bonds from USD 6 billion to USD 15 billion.
12. Beginning in July 2009, local currency bonds issued by sovereign borrowers and sovereign-backed foreign corporations in the Singapore market became eligible for collateral for loans from the Monetary Authority's Standing Facility and are eligible for collateral in interbank lending on the same terms as Singapore government debt.
13. The strongest form of dollarisation, where the domestic currency is completely replaced by a foreign currency, is very rare historically, although currency board systems, such as that of Hong Kong, China are very similar in their functional characteristics.
14. Vietnamese hold more gold in relation to their income than do citizens in most other countries in the world.
15. India statutory rates are 32.445% for domestic companies and 42.024% for foreign companies with total income exceeding INR 10 million (Indian rupees); and 30.9% for domestic companies and 41.2% for foreign companies with less than INR 10 million.
16. International best practices imply that value added tax regimes should apply uniformly to all goods and services but with a high enough threshold in terms of turnover to avoid undue burden on smaller businesses and to reduce collection costs. See IMF, 2011a.
17. Actual to potential revenue refers to the ratio of actual VAT revenue to the ratio of the product of the statutory VAT rate times personal consumption (the "potential VAT revenue"). This ratio is often referred to as the "C-ratio" since it is most appropriate for a consumption-based VAT system in which capital expenditures are deductible from the VAT base. C-ratios for Thailand, Viet Nam and Singapore are considerably higher, in the order of 80% or more depending on the year in which they are calculated.

18. See also IMF, 2011b. Admittedly, extending the VAT to fully realise its potential yield might well require compensating households or businesses that would otherwise be intolerably burdened by cuts in other taxes or by targeted subsidies, so the net yield in revenue would be somewhat less than these calculations suggest. However targeted subsidies or cuts in other taxes can also be a more accurately targeted means of compensating highly burdened taxpayers than VAT exemptions.

19. See "Major expansion of VAT reforms progressively from 1 August 2012", *China Alert*, KPMG, July 2012, accessed at www.kpmg.com/CN/en/IssuesAndInsights/ArticlesPublications/Newsletters/ChinaAlerts/Documents/china-alert-1207-16.pdf. Some other segments of the transport, logistics, and asset leasings sectors have seen some increase in their tax burdens, although these may be reduced as the reforms are refined.

20. "China mulls new tax for environmental protection", *China Daily*, 24 October 2011. Accessed at: http://europe.chinadaily.com.cn/china/2011-10/24/content_13965473.htm.

21. A recent report on fuel subsidies issued by the International Monetary Fund (del Granado et al., 2010) estimates that transferring USD 1 to poorer households through a gasoline price subsidy costs USD 33 to the government.

22. Fitrian Ardiansyah, "Bearing the consequences of Indonesia's fuel subsidy", *East Asia Forum*, 4 May 2012. Accessed at www.eastasiaforum.org/2012/05/04/26135/.

23. Developing ASEAN comprises all the ASEAN countries except Brunei and Singapore, which are upper income countries. Data on the middle class for Myanmar are not available.

24. In Malaysia, a sizeable portion of the population moved into the above USD 20 per person per day income brackets between the mid-1990s and 2009 and is responsible for the small drop in the middle-class share.

25. Whether or not a large and growing middle class adds appreciably to economic growth has been the subject of much study in the literature on economic history. A number of scholars have argued that the emergence of a large middle class was a significant factor behind the rapid growth and industrialisation of England during the 19th century (for example, Easterly, 2001).

26. The difference between a scenario in which ASEAN falls into a middle-income trap and one in which it avoids that trap and realises its development potential is potentially quite large. Under simulations constructed by Kohli and Mukherjee (2011), nearly 100 million fewer of the population of ASEAN plus Pacific developing nations, or about 10% of the total population, would be in the middle or upper classes by 2050 if the middle-class trap prevailed compared to a scenario in which the trap was avoided.

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PART TWO
Structural policy country notes

CHAPTER TWO

Structural policy challenges for Southeast Asian countries

Abstract

Many Southeast Asian countries are searching for new growth and development strategies to reflect the changing growth dynamism in the region and international market conditions.

Policy makers in the region recognise the need to adapt their development strategies and indeed have included several new elements towards a new growth model in their medium-term development plans, which include human capital development, social and labour market policies, green economies and disparity issues. Implementation of the new development strategies will require the adoption of a comprehensive package of reform measures. Enhancement of productivity through structural policy reforms will be the key to the success of the new development strategies in the region.

Starting from the second edition, this Outlook includes Structural Policy Country Notes on selected Southeast Asian countries – this year we have notes on seven countries: Cambodia, Indonesia, Malaysia, the Philippines, Singapore, Thailand and Viet Nam. The policy areas discussed in each note are identified in the national development plans of the country concerned.

These structural policy country notes address what kinds of elements will be important for the new development strategies in Asia and how the countries incorporate new development models into their medium-term plans.

Synopsis of structural policy challenges in Southeast Asia

Many Southeast Asian countries are searching for "new growth and development strategies"

The global financial crisis has underscored the need for Asian economies to rethink their past growth models. The export-oriented growth strategies, successful in earlier decades, have shown their weaknesses. Excessive dependence on external demand has made many Asian countries vulnerable to fluctuations in global demand and to external shocks. Domestic demand will be an important engine for medium-term growth in the region.

Many Southeast Asian countries are searching for new growth and development strategies to meet the changing growth dynamism in the region and international market conditions. Policy makers in the region recognise the need to adapt their development strategies and indeed have included several new elements towards a new growth model in their medium-term development plans, which include human capital development, social and labour market policies, policies to promote greener economies and policies to address economic and social disparities. Implementation of the new development strategies will require the adoption of a comprehensive package of reform measures. Overall enhancement of productivity through structural policy reforms will be key to the success of the new development strategies in the region.

Starting from the second edition, this Outlook includes *Structural Policy Country Notes* on selected Southeast Asian countries – this year we have notes on seven countries, namely, Cambodia, Indonesia, Malaysia, the Philippines, Singapore, Thailand and Viet Nam. The policy areas discussed in each note are identified in the national development plan of the country concerned. Each note also discusses relevant experiences in OECD countries, providing useful insights and suggesting "best practices" that may be of use for ASEAN policy makers. These structural policy country notes address what kinds of elements will be important for the new development strategies in Asia and how the countries incorporate new development models into their medium-term plans.

New development strategies will differ by country

The policy challenges facing each country depend to a large extent on their levels of development (see Table 2.0.1). For instance, **Cambodia** faces the challenge of building and upgrading infrastructure to bring agriculture into the commercial mainstream. Milled rice exports could be the engine of growth and help reduce poverty, but not until the export procedure has been streamlined and the milling process made more efficient. Productivity is a weakness not only in agriculture but in most other sectors. Human capital development could help to boost productivity, but Cambodia's educational and technical and vocational education and training (TVET) system need to be reformed. Enrolment rates at all levels are very low. The result is a mismatch with economic needs and a large unskilled labour force. The banking sector offers a relatively brighter picture. Its capital base is sound and growth has been brisk, with microfinance business burgeoning. Cambodia's central bank must build its capacity and modernise its infrastructure so that it can support economic growth. The central bank also needs to establish effective supervisory processes that can ensure customer protection and the stability of the sector.

Indonesia faces a number of challenges all of which centre on the key question of equality. It must build and upgrade its infrastructure primarily to close the development gap between the urban and rural areas and the west and east of the country. As a vast sprawl of scattered islands, connectivity is a key first step in its infrastructure policy. The same gaps – west-east, urban-rural – affect education and, by the same token, human resource development. A widely available health-care system needs to be established. Indonesia's expenditure on health care is among the lowest in ASEAN. Access to health care and public confidence in the health-care system are both limited. The government has undertaken far-reaching social security reform, including to the health-care system, but much is still to be done to create a sustainable, equitable system.

Malaysia will need to address some important long-standing economic weaknesses in the medium term in order to progress toward becoming an advanced economy within the next decade. Skill shortages and mismatches and the deficiencies in the education system that underlie them and the low participation of women in the workforce particularly need to be remedied. Measures to improve SME productivity and to reduce gaps between rural and urban SMEs will also be needed.

The major policy challenges **the Philippines** faces in its Medium-Term Development Plan are to improve its road infrastructure, increase access to education and development resources, and ensure jobs for all. Both road transport and power are critical to achieve a more closely integrated Philippine economy, helping to attract widely dispersed private-sector investment. Increasing secondary enrolment and improving the standards of teachers and pupils are vital reforms, without which there can be no human and economic development or job creation.

Singapore is aiming to undertake a number of reforms to be a hub of the global economy. Political pressure is forcing Singapore to rethink the liberal immigration policy that was part of its drive to be a global city. The government is tightening entry conditions for foreign workers while encouraging foreign entrepreneurs and investing heavily in developing the human capital of indigenous workers. It is also encouraging businesses to upgrade their technology and production methods. As part of that investment effort, the government has lent strong backing to small and medium-sized enterprises (SMEs). Research and Development (R&D) has been an important component of Singapore's policy of productivity-driven economic growth. Combined public and private R&D expenditure has put Singapore among the most R&D-intensive countries. Nevertheless, it lags behind in private R&D spending.

Thailand faces challenges to further improve its education and health-care systems while addressing the accumulated environmental damage from its rapid growth. The country has made impressive progress in providing education and health care to most of the population. However, significant disparities in access remain, especially for poorer households and between rural and urban areas, that need to be addressed. Education quality needs to be improved, particularly the quality of teachers, and rising health-care costs need to be contained through reforms to improve efficiency in the delivery of services. Thailand also needs to address environmental damage from past growth and achieve greener growth in the future by reducing carbon emissions and other forms of pollution. This will require commitment to greener growth by government, business and the public and new policies, including increased use of fiscal incentives to encourage more environmentally friendly activities and behaviours.

Viet Nam will need to meet several challenges in the medium term to sustain rapid growth and realise its development potential. As in several other countries in the region, the supply of skilled labour needs to be increased and better adapted to the needs of industry through reforms to the vocational training and education systems, including further encouragement of workplace training. Reforms to the financial system and to state-owned enterprises need to be broadened and accelerated. The bad loans of the commercial banking sector need to be addressed in the medium-term but reforms to improve their governance and strengthen regulatory oversight are crucial to ensure that they function effectively and prudently in the future. Ownership diversification of state-owned enterprises (SOEs) needs to be broadened and governance and oversight improved. Reforms to allow all businesses to compete on equal terms will be especially critical to ensuring that SOEs can compete as fully market-based enterprises.

Table 2.0.1. **Summary of medium-term policy challenges and responses in Southeast Asia**

Cambodia	**Agriculture**	Build agricultural productivity and tap the export potential
	Human capital development	Increase enrolment rates at all levels of education and strengthen TVET to build a skilled labour force
	Reform of financial sector	Strengthen the banking sector and prudential measures
Indonesia	**Infrastructure**	Narrow the regional divide by enhancing connectivity and the capacity of local government
	Education	Strengthen the capacity of local government to provide education infrastructure
	Social security reform	Accelerate health-care reform, focusing on coverage and access to health-care services
Malaysia	**Human capital development**	Strengthen TVET and the education system to address skills shortages
	Labour market	Address weaknesses in labour market functioning
	SME development	Enhance productivity of SMEs
Philippines	**Infrastructure**	Improve road transport, power and energy infrastructure and strengthen public and private investment
	Labour market	Focus sharply on job creation strategies
	Education	Improve access to quality education and training by strengthening the K+12 programme
Singapore	**Labour market**	Manage foreign worker dependence by increasing the productivity of local workforce
	SME development	Sustain SME growth through fostering entrepreneurial environment
	Innovation	Enhance the innovation capabilities of local enterprises
Thailand	**Education**	Raise the quality of education and reduce disparities
	Health-care system	Achieve a more equitable health-care system
	Green economy	Foster green growth through investment and fiscal reform
Viet Nam	**Human capital development**	Reform training and education to better meet demand for skilled labour
	Development of banking sector	Strengthen the banking system by establishing effective supervision
	SOEs reform	Strengthen market-based reforms and monitoring of SOEs

Source: OECD Development Centre.

Cambodia

A. Medium- term economic outlook (forecast, 2013-17 average):

GDP growth (percentage change):	6.9
Current account balance (% of GDP):	-8.3
Fiscal balance (% of GDP):	-2.7

B. Medium-term plan

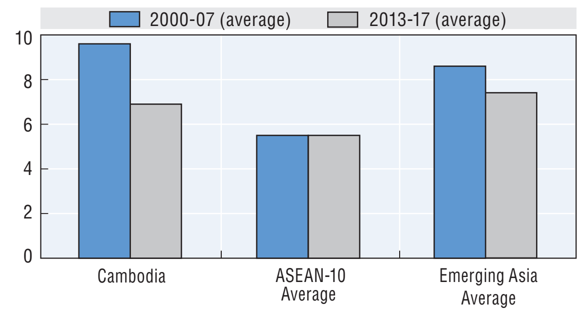
Period:	2009-13
Theme:	For growth, employment, equity and efficiency

C. Basic data (in 2011)

Total population:	15 million*
Population of Phnom Penh:	1.3 million (in 2008)
GDP per capita at PPP:	2 216 (current USD)

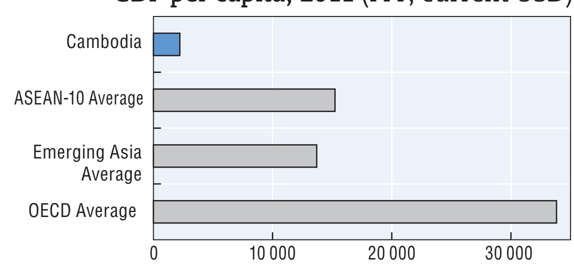
Note: *Total population data for 2011 is an estimate.
Sources: OECD Development Centre, MPF-2013, national sources and IMF.

GDP growth rates (percentage change)



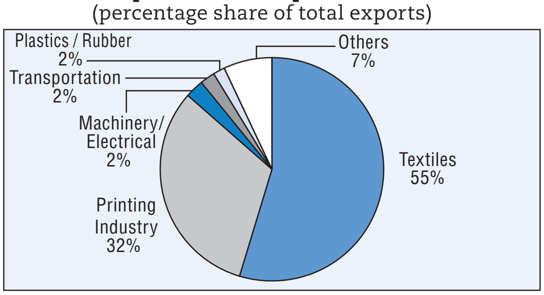
Source: OECD Development Centre, MPF-2013.

GDP per capita, 2011 (PPP, current USD)

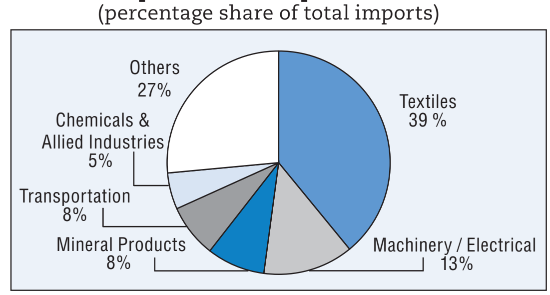


Source: IMF and national sources.

Composition of exports in 2011
(percentage share of total exports)



Composition of imports in 2011
(percentage share of total imports)



Source: Trademap.

The government of Cambodia has transformed the country from a post-conflict to a market-oriented economy characterised by steady economic development. Peace and political stability were eventually re-established in 1991 with the signature of the Paris Peace Agreements. Two years later came the 1993 Constitution, which laid the foundations for liberal democratic development and a market economy. Economic performance has indeed been impressive and the government has made headway in its work to strengthen governance (which lies at the heart of its Rectangular Strategy for growth, employment, equity and efficiency). Its efforts include the Anti-Corruption Law which was passed in 2010. In 1999, Cambodia joined ASEAN then, five years later, the World Trade Organization (WTO) in 2004. Its membership of the two organisations has allowed Cambodia to reap the benefits of regional co-operation and international trade.

The country faces a number of challenges. It must further upgrade infrastructure to bring agriculture into the commercial mainstream. Milled rice exports could be an engine of growth and help reduce poverty, but not until the export procedure has been streamlined and the milling process is made more efficient. Productivity is a weakness in agriculture and most other sectors. Human resource development could help, but Cambodia's educational and TVET system need to be reformed. Enrolment rates at all levels are quite low. The result is a mismatch between economic needs and a large unskilled labour force. The banking sector offers a relatively brighter outlook. Its capital base is sound and growth has been brisk, with microfinance business burgeoning. Cambodia's central bank must build its capacity and modernise its infrastructure if it is to play a part in economic growth and operate effective supervisory processes that ensure customer protection and the stability of the sector.

Cambodia's medium-term policy challenges and responses

- Build agricultural productivity and tap the export potential
- Increase enrolment rates at all levels of education and strengthen TVET to build a skilled labour force
- Strengthen the banking sector and prudential measures

POLICY FOCUS

Build agricultural productivity and tap the export potential

The critical importance of agriculture and agricultural reform

Agriculture is of critical importance to the Cambodian economy. It employs more than half of the country's total labour force and is the chief source of income for the rural poor, who account for the poorest 10% of the population. Cambodia has adopted a three-pronged strategy to develop its agriculture: productivity enhancement, diversification and transition from subsistence to commercial agricultural. To that end, it is implementing a package of inter-related measures. They involve building and upgrading institutions and infrastructure (roads, irrigation, power, ICT); instituting land reform; encouraging farmers' organisations; providing agricultural extension services and inputs; modernising the financial sector.

Milled rice production and exports offer Cambodia great growth potential

Rice is the dominant crop and, for low-income Cambodia, a strategic commodity in policies to foster income growth, poverty reduction and food security. It is pivotal to the first pillar – agricultural development – of the country's Rectangular Strategy, whose second phase the government has firmly committed to implementing. Cambodia nurses the ambition of becoming a major international exporter of rice, or "white gold". In this respect, paddy rice offers great export potential and could make a strong, valuable contribution to growth. Production has bounced back in remarkable fashion over the past decade since the Asian financial crisis and could reach 7.3 million tonnes in 2010-11, borne by the impetus of rising global and regional food demand and prices.

The global milled rice trade grew from 29.7 million tonnes in 2009 to an estimated 31.3 million in 2010, even though prices continued to fluctuate as a result of the changing economic and political landscape. Furthermore, because paddy rice is politically sensitive and central to national religions and food security in many countries across the world, they protect and heavily subsidise their markets. In Asia, it is estimated that the milled rice trade may reach 14.5 million tonnes in 2010, while prices, though fluctuating, should follow an underlying upward trend. The Asian demand for imports of medium- and low-quality milled rice has been on the rise, owing to the combined effects of unfavourable weather conditions in the Philippines, crop failures and reduced fertiliser subsidies in Indonesia, and the requirement by some countries in the region to fill their reserve stock. Overall, however, the regional and global milled rice trade offers Cambodia high growth potential in the medium and long term.

A successful rice policy could drive growth if support framework is in place

In order to capitalise on the global and regional market potential and translate into reality its vision of becoming a world "rice basket" and a major world milled rice exporter, Cambodia has launched a "policy for paddy rice production and the promotion of milled rice exports". Should it prove successful, it will act as a catalyst for the promotion of Cambodia's exports in general. The policy comes on top of other already-adopted policy measures designed to pick low-hanging fruit in 2010 and 2011. It will also pave the way for medium- and long-term measures to ensure sustainable growth in milled rice production and exports and constitute a common policy framework to guide future implementation.

Medium-term measures

- Increase paddy rice productivity by using high yield seed and modern farming techniques.
- Continue to expand irrigation.
- Continue to build and maintain rural roads to connect rice production areas to markets.
- Promote micro lending to farmers.

Long-term measures

- Enhance water management, key to crop productivity and intensification of yield.
- Implement the National Policy on Rural Electrification.
- Promote and establish farmers' organisations (the Rice Millers' Association) to strengthen their capacity to secure and make efficient use of loans from financial institutions and acknowledge their contribution to the economy.
- Promote and encourage the implementation of policy to ensure the sustainable use of agricultural land and ensure security of tenure.
- Encourage participation of the private sector in paddy rice processing and milled rice export.
- Ensure paddy rice millers' and exporters' access to government-guaranteed loans, recapitalise the Rural Development Bank and Agriculture Development and Support Fund, create new financial instruments and leverage mechanisms, and put in place the Agriculture Development Bank.
- Reduce electricity prices in line with fairness and efficiency and extend coverage to rural areas through the rigorous enforcement of existing laws and regulations.

In general, developments in the global milled rice market, together with Cambodia's sound economic growth, have created an overarching environment conducive to the supply chain and milled rice export. Nonetheless, Cambodia still faces a number of key challenges and obstacles to the supply chain, particularly in agricultural land management, farming techniques, the lack of infrastructure, financing arrangements, and institutional capacity.

Rice exports inhibited by inadequate processing methods and weak infrastructure

One key challenge is productivity. If Cambodia is to export between 3 and 4 million tonnes of milled rice every year, it needs to produce at least 10 or 11 million to ensure a sufficient export surplus. That surplus is still limited, which raises issues of productivity such as land management, research and extension services, intensification and farmers' organisations. The government's over-riding priorities, however, are to expand the irrigation system and rural road infrastructure, invest in modern farming techniques and ensure security of land tenure.

Cambodian rice farmers receive 35-40% less for their produce than their Thai and Vietnamese counterparts. Although such low prices may be perceived as an important factor in export competitiveness, any gains are offset by informal fees and high transport and processing costs by the time the milled rice reaches the ports. The snag is that exporting unprocessed rice results in a significant loss of value added for the economy. If Cambodia could mill all its paddy rice, it would generate substantial gains by taking broken grains, husks, and bran and spinning them off into other activities such as cooking oil production, aquaculture and animal husbandry – not to mention benefits such as job creation and income generation.

With additional investment in modern rice milling facilities, Cambodia could produce more high-quality milled rice for growing international markets. To that end, however, it must address two critical cost-related impediments – the high cost of energy and transport; and the high cost of and difficult access to credit.

Another big obstacle to the promotion of Cambodian milled rice exports is export facilitation, which is neither smooth nor consistent. That is as true of hard export infrastructure such as transportation, seaports and warehouses as it is of soft trade enabling mechanisms such as support institutions, quality standards, or sanitation and phyto-sanitation standards (SPS), etc. The crucial issues in this respect are weak institutional support, rice whose quality is not yet recognised internationally and a limited seaport infrastructure.

To compound matters, milled rice is a protected market with complicated mechanisms shaped by the terms and requirements specific to each importing country. At the same time, milled rice export is a new venture for Cambodia. Its experience and knowledge are limited and it will require time and resources to strengthen its ability to access international markets.

POLICY FOCUS

Increase enrolment rates at all levels of education and strengthen TVET to build a skilled labour force

Expanding but unskilled labour force

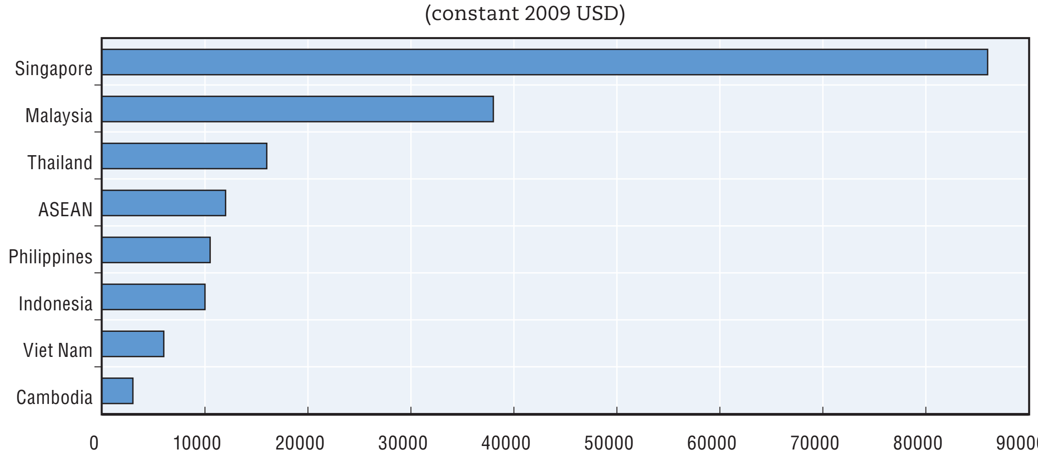
Cambodia's demography has been largely shaped by its history over the last four decades. The civil war and Khmer Rouge regime left millions dead, but the fall of the regime in the early 1980s and the lasting peace which took shape in the 1990s were marked by baby booms. The result today is a so-called "youth bulge" in Cambodia's population, which has led to an expanding workforce and a shortage of skilled labour due to the country's inefficient education system.

Nevertheless, labour productivity has increased in almost all industries over the last decade, although overall employee output level is lower than in other ASEAN countries (Figure 2.1.1). The growth in labour productivity – value added per person employed – was most impressive in mining and quarrying, with an annual growth of 19.4%. Next came finance and other services, then transport and communications, while productivity dropped in the electricity, gas and water sectors.

If Cambodia is to compete with other countries in the region, especially in the aftermath of the global economic crisis, it will have to further improve its labour productivity.

Figure 2.1.1. **Output per worker in Cambodia and other Southeast Asian countries, 2008**

(constant 2009 USD)



Source: National Institute of Statistics. 2010. Ministry of Planning Cambodia. *Labour and Social Trends in Cambodia* 2010, ILO. p.31.

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Poor enrolment rates and returns on education

Cambodia's overall education enrolment rates are the lowest in ASEAN. Although it does quite well in primary education, it brings up the rear in secondary and tertiary education. Its secondary level gross enrolment ratios may be only four points behind Lao PDR's, but they are 57 points behind Brunei's and 43 behind those of the Philippines and Thailand, which rank first, second and third. At tertiary level Cambodia's performance is even worse (Table 2.1.1).

Table 2.1.1. **Gross primary, secondary and tertiary enrolment ratios in Cambodia and other Southeast Asian countries**

Country	Primary		Secondary		Tertiary	
	2000	2007	2000	2007	2000	2007
Cambodia	102	119	18	40	2	5
Indonesia	109	117	55	73	14	17
Philippines	112	109	77	83	30	28
Malaysia	97	98	65	69	26	30
Singapore	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Myanmar	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Brunei	111	106	85	97	13	15
Thailand	106	104	67	83	35	48
Lao PDR	109	118	35	44	3	12
Viet Nam	106	n.a.	65	n.a.	9	n.a.

Source: UNESCO Institute for Statistics.

One of the most important aspects of a good education system is that it forms skilled workers who, when they embark on their careers, yield returns on their education both themselves and for the economy as a whole. One major problem with education and TVET in Cambodia is that they do not seem to yield high returns in employment and career advancement. The country's listed unemployment rate is actually quite low: in 2007 the Supreme National Economic Council reported a rate of 0.9% according to its strict definition of "unemployed and actively looking for work", and 3.82% under the looser wording "unemployed and available for work but not actively looking". However, those figures may be low because, given the lack of unemployment support schemes, many people are forced to find some kind of work rather than earn no income at all. However, the quality and pay levels of such jobs are poor, even for qualified workers.

What is important is that low returns on education limit the incentive to attain anything higher than the most basic levels of education. The nature of the Cambodian economy does not help matters: a high proportion of the labour force works in informal economic activities, either in a self-employed capacity or as unpaid family workers (Table 2.1.2).

Table 2.1.2. **Employment status of the population 10 years and older in Cambodia, 2004 and 2007**

(percentage)

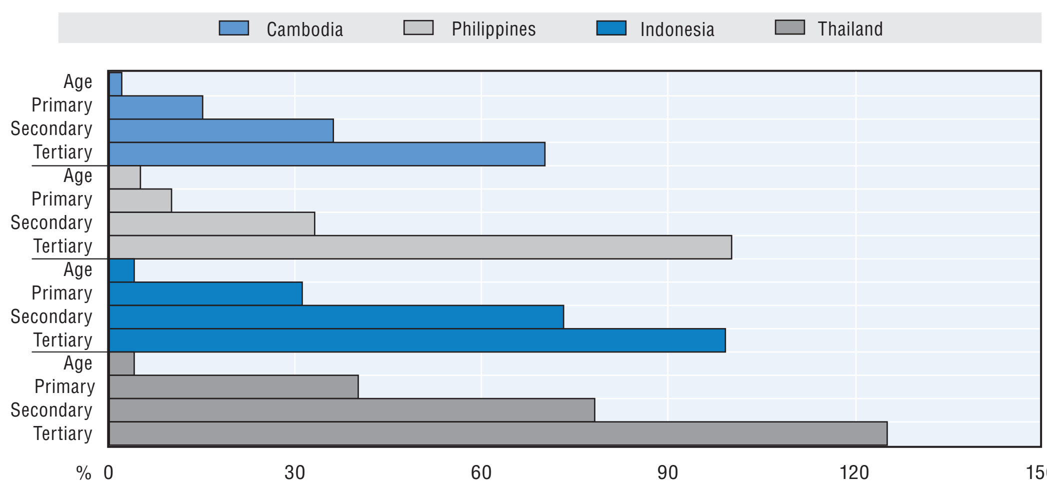
	2004			2007		
	Total	Male	Female	Total	Male	Female
Employee	20.0	23.3	16.6	23.3	26.9	19.5
Employer	0.1	0.1	0.1	0.1	0.1	0.03
Own account worker	34.4	39.7	28.8	35.8	43.1	28.2
Unpaid family Worker	43.3	34.8	52.0	40.7	29.8	52.3

Source: Supreme National Economic Council (2009), Labour Market and Youth Employment, Supreme National Economic Council under auspices of UNDP/IFA, p. 12.

Formal sector employment, though growing, remains small, with paid employees accounting for only 23.3% of the overall workforce. However, wages do not rise with levels of schooling. Although the average income in Cambodia is relatively low, the rise in monthly pay levels for several more years of schooling is too slight to act as an incentive for staying on in education. In 2007, the average wage for someone who had completed primary school was USD 58.14 per month, while a worker who had reached lower secondary level earned USD 61.35 – only USD 3.21 per month more for three extra years in education. Comparison between the wages of workers who have attained lower secondary and upper secondary levels reveals an even slimmer pay differential: USD 62.17, or USD 0.82 more for an extra three years of schooling. While workers who hold vocational/technical qualifications and university degrees do earn considerably more, there is powerful disincentive for staying on at school to secondary level.

The returns on education are in fact lower in Cambodia than in many other parts of ASEAN. In its returns on primary education, it performs similarly to the Philippines, but worse than Indonesia and Thailand. It is significant that in the other three countries, most pupils continue on to higher levels of education, which suggests that returns are expected to be lower. In Cambodia, however, a large portion of the population will not stay on. Returns on secondary education are again similar to those of the Philippines, but behind Indonesia and Thailand. In tertiary education, the picture is even grimmer (Figure 2.1.2).

Figure 2.1.2. **Returns to age and education in Cambodia and other Southeast Asian countries, 2004**



Source: World Bank, 2010. *Providing Skills for Equity and Growth: Preparing Cambodia's Youth for the Labor Market.* Human Development Department East Asia Pacific Region. p. 45.

StatLink http://dx.doi.org/10.1787/888932774053

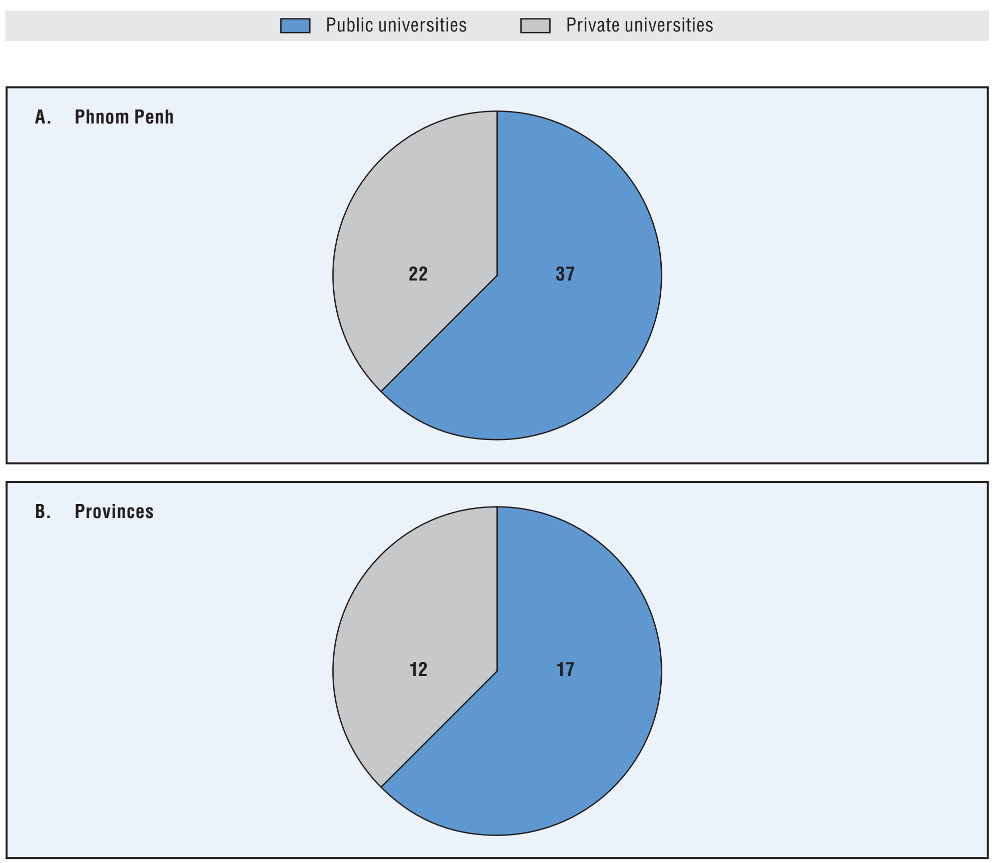
Higher education suffers from low enrolment and institutional disarray

The state of the higher education system in Cambodia, which consists of university degree courses and TVET qualifications, is characterised by very disparate organisational mechanisms, weak quality output and low enrolment. These three factors greatly inhibit the development of higher education and grooming more capable human capital in the country should be a major focus for reforms.

A university degree course in Cambodia usually spans four to seven years, depending on the course and the establishment. Most students begin at the age of 18, although there are also a number of mature students of varying ages. A total of 11 ministries and agencies provide higher education services and thus have access to public education budgets. Two of the biggest ministries are the Ministry of Education, Youth and Sport (MOEYS) and the Ministry of Labour and Vocational Training (MOLVT). While Cambodia's Education Law states that the MOEYS is responsible for general, higher and vocational education, it provides no explanation for the role of the MOLVT. The result is mismanagement and competition between the two ministries, which clearly makes co-ordination of the higher education system very difficult for the government – an issue examined in greater detail later.

A further challenge to higher education comes in the shape of urban-rural disparities. The vast majority of universities are in Phnom Penh, although there is a growing number of higher education institutions, mainly private, in the provinces (Figure 2.1.3).

Figure 2.1.3. **Number of universities in Cambodia, by location**



Source: Ministry of Education, Youth and Sport.
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Table 2.1.3 shows that both university education and TVET face the same problem of low enrolment levels. While the numbers of students at tertiary level have grown over the last five years, they remain extremely low for a population of over 14 million and must be increased if reform of the TVET and university systems is facing any measurable effects.

Table 2.1.3. **Numbers of students enrolled in higher education and TVET in Cambodia**

Level	2004-05	2005-06	2006-07	2007-08	2008-09	2009-10
Bachelor degree (4 years)	1 041	1 126	1 158	1 408	1 330	1 981
Associate degree (2 years)	1 237	2 201	2 172	3 151	2 959	3 308
Vocational Training Certificate 1, 2 and 3 (from grade 10-12)	594	503	1 562	1 524	1 214	746
Vocational Training Certificate (less than 1 year/non-formal)	10 692	17 722	64 970	67 178	117 240	66 695
Training at private institutes and NGOs	14 330	26 434	18 505	40 387	45 887	47 447

Source: Ministry of Labor and Vocational Training, Cambodia.

Cambodia's education system's inefficiency to build human capital threatens its development

The challenges of Cambodia's education system are of two kinds: demand side and supply side. On the demand side is an unwillingness or inability to attend school, while on the supply side lies the inefficiency of the Cambodian government and education system to deliver quality educational resources.

These challenges are daunting road blocks to attaining higher levels of education. Cambodia must address both the supply and demand sides of its inefficient education systems it is to grow its stock of skilled human capital.

Other ASEAN countries seem to be more successful in realising an employment market which rewards individuals for attaining higher levels of education. Cambodia is failing to do so, which will turn even more students away from continuing their further education in the future. The skills level and productivity of the workforce will suffer, which will, in turn, affect the country's economic growth.

POLICY FOCUS

Strengthen the banking sector and prudential measures

Strong year-on-year growth in bank assets and retail services

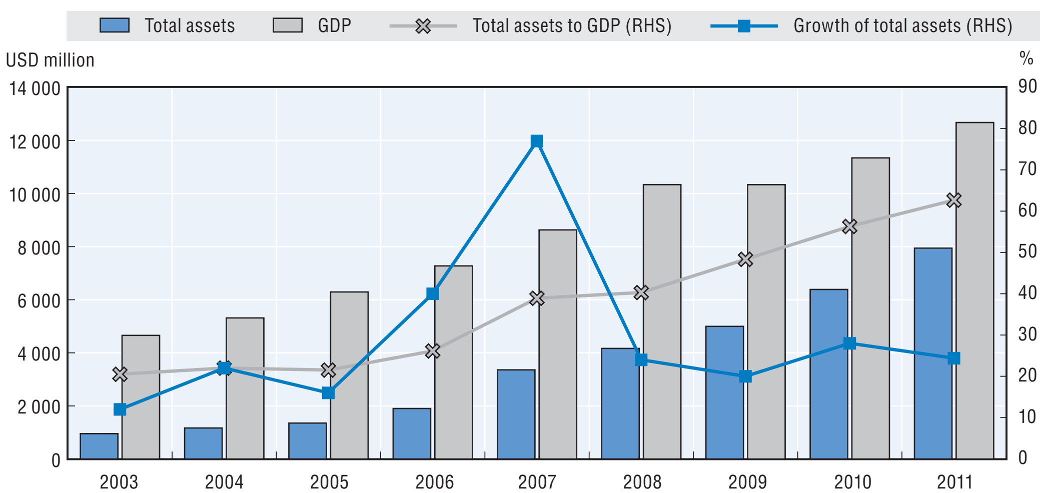
The Public Financial Management Reform Programme (PFMRP) is one of the key elements of Cambodia's Rectangular Strategy for growth. The long-term vision of the PFMRP is to build an international standard for its public financial management system through a strategic plan that comprises four stages: (1) building budget credibility, (2) improved financial accountability, (3) improved budget-policy linkages, and (4) improved performance accountability.

Banking sector reform in particular lies at the heart of PFMRP. The sector grew significantly in 2011, with total assets increasing by 24.39% and credit by 33% (or USD 1 085 million) over the previous year. The growth in credit was the result of a 20% or

USD 880 million rise in deposits and a 9.85% or USD 112 million expansion in the capital base. The ratio of total assets to gross domestic product (GDP) reached 63% in 2011 from 56% in 2010, while those of total loans and total deposits to GDP in 2011 also rose – from 28% in 2010 to 34% and from 37% to 41% respectively.

In terms of outreach, performance in the banking sector presented substantial progress. Though the number of borrowers increased slightly, the number of depositors jumped by 19% to 1 266 412 accounts by the end of 2011. The number of branch networks and banking service outlets climbed 7.1% in 2011 to number 421 country-wide. Other modern banking services such as automated teller machines (ATM), debit cards and credit cards also expanded rapidly. The number of ATMs rose to 588, while new credit cards issued in 2011 increased by 53% and debit cards by 29% against 2010. As of year-end 2011, the total number of money changers in Cambodia was 1 296, of whom 47 were licensed money changers and 1 249 registered counters.

Figure 2.1.4. **Growth in the ratio of total assets to GDP in Cambodia, 2003-11**



Source: National Bank of Cambodia Annual Report 2011.

StatLink http://dx.doi.org/10.1787/888932774091

Microlenders gain business and help reduce poverty

Cambodia's microfinance sector continues to grow rapidly in size and numbers of operations. It provides financial services to SMEs as well as to people in the remote areas who have no access to financial services from commercial banks.

As of year-end 2011, there were 32 licensed microfinance institutions, of which seven were microfinance deposit takers. This development is reflected in the 47.97% increase in the whole sector's total assets from KHR 2 051 billion (Cambodian riel) (USD 506.16 million) at the end of 2010 to KHR 3 025 billion (USD 748.97 million) at the end of 2011.

Thanks to favourable business, regulatory and policy environments, the sector has won significant confidence from debtors and creditors alike, particularly from the poor in rural areas and foreign investors. As of 31 December 2011, Cambodian shareholders owned 23% of total registered capital, while foreigners held 77%. Total loans increased by 50% from KHR 1 725 billion (USD 426 million) at the end of 2010 to KHR 2 591 billion

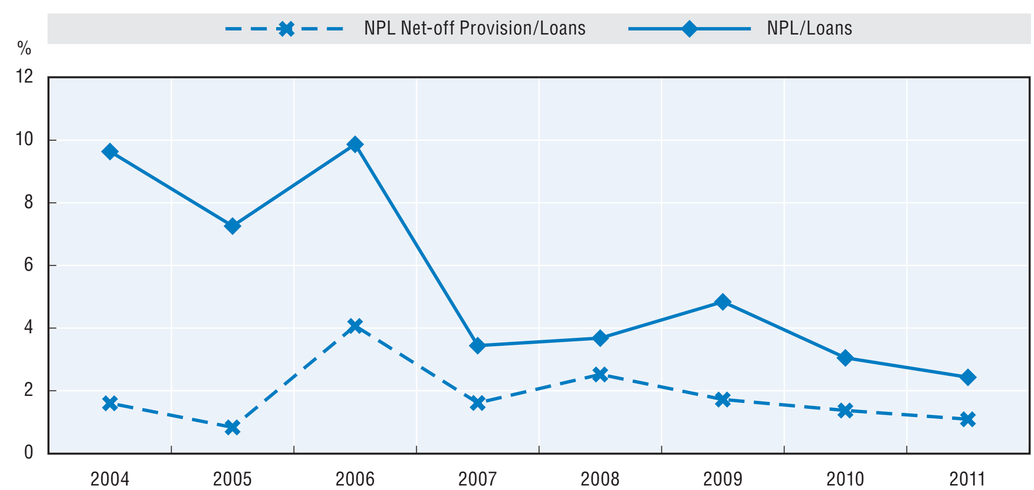
(USD 641.53 million) a year later, while the number of borrowers climbed 17% from 978 077 to 1 141 913. Over the same period, the aggregate amount of deposits surged 180% from KHR 164 billion (USD 41 million) to KHR 459 billion (USD 114 million).

The microfinance sector not only contributes to reducing poverty in rural areas through its micro lending services, but also affords job opportunities to many Cambodian graduates. As of December 2011 the total number of staff employed in the microfinance sector was 9 744, of whom 2 617 were women.

Banks have sound capital base, but the growth in credit calls for vigilance

The average delinquency rate in 2011 was 0.22%, falling from 1.18% in 2010 despite the severe flooding in the country in the third quarter. In compliance with the regulations of the National Bank of Cambodia, the average solvency ratio was 21.25 % and the liquidity ratio 398.66%. Microfinancing profitability continued to increase. In 2011, total net profit was KHR 110 117 million (USD 27.26 million), a 63% rise against the previous year. Returns on asset and equity ratios were 3.64% and 15.10% respectively.

Figure 2.1.5. **The ratio of non-performing loans to total loans in Cambodia, 2004-11**



Source: National Bank of Cambodia Annual Report 2011.

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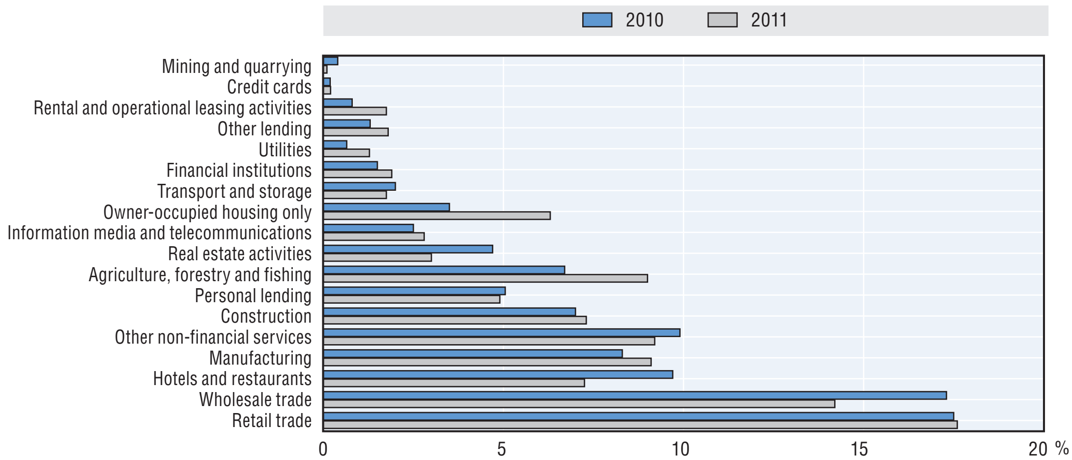
Despite the relatively high growth in loans as of year-end 2011 (33.5%) and the flood disaster that affected agriculture, non-performing loans in the banking sector declined to 2.43% from 3.05% in 2010. Net nonperforming loans fell from 1.37% to only 1.09%, while total reserve provisioning remained stable at 55% of the non-performing assets.

Related-party lending is reported to be within the prudential limit of 10.7% of net worth. Total large exposures in proportion to net worth surged to 97% from 80% in 2010.

The retail and wholesale sectors captured one-third of the total portfolios, while manufacturing, non-financial services and agriculture each accounted for around 9%, and tourism and construction 7.4%. Though all indicators point to a satisfactory outlook in loan performance, vigilance should be exercised in closely monitoring credit growth, particularly in the real estate sector.

Figure 2.1.6. **Bank loans in Cambodia, by economic sector, 2010-11**

(percentage of total)



Source: National Bank of Cambodia Annual Report 2011.

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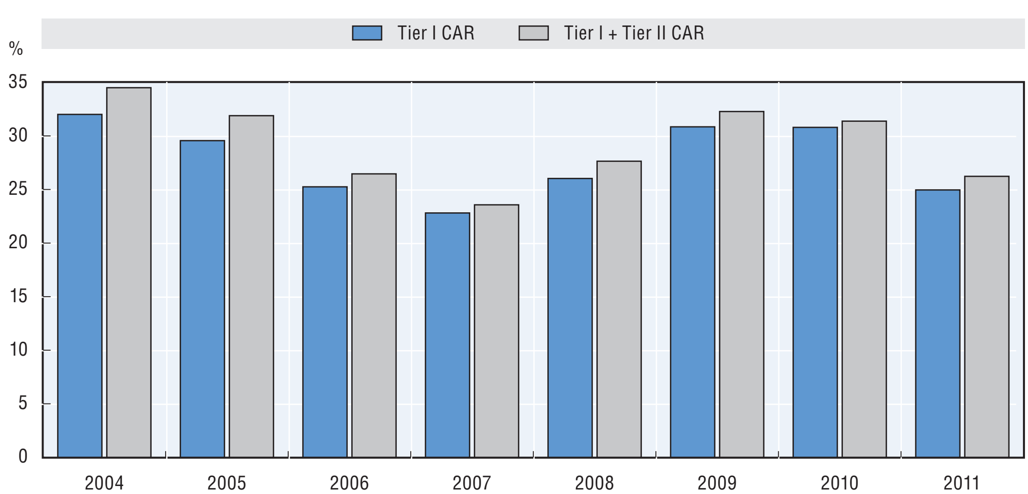
Bank liquid assets remained relatively stable while liquidity stress coverage for one-month periods increased. Off-balance sheet commitments doubled from the previous year.

The development of money and capital markets is expected to provide more room for liquidity management in banking institutions. Profitability in the banking sector showed significant improvement over the previous year. The average return on assets increased to 1.89% while the average return on equity was 9.02% by the end of 2011. The solvency ratio dropped from 31.38% by year-end 2010 to 26.23% by the end of 2011, but still remained above the prudential limit and the early-warning threshold. The fall was due mainly to rapid credit expansion and, by the same token, an increase in risk-weighted assets. Tier I capital was 24.96%, demonstrating to the regulator that banks had a strong stable capital base in 2011.

Figure 2.1.7. **Tier I CAR and Tier I + Tier II CAR in Cambodia, 2004-11**



Source: National Bank of Cambodia Annual Report 2011.

StatLink http://dx.doi.org/10.1787/888932774148

Strengthen prudential measures as bank business grows and new products proliferate

To complement its regular off-site and on-site inspections, Cambodia's central bank is responding by gradually evolving its supervisory approach to one that is risk-based and forward-looking. It needs to accelerate the process and, to improve the information flow, update its supervisory reporting system for both banking and microfinance institutions. The central bank could switch to a reporting system that uses online submissions, which would be an effective way of providing timely, accurate information on the condition of banking and financial institutions. It would help ease the administrative burden and costs of banks and financial institutions submitting their reports. Such a move would also be a sign that Cambodia's banking sector is responding to rapid technological change and the fast-moving environment of the industry.

The central bank has indeed made a number of improvements. In 2011, the National Bank of Cambodia issued a circular related to net worth calculation and five other *prakas* (regulations): on risk-based and forward-looking supervision; credit information sharing systems; transparency in banks' and financial institutions' credit-granting; the financial leasing business; and the licensing of financial lease companies. However, the central bank needs to do more.

As banking sector growth continues to accelerate, new products and services develop. Examples are financial leasing and hire purchase arrangements for consumer purchases and the bank centric and mobile banking centric models now operating in Cambodia. The National Bank of Cambodia must regulate and supervise the mobile banking business – and sophisticated new products – in order to ensure the protection of consumers.

If the banking sector is to play a part in promoting economic growth, then it needs to improve its existing infrastructure, reform and upgrade its national payment system, and create a regulatory platform for an interbank market. The central bank has actually helped to create a privately owned credit bureau (which was launched in March 2012) to enhance the intermediary functions and risk management functions of regulated entities. It is designed to facilitate credit flows in the economy by reducing information asymmetries between banking institutions and their consumers.

Strengthening banks' accounting practices would be a major contribution to the sectors' domestic development and its regional integration. Cambodia banks are expected to implement the International Financial Reporting Standard (IFRS) by 2016 and are currently studying the IFRS road map ahead of full adoption. The road map sets out areas in which both banking authorities and market players can improve their current practices. It is hoped that they will lead to desirable changes in accounting policy, information systems, personnel and skills sets, and prudential regulations. Another crucial step towards ensuring sustainable development should be to improve co-operation among financial regulators within the country. As demonstrated by the global financial crisis of 2009, there is a need for closer co-ordination between onsite supervisors and offsite regulators in order to avoid regulatory arbitrage.

Cambodia has adopted a number of prudential measures to address the issue of operational risks in the areas of governance, fit and proper testing, and internal control. Its progress in risk management, particularly operational risk, has so far proved satisfactory. Nevertheless, additional prudential measures – especially capital charges for operational risk – should be taken in response to banking institutions' growing scope and scale of operations.

Box 2.1.1. **How prudential regulations affect financial stability and competition – OECD countries' experience**

The 2008-09 global financial crisis has thrown into relief the vital role of strong, well-designed prudential regulations in ensuring financial stability and put the issue at the centre of discussions and research in OECD countries. A study by Ahrend et al. (2009) explores how financial sector regulation affects stability and competition outcomes. Drawing on survey information collected by the World Bank, the authors build banking prudential regulation (BPR) indicators in eight thematic areas:

- capital requirements;
- liquidity and diversification requirements;
- accounting and provisioning requirements;
- external auditing and information disclosure requirements;
- entry rules and ownership structures;
- exit rules and disciplining devices;
- depositor protection;
- strength of the supervisory authority.

Their examination of the links between prudential regulation and the recent financial crisis shows that, in the period between 2007 and 2009, OECD countries with relatively tight prudential regulations in the areas of entry and ownership rules, exit and disciplining rules, and strength of supervisory authority suffered significantly smaller losses in bank share prices in the first quarter of 2009 relative to their pre-crisis values. The size of the coefficient estimated by Ahrend et al. suggests that improving regulation from the level of a moderately loosely regulated country – at the 25th percentile of the cross-country distribution – to that of one that is moderately tightly regulated – at the 75th percentile – would have been associated with a share value that was 19% higher at the beginning of 2009 than in 2007.

According to the findings of Ahrend et al. the net fiscal costs of the crisis would have been roughly 1.5% of GDP lower in a country with moderately strong prudential regulation (especially in the areas of capital requirements, accounting and provisioning requirements, and entry rules and ownership structures) than in one with moderately weak regulatory settings.

Although the empirical evidence suggests that the share prices of banks which were more strongly regulated in the pre-crisis period (i.e. between 2002 and 2007) rose less than loosely regulated ones, they also declined less during the crisis. The result was a net positive effect, due mainly to the positive effects of accounting and provisioning and entry and ownership requirements. The analysis by Ahrend *et al.* found that, ceteris paribus, a country with moderately strong average prudential regulation had about 30% more banking equity left in 2009, relative to its 2002 value, than a country with moderately weak pre-crisis regulatory settings.

OECD evidence also seems to suggest, moreover, that there is not necessarily a trade-off between stability and competition in the banking sector. Although in a few areas, such as entry rules and ownership structures, tighter prudential regulations appear to hamper competition, they do not in general affect it and, in areas like the strength of the supervisory authority, they even enhance it.

Source: Ahrend et al. (2009).

Another prudential challenge to which Cambodia's central bank should rise is minimising the possibility of regulatory arbitrage and, at the same time, assessing the need for introducing additional prudential regulations. The bank should review key regulations related to credit and liquidity risk and put in place regulations governing market and operational risk.

Capacity building should continue to be the National Bank of Cambodia's top priority and it has acknowledged that it needs sufficient human resources in place and the time necessary to build the right skills and expertise. Institutionalising the capacity building programme should be a priority in order to ensure qualified, high quality human resources.

Overall, vulnerabilities within the banking sector remain at manageable level despite some concerns on credit and liquidity risk. The banking sector's performance is "back on track" with all signs pointing to a positive outlook for the pace and depth of growth. The intermediary function is expanding rapidly, giving the financial system greater depth and outreach.

Indonesia

A. Medium-term economic outlook (forecast, 2013-17 average):

GDP growth (percentage change):	6.4
Current account balance (% of GDP):	-3.7
Fiscal balance (% of GDP):	-1.2

B. Medium-term plan

Period: 2010-14

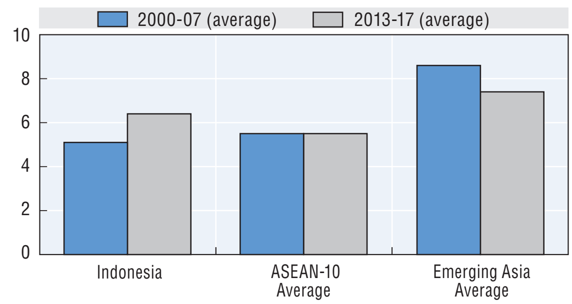
Theme: Prosperous, democratic and just

C. Basic data (in 2011)

Total population:	241 million*
Population of Jakarta:	9.6 million (in 2010)
GDP per capita at PPP:	4 666 (current USD)

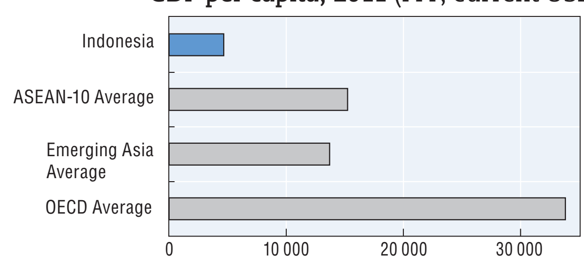
Note: *Total population data for 2011 are an estimate.
Sources: OECD Development Centre, MPF-2013, national sources and IMF.

GDP growth rates (percentage change)



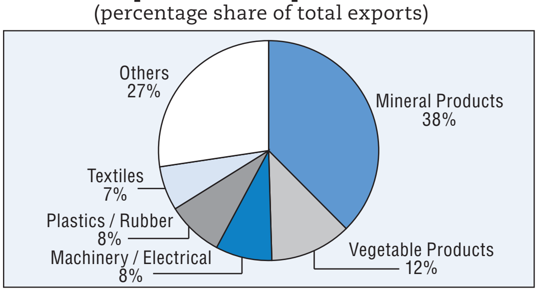
Source: OECD Development Centre, MPF-2013.

GDP per capita, 2011 (PPP, current USD)

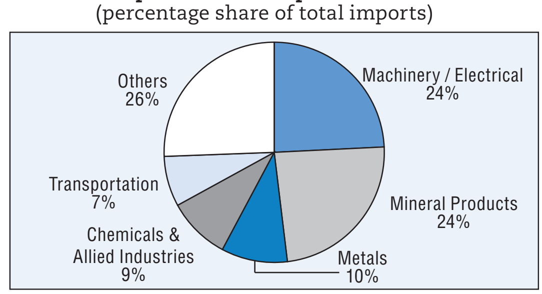


Source: IMF and national sources.

Composition of exports in 2011
(percentage share of total exports)



Composition of imports in 2011
(percentage share of total imports)



Source: Trademap.

Indonesia faces a number of challenges all of which centre on the key question of equality. It must build and upgrade its infrastructure primarily to close the development gap between the urban and rural areas and the west and east of the country. As a vast sprawl of scattered islands, connectivity is a key first step in its infrastructure policy. The same gap – west-east, urban-rural – affects education and, by the same token, human resource development. Generally, education enrolment and attainment levels are lower than in other ASEAN-6 countries, but they are particularly stark when urban and rural areas are compared. As part of its drive to achieve education for all, Indonesia has made significant progress in improving enrolment, particularly at the lower level of education. Decentralisation is key, but local government's capacity, particularly in staffing and the allocation of funds, is still too limited and there is little accountability.

Widely available health-care systems need to be established. Indonesia's expenditure on health care is among the lowest in ASEAN. Health-care provision and facilities are limited and over one-third of the population has no health insurance. The government has undertaken far-reaching social security reform, but much is still to be done to create a sustainable, equitable system.

Indonesia's medium-term policy challenges and responses

- Narrow the regional divide by enhancing connectivity and the capacity of local government
- Strengthen the capacity of local government to provide education infrastructure
- Accelerate health-care reform, focusing on coverage and access to health-care services

POLICY FOCUS

Narrow the regional divide by enhancing connectivity and the capacity of local government

MP3EI focuses on urban-rural disparities and strengthening connectivity

One of the main pillars of the 2011-25 Master Plan for the Acceleration and Expansion of Indonesia's Economic Development (MP3EI) is strengthening national connectivity. Under the terms of the plan, the provision of infrastructure will enable connectivity and, by reducing transportation and logistics costs, improve product competitiveness and accelerate economic growth. MP3EI aims to address regional disparities in infrastructure and ensure connectivity among the six economic corridors (Sumatra, Kalimantan, Java, Sulawesi, Bali and Nusa Tenggara, and Papua-Maluku) through an integrated system of national logistics, transportation, and communication and information.

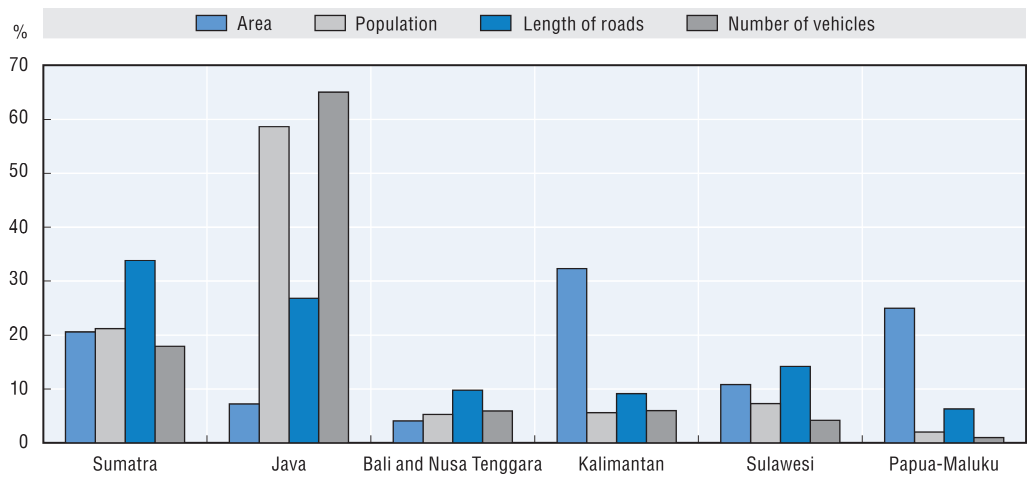
Regional disparities in infrastructure remain a big challenge for Indonesia

Insufficient in quantity and inadequate in quality, transport infrastructure is a serious bottleneck in the economic development of Indonesia (OECD, 2011a). While the total number of vehicles in Indonesia increased threefold between 2001 and 2010, the national road network – which serves more than one-third of vehicle traffic (in vehicle-kilometres) – grew by only a quarter. What is more worrisome is that most of the district and city roads, which account for nearly 80% of the network, are in bad condition (World Bank, 2012a), while the disparities between urban and rural infrastructure pose further challenges.

As for the extent of transport infrastructure, the predominantly rural regions of Kalimantan and Papua-Maluku have substantially less as a proportion of their land area than other regions, especially Sumatra, Java and Sulawesi (Figure 2.2.1).

Disparities also exist between urban and rural regions in the quality of road infrastructure. Over 20% of it is classified as damaged in the Kalimantan and Maluku, while in Papua the proportion of roads classified as good is only 19% of the total.

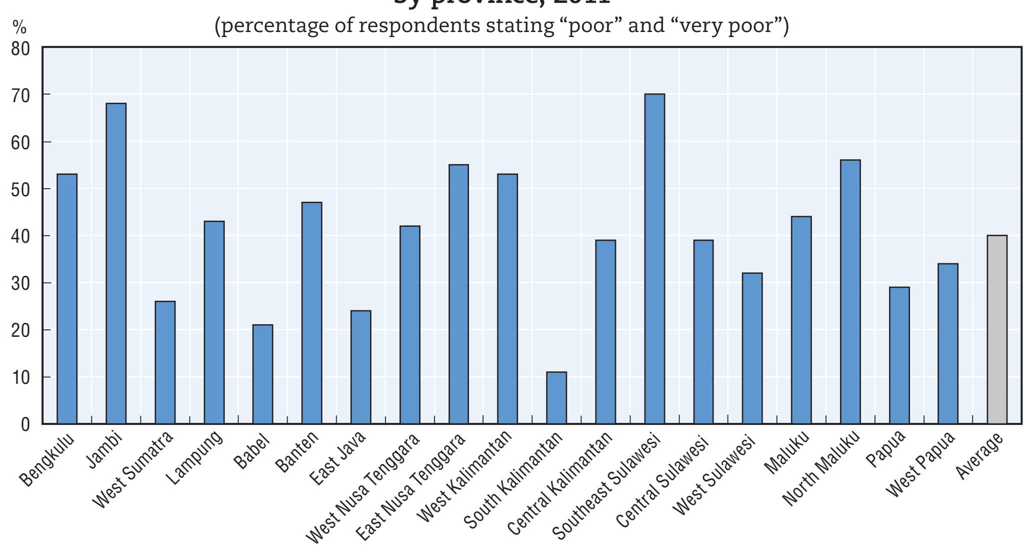
Figure 2.2.1. **Area, population, length of roads and number of vehicles in Indonesia, by region, 2011**
(percentage of total)



Source: Ministry of Transportation, Directorate of General Land Transportation, Land Transport in Figures 2011.
StatLink http://dx.doi.org/10.1787/888932774167

Disparities in the quality of infrastructure are corroborated by the results of the 2011 Report on Local Economic Governance (LEG).[1] It found that over 55% of respondents perceived the quality of road infrastructure as being "poor" or "very poor" in the provinces of Southeast Sulawesi, Jambi, and North Maluku, while the figure was under 25% for South Kalimantan, Babel and East Java (Figure 2.2.2). The report considered five kinds of infrastructure – roads, street lighting, water supply, electricity, telecommunications. The provinces of Southeast Sulawesi, Maluku and North Maluku came out worst on all five counts.

Figure 2.2.2. **Perceptions of the quality of local road infrastructure in Indonesia, by province, 2011**
(percentage of respondents stating "poor" and "very poor")



Source: Komite Pemantauan Pelaksanaan Otonomi Daerah (Regional Autonomy Watch [KPPOD]) (2011), Local Economic Governance, A Survey of Business Operators in 245 Districts/Municipalities in Indonesia, www.kppod.org.
StatLink http://dx.doi.org/10.1787/888932774186

In general, the report concluded that infrastructure in western Indonesia, the municipalities and main islands is of higher quality than in eastern Indonesia, the regencies, and smaller islands (KPPOD, 2011). It adds that the more densely populated regions score higher on the local infrastructure sub-index – the five types of infrastructure plus four variables: quality of local infrastructure, length of time needed to repair damaged infrastructure, level of generator ownership and frequency of power cuts.

Another reason why developing and improving connectivity is one of the main building blocks of the Master Plan is that the sheer distances between and within Indonesia's regions make transportation and logistics costs particularly high. Shipping goods in and out as well as within Papua and West Papua is more costly than in other regions of Indonesia.

Decentralisation needs to be reinforced through better co-ordination

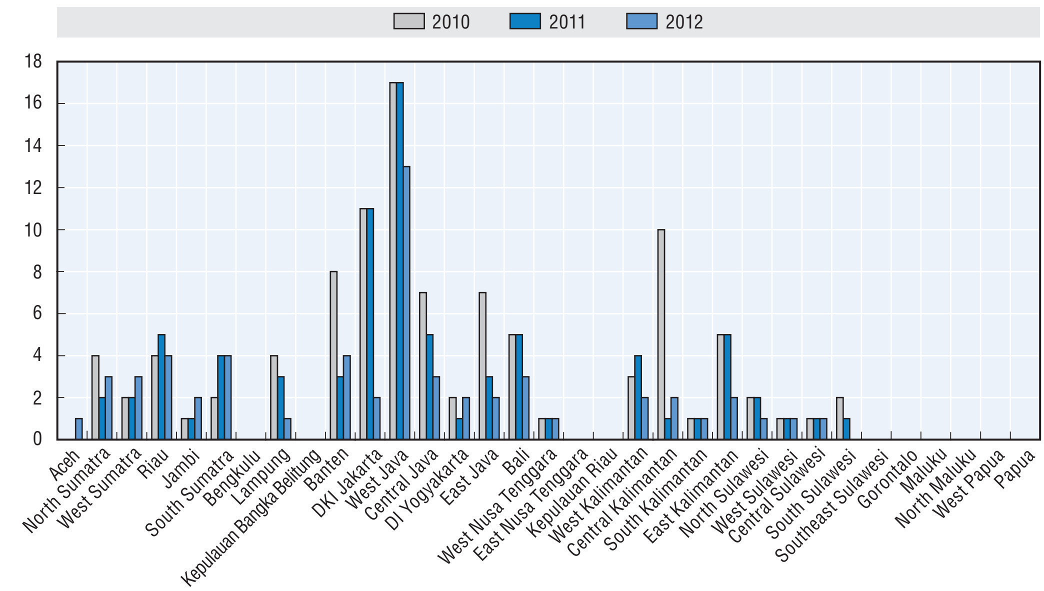
In addition to its efforts to improve the funding of infrastructure development, the government's main policy for narrowing the urban-rural infrastructure gap has been decentralisation. The decentralisation process, which started in 2001, transferred both decision making and financial resources for the delivery of basic services, such as the provision of transport infrastructure, to local governments.[2] However, the lack of co-ordination between key stakeholders has dogged the process.

In 2005, as part of a further effort to accelerate the development of infrastructure, the government established the National Committee for the Acceleration of Infrastructure Provision (KKPPI) to better co-ordinate infrastructure development activities among the ministries involved – the Ministry of Finance, the Co-ordinating Ministry for Economic Affairs, and the Ministry of National Development and Planning (Bappenas, 2010). However, KKPPI faces several challenges: it lacks concrete powers to shape policies, make decisions and act independently of the line ministries. For the time being, there is a sizeable gap between urban and rural areas in the number of infrastructure projects that may expect funding through public-private partnership (PPP) schemes (Figure 2.2.3).

In May 2011, as part of MP3EI, the Indonesian government launched 17 new infrastructure projects at numerous locations including Papua (OECD, 2011a), one of the regions lagging behind in terms of transport infrastructure. As the master plan identifies almost 400 infrastructure investment projects – in transport, energy, water and ICT infrastructure – to be completed by 2025, local government capacity to implement such projects needs to be bolstered. The aviation sector in Papua and West Papua, for example, has been underfunded in recent years and there was an acute shortage of high-level technical expertise in a variety of fields. Also in short supply is careful co-ordination between the various components that make up the aviation system and streamlined arrangements for cost sharing between local and central government (World Bank, 2009a).

In December 2011, the Indonesian Parliament passed the long-awaited Land Acquisition Law, which is designed to ease the bottleneck in infrastructure development by improving investment. It empowers the government to appropriate land in return for monetary compensation, the resettlement of occupants, or an ownership share in public projects. A further regulation setting out procedures for land acquisition was signed by the President in August 2012.

Figure 2.2.3. **The number of PPP infrastructure projects in Indonesia, by province**



Source: Ministry of National Development Planning and National Development Planning Agency, Republic of Indonesia.

StatLink http://dx.doi.org/10.1787/888932774205

Extra focus needs to be given to local government capacity building

Increasing resources both from public and private sources as well as improving the regulatory environment are essential measures. They are not, however, enough to complete all the infrastructure investment projects identified by the Master Plan. While infrastructure development activities among ministries and across tiers of government need to be better co-ordinated, there is also room for improvement in local government capacity building.

Although decentralisation and multi-level governance mechanisms are necessary parts of the effort to address urban-rural and regional disparities, the interests of Indonesia's sub-national divisions cannot be effectively represented without local knowledge. Infrastructure development projects may fail or lead to significant waste or corruption in the absence of adequate resources, knowledge and human capital (OECD, 2011b).

In Indonesia, local governments do not necessarily have the capacity to design and implement their assigned infrastructure projects effectively. Central government therefore needs to intervene to build local capacity, by increasing resources, training local government staff, and improving e-government tools (Box 2.2.1).

One of the main challenges Indonesia faces is the quality of its human resources. According to MP3EI 2011-25, around 50% of the workforce in Indonesia have only primary school education, while a mere 8% hold a formal qualification. Moreover, as a result of the apparent development gap between the western and eastern parts of Indonesia and between the urban and rural parts of the country, there are considerable disparities in access to high-quality education.

Box 2.2.1. Bridging the capacity gap: Examples from OECD countries

Capacity gaps arise when a local government lacks the human, knowledge-related and/or infrastructural resources to carry out development projects. OECD examples of capacity building include involving specialised non-profit organisations and improving the use of e-government tools.

In **Greece**, as a response to the sovereign debt crisis, a special non-profit organisation was set up to assist small municipalities (with populations of less than 10 000) which lacked the necessary skills for preparing the four-year action plans required to access EU structural funds.

In the **United States**, at the height of the recent financial crisis in 2009, distressed areas and small towns were less able to apply for relevant programmes and secure funding owing to the rigorous reporting requirements attached to the Recovery Act. Most importantly, they lacked the trained manpower needed to carry out intensive contracting and monitoring processes. The federal government website therefore supplied e-government tools to help recipients of recovery funds meet their quarterly reporting requirements by submitting their project updates online. Moreover, the use of such technology also considerably enhanced the accountability, speed and transparency of the Recovery Act.

Source: OECD (2011b).

POLICY FOCUS

Strengthen the capacity of local government to provide education infrastructure

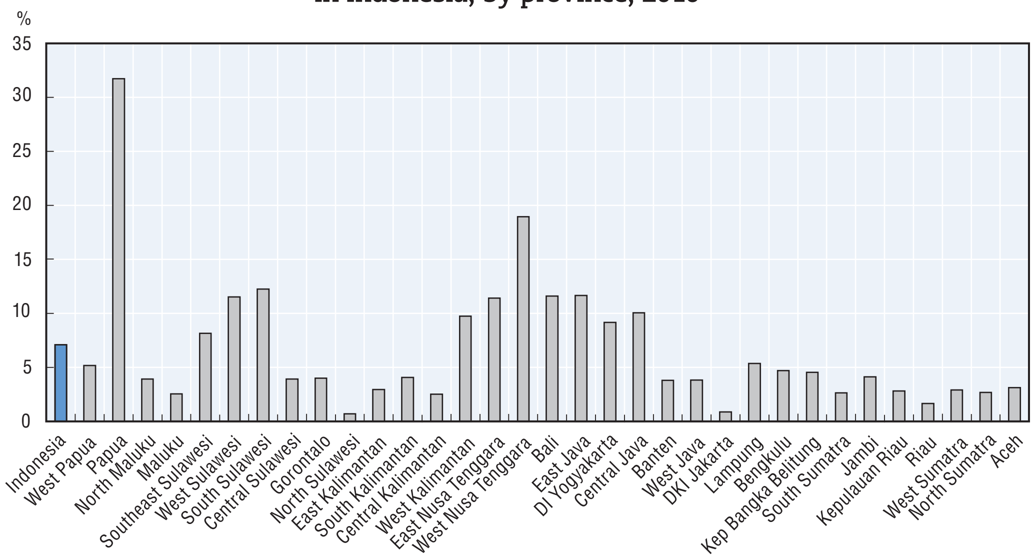
The improvement of human resources is an important pillar of the implementation strategy outlined in MP3EI. The master plan places a special emphasis on higher education, arguing that in a country that is shifting towards a knowledge-based economy the role of good quality education is paramount. MP3EI aims to tackle the issue of disparities in higher education through supply-side interventions such as establishing community colleges in every district and city. Furthermore, both vocational and academic education programmes are to be aligned with the economic potential of the six economic corridors so that graduates entering the labour market meet their particular needs.

The urban-rural education gap is still a vexed question

Although access to basic education has been steadily improving in Indonesia, as its mounting enrolment rates show (OECD, 2011a), disparities in education are still widespread.

The urban-rural education gap is apparent from literacy, enrolment rates and attainment levels. For instance, while the illiteracy rate among 15-year-olds and over was just 0.9% in the Capital Region of Jakarta in 2010, the comparable rate in Papua was 31.7% (Figure 2.2.4).

Figure 2.2.4. **Percentage of illiterate individuals aged 15 years or over in Indonesia, by province, 2010**

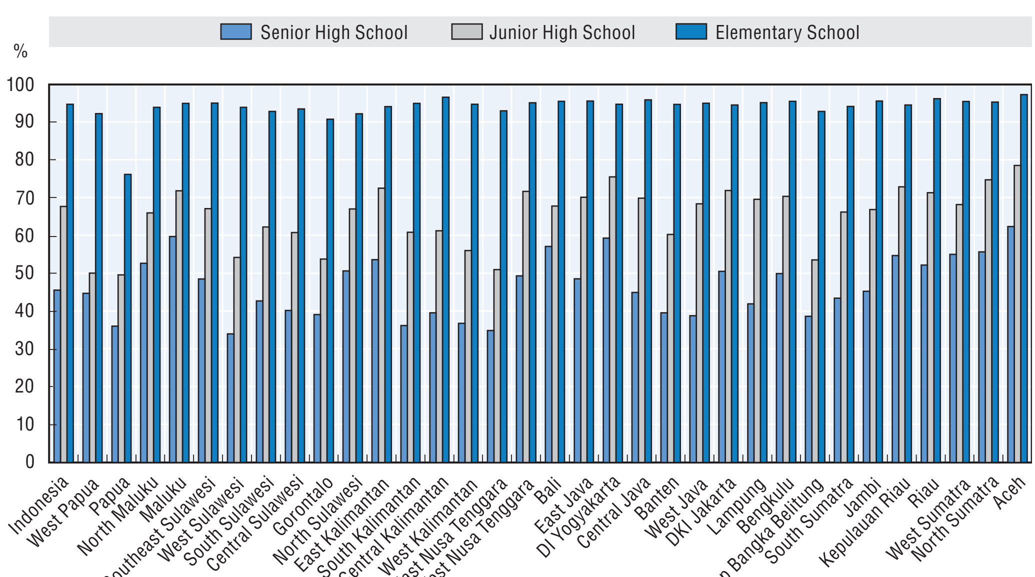


Source: BPS Statistics Indonesia.

StatLink http://dx.doi.org/10.1787/888932774224

Disparities in enrolment rates increase with the level of education. Nearly all provinces boast elementary school enrolment rates of over 90%, the only straggler being the predominantly rural province of Papua with an enrolment rate of 76%. Enrolment gaps are wider at junior and senior high school level (Figure 2.2.5).

Figure 2.2.5. **Net school enrolment rates in Indonesia, by province, 2010**



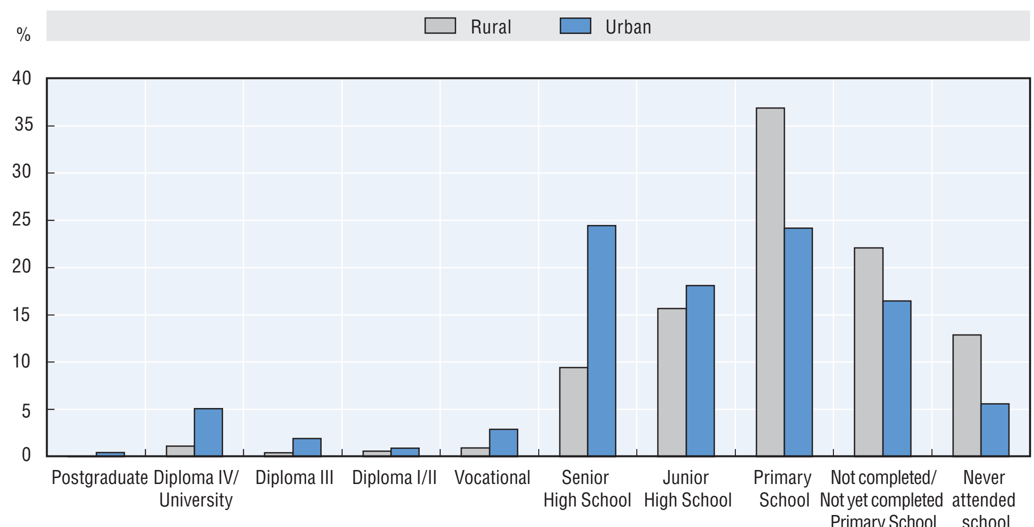
Source: BPS Statistics Indonesia.

StatLink http://dx.doi.org/10.1787/888932774243

Examination by age group of the percentage of the population attending school reveals that the urban-rural gap is already apparent among 5 to 6 year-olds at pre-school level. Indeed it is even wider than among elementary pupils. After elementary school the disparity in enrolment rates increases again, reaching its peak at post-secondary level between the ages of 19 and 24 years old.

The educational attainment gap among the population aged 5 years old and over shows wide disparities along the urban-rural fault line. While the most widely attained level in rural areas is primary school at 37%, among the urban population it is senior high school at 24%. Furthermore, while only 1% of the rural population is educated to university level, the figure is 5% among urban dwellers (Figure 2.2.6).

Figure 2.2.6. **Educational attainment of population aged 5 years and over in Indonesia, 2010**



Source: BPS Statistics Indonesia, 2010 Population Census.

StatLink http://dx.doi.org/10.1787/888932774262

Observation of the disparities in educational attainment among the different provinces shows that Jakarta has the best qualified human resources with 13% of the population of 5 years of age and older reaching higher education. The picture is in stark contrast to the mostly rural provinces of Papua, West and East Nusa Tenggara, West and South Sulawesi, and West Kalimantan, where between 13% and 38% of 5-year-olds and older have never attended school at all.

The nature of the disparities in enrolment rates and educational attainment in the different age cohorts reflects the policy of compulsory, and therefore free, basic education. Since compulsory education was extended from six to nine years in 2000, disparities at elementary level have been considerable. Similarly, disparities at junior high school level, though still wide, have narrowed since the extension of the length of compulsory education. On the other hand, as upper secondary education is not compulsory, regional gaps are not only wider than at lower levels, but have steadily worsened (Moeliodihardjo, 2010).

Regional disparity in Indonesia is mostly due to the paucity of social and economic infrastructure in the less developed areas (ibid.). The most serious impediments, though, in addition to the great differences in economic development among the provinces, are the shortages of educational infrastructure and quality teachers in disadvantaged areas. The 2005 Teacher Law has helped improve the standard of teaching by introducing incentives and sanctions to ensure that teachers have a minimum level of competency. The law has cut the numbers of teachers holding second jobs, but student learning outcomes do not seem to have improved so far. Nor does the current process of academic upgrading appear to have had anything but limited effects on student learning (World Bank, 2012b).

Although most universities do provide scholarships for students from the less developed provinces, the accumulated lag in education may well prove to be an insurmountable challenge when disadvantaged students take their entry exams to universities. The proportion of students admitted to the top five public universities – all located in Java – and who completed their secondary education outside Java is less than 15% (Moeliodihardjo, 2010).

Local governments need more flexibility to allocate centrally provided education funds

The decentralisation of political and economic powers from central to local governments has also devolved the delivery of education. Consequently, it is the regional governments' responsibility to maintain schools, pay teachers' salaries and collect students' fees. One of the main objectives behind decentralisation was to improve access to and the quality of education – yet it may actually have widened regional differences in educational attainment (Arifin, 2011). Although local governments account for the bulk of spending on education, they have limited autonomy in the allocation of funds transferred to them by central government, as most investment programmes are designed and financed by the central government through grants (OECD, 2010a).

In 2003, as a part of the decentralisation process, the Education Law set out four major directions: *i)* basic education should be free of all charges; *ii)* schools should be given the authority to manage their own programmes; *iii)* community participation in education should be encouraged; and *iv)* the financing of education should be based on the number of students rather than on the number of schools.

In 2005, the government implemented the School Operational Assistance Programme (BOS) in order to increase enrolment rates. This generally successful scheme (SMERU, 2006) has helped reduce school costs, so easing the burden on Indonesian households, particularly disadvantaged rural ones. Moreover, as part of the 2010-14 Medium-Term Development Plan (RPJN) additional support from the regional government budget (APBD) has extended free education to more and more regions.

In 2007 – and again as part of RPJN – the government started a conditional cash transfer scheme, the Family Hope Programme (PKH), to encourage poor households to send their children to school. The PKH was designed specifically to increase enrolment rates by making the nine-year duration of compulsory basic education a reality.

In the same year, the government launched another conditional cash transfer programme for rural communities, the PNPM Generasi. Under the terms of the programme, community funds (BLM) are allotted to villages, with the amount depending on the number of beneficiaries in a village – namely, pregnant women and children under 5 years old or of primary school and junior high school age. How the funds are used is decided by agreement among the villagers, but they must be spent on improving the provision and use of maternal and child health care and basic education services (SMERU, 2011)

Box 2.2.2. **Grants for remote, rural and small schools reinforce inequality.**

Over half of all provincial and district authorities have attempted to bridge the gap between the School Operational Assistance (BOS) grant that schools receive and their actual operating costs by introducing local school grants (BOSDA). However, BOSDA allocation criteria reinforce patterns of inequality with bigger, better equipped urban schools receiving higher grants than smaller, less well equipped rural schools. Its per-student formula fails to account for differences in operating costs. A school in a remote part of Papua can purchase fewer textbooks and other supplies than a school in Jayapura, the provincial capital, even with the same amount of BOSDA. In addition, electricity usage varies only according to the physical size of the school and the number of classrooms, not the number of students. A per-student formula allocates more to large schools with higher levels of enrolment than smaller schools. Ensuring that smaller schools have enough resources to cover their overheads is a significant issue, because nearly half of all primary schools in Indonesia have fewer than 150 students.

The BOS has recently been decentralised to improve it implementation.

Source: World Bank (2012c).

The 2010-2014 Medium-Term Development Plan also has provision for school infrastructure. Central government has assisted the regional authorities in rehabilitating school buildings built in the 1970s and 1980s and further increasing the total number of classrooms and new schools.

A further measure – the open junior high school system – addresses the lack of school infrastructure and the needs of students who either live in remote locations or simply cannot attend school regularly for economic reasons. Children in poor areas tend to drop out and start working once they have gained basic literacy and numeracy skills, because their parents, who mostly work informally, see their children as workers and place no value in further education (Mukherjee, 2006).

The open junior high school system was created to provide a teaching and learning schedule that is as flexible as possible. Tutors assist in the "learning process" in their neighbourhoods, while students meet every now and then to discuss what they learned and eventually take exams in a "learning place" that may be further away from where they live. No tuition fees are charged in open junior high schools and, although the general curriculum is similar to that of their peers in regular junior high schools, there is more emphasis on life skills as most students do not continue formal education afterwards.

Target funding where needs lie

In addition to increasing public spending on education[3] to improve the development of rural school infrastructure, it is also important to balance local autonomy with efficiency and make school funding strategies more responsive to the needs of disadvantaged regions, schools and students. A balance should also be struck between the autonomy delegated to local governments and their accountability. Decentralising the governance of education is not necessarily a way to respond to local needs or address disparities, as local authorities may lack the required capacity. The experience of OECD countries shows that, while the central government should exert control over levels of school funding and performance standards (OECD, 2012a), schools should enjoy autonomy in areas where their knowledge and know-how are relevant – e.g. managing their personnel. Currently personnel management is the responsibility of regional and sub-regional authorities (OECD, 2012b).

As disadvantaged regions and schools may need additional resources (to attract more experienced, better qualified teachers, for example), it is paramount that the right amounts are allocated if disparities are to be effectively addressed. Formula funding – which relies on a mathematical equation incorporating parameters like students' socio-economic backgrounds and parents' educational levels – is considered to be a more efficient strategy for ensuring equity (Box 2.2.3) than the current practice of historical budgeting.

Box 2.2.3. **Formula funding for equitable and effective resource allocation: Examples from OECD countries**

Disadvantaged schools may need additional resources as the challenging socio-economic profiles and varying needs of the students tend to push up teaching costs. The OECD experience is that disadvantaged schools have less experienced, less qualified teachers, even though quality teaching is particularly vital to meeting the learning needs of their students. It is therefore essential that resource allocation should be optimised through an adequate funding scheme in order to improve equity.

Formula funding uses mathematical formulae comprising meaningful parameters to determine school budgets. Formulae contain four main groups of variables used across OECD countries. The variables are based on: *i)* student numbers and grade levels; *ii)* needs; *iii)* curricula or educational programmes; *iv*) school characteristics. In general, formula funding is considered to be the most efficient, transparent method of school funding that incorporates needs criteria.

In the **Netherlands**, formula funding that is weighted to meet the needs of disadvantaged students has been in place in all primary schools since 1985. The "weight" of each student is determined by their parents' educational level, while schools have the freedom to spend the extra resources as efficiently as they can. Formula funding arrangements have apparently succeeded in distributing differentiated resources to schools according to their different needs: primary schools with high proportions of "weighted" students have on average 58% more teachers per student as well as more support staff.

Chile introduced a weighted voucher scheme in 2008 to favour students from low socio-economic backgrounds and schools with high concentrations of disadvantaged students. It replaced a system where all students were weighted equally. Although acceptance of supplementary funds is voluntary, the schools who do accept them are subject to mandatory technical support and a quality assurance system that includes improvement plans and objectives to ensure value for money. Evidence points to the weighted voucher system achieving results and mitigating disparities in education.

Source: OECD (2012a).

Formula funding weighted to account for disadvantaged students and schools would be a step in the right direction of mitigating educational disparities in Indonesia.

POLICY FOCUS

Accelerate health-care reform, focusing on coverage and access to health-care services

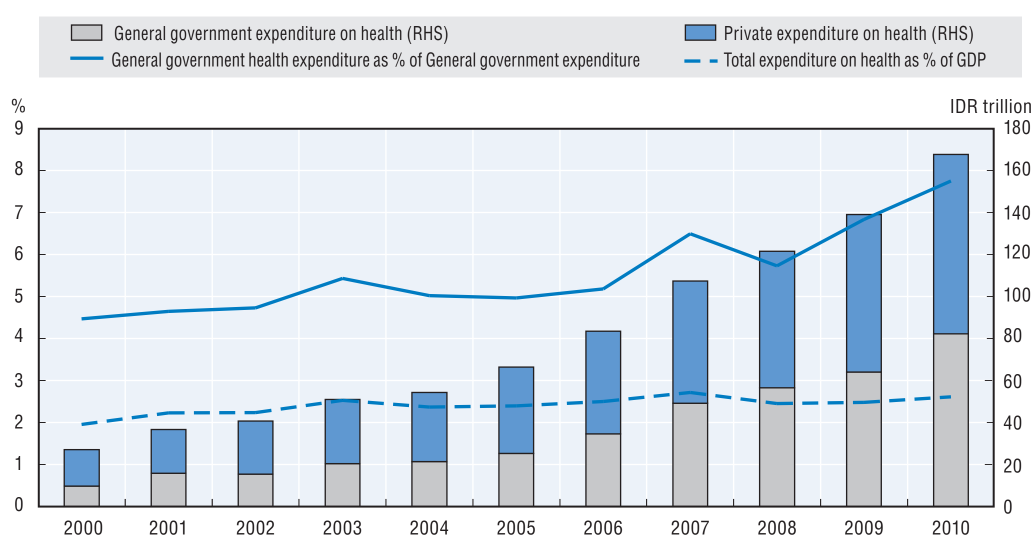
Both the RPJN 2010-2014 and the MP3EI 2011-2025 stress the importance of health care. The RPJN seeks to widen access to health services and sets ambitious numerical targets for increasing life expectancy and reducing infant and maternal mortality rates. Other objectives, it states, are improving the quality of internationally accredited hospitals, standardising pharmaceutical procurement, controlling the prices of branded generic medicines, and gradually expanding the health insurance system to universal coverage by 2014.

The MP3EI reaffirms the importance of improved access to health-care services and proposes to do so through targeted economic assistance to the poor and social insurance for all.

Indonesia's health-care system remains underdeveloped

Indonesia does not spend enough on health care. Although government health expenditure has increased in recent years, total health expenditure has remained under 3% of GDP (Figure 2.2.7). Among ASEAN countries, only Myanmar spends less on health than Indonesia (Figure 2.2.8).

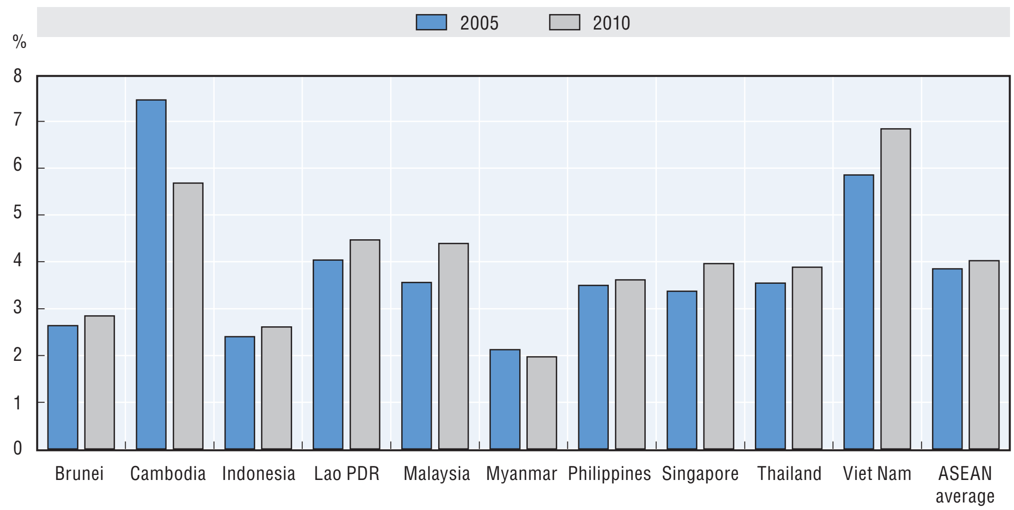
Figure 2.2.7. **Expenditure on health in Indonesia, 2000-10**



Source: WHO Global Health Expenditure Database, http://apps.who.int/nha/database/DataExplorerRegime.aspx.

StatLink http://dx.doi.org/10.1787/888932774281

Figure 2.2.8. **Expenditure on health in Southeast Asia**
(percentage of GDP)



Source: WHO Global Health Expenditure Database, http://apps.who.int/nha/database/DataExplorerRegime.aspx.
StatLink http://dx.doi.org/10.1787/888932774300

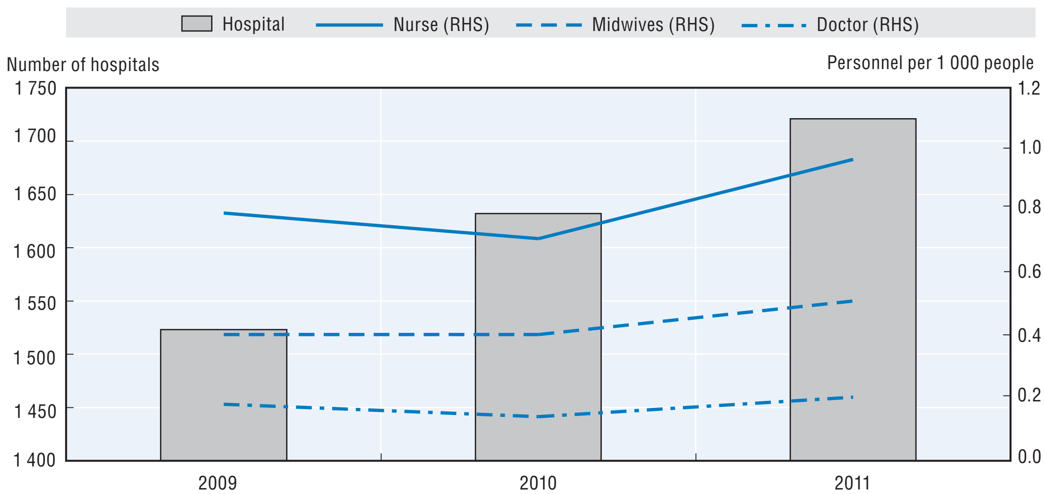
An additional issue of health-care spending is its inefficiency. Although local authorities are responsible for a substantial part of health service delivery, there is a lack of administrative and managerial capacity, while local governments have no incentive to contain costs or increase cost-effectiveness (OECD, 2010a).

The insufficiency and inefficiency of Indonesia's health expenditure has produced sub-par service provision, as measured by the number of hospitals and the density of medical staff. And even though they have increased slightly (Figure 2.2.9), Indonesia still lags behind its regional peers (Figure 2.2.10). The number of hospital beds per 1 000 people is only 0.6, lower than in Cambodia or Lao PDR. Similarly, there are only 0.3 doctors for every 1 000 inhabitants, while the figure is 0.5 in Myanmar (Figure 2.2.10). The low effective density of medical personnel is due mainly to protective regulations that bar entry into the medical profession as well as to the limited powers of local authorities to sanction absenteeism (OECD, 2010a).

There is room to improve the quality of services on account of the lack of medical appliances and supplies (OECD, 2010a). The result is low confidence in health-care services, with relatively high percentages of the population treating themselves (70%) or using traditional medicine (30%) (Figure 2.2.11).

As a consequence of insufficient, inefficient expenditure and shortages of equipment and medicine, the health status of the population is poor. Figure 2.2.11 shows that when Indonesians are questioned about their health, 31% report they have had complaints in the last month. Furthermore, life expectancy is lower than in any other ASEAN countries except for Cambodia, Lao PDR and Myanmar.

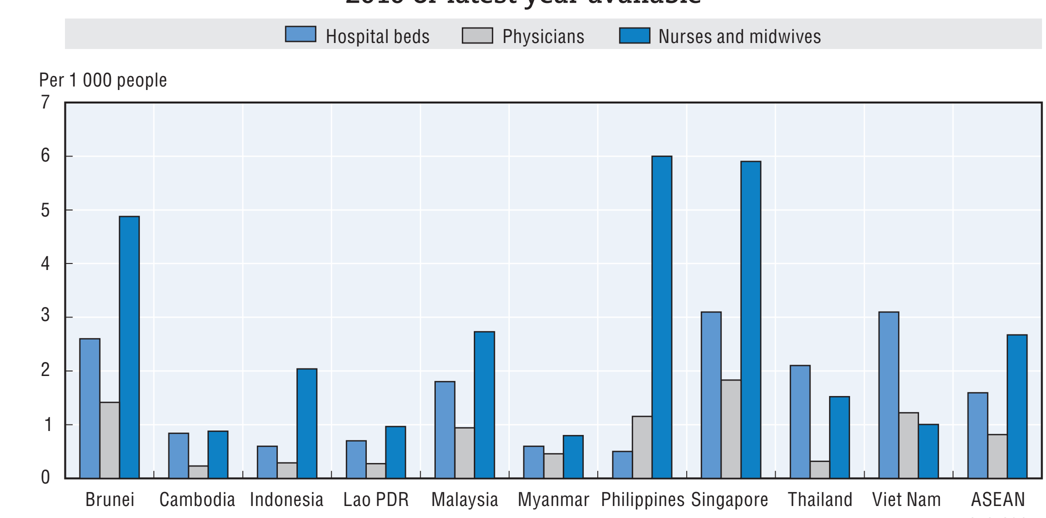
Figure 2.2.9. **Supply of health services in Indonesia**



Source: Ministry of Health.

StatLink http://dx.doi.org/10.1787/888932774319

Figure 2.2.10. **Supply of health services in Southeast Asia, 2010 or latest year available**

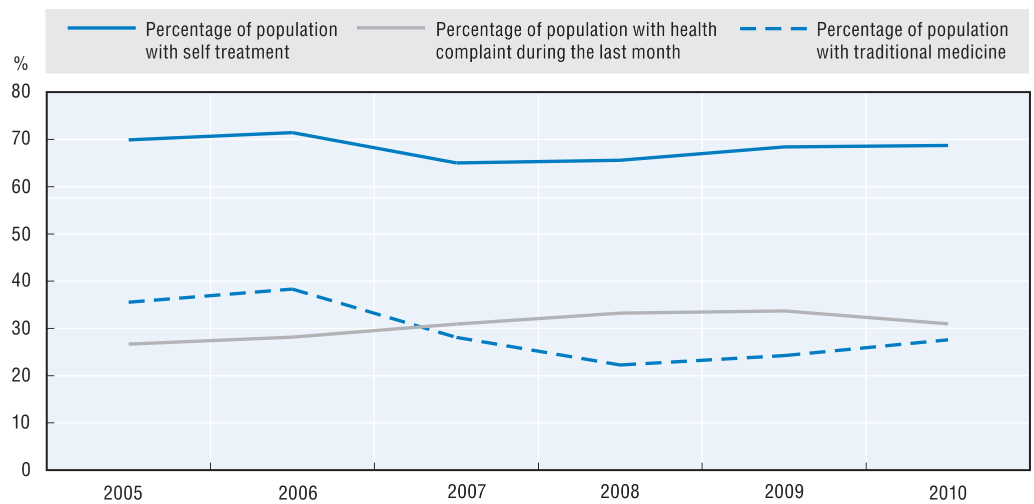


Source: World Bank.

StatLink http://dx.doi.org/10.1787/888932774338

Much of the Indonesian society does not have any type of health insurance, either although the share of the population covered by any health insurance programme increased from 43% in 2007 (ILO, 2008) to 65% in 2011 (Figure 2.2.12).

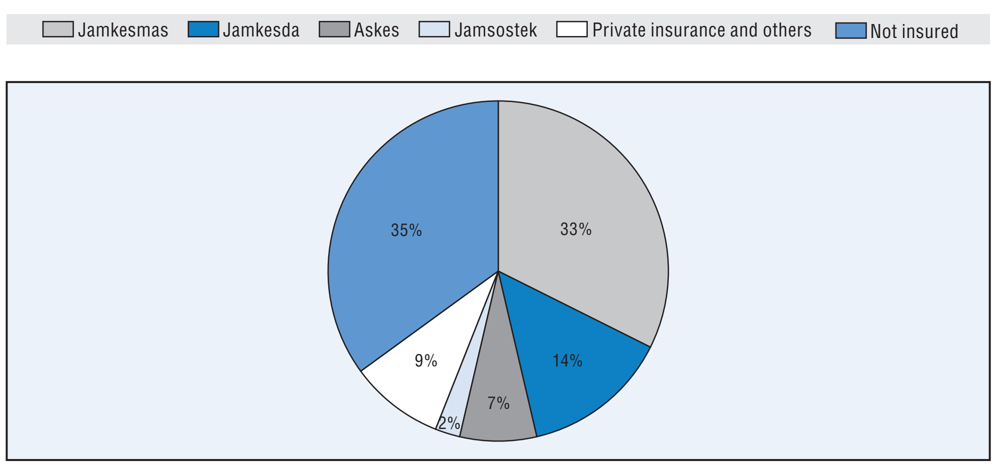
Figure 2.2.11. **Health status and alternative treatment in Indonesia**



Source: BPS Statistics Indonesia.

StatLink *http://dx.doi.org/10.1787/888932774357*

Figure 2.2.12. **Health insurance coverage in Indonesia, by programme, 2011**



Source: Ministry of Health.

StatLink *http://dx.doi.org/10.1787/888932774376*

Despite government efforts to provide coverage for all, the extent of the informal economy – which accounts for about two-thirds of total employment (OECD, 2011a) – and the fragmented nature of the different health insurance schemes leave a considerable proportion of the population without insurance. There is empirical evidence that illness leads to financial risk as people pay for treatment out of their own pockets. This is especially true of the rural population and the poorest quartile of the population where consumption smoothing is imperfect as non-food expenditure is affected by ill health (Sparrow and Van de Poel, 2012).

The existing publicly managed health insurance programmes differ as to their beneficiaries, benefits, premiums and in the efficiency of their health-care provision and management. The government-financed programmes, *Jamkesmas* and *Jamkesda*, for the poor and near-poor cover over 100 million people, or almost 50% of the population. The benefits of *Jamkesmas* include comprehensive out-patient and in-patient care in public health clinics and third-class hospitals, while those of *Jamkesda* are provided only in certain provinces and districts and vary in nature from one to the other.

Table 2.2.1. **Health insurance programmes in Indonesia**

	Beneficiaries	Premium	Benefits	Coverage	Performance
Jamkesmas	- Poor and near-poor population (target population is 93 million people)	- Financed by the government	- Comprehensive out- and in-patient care in public health clinics and third-class hospitals	76 million people	- Lack of co-ordination between planning and implementation
				(33% of the population)	- Beneficiaries poorly informed about the benefits they are entitled to.
Jamkesda	- People who are identified by the local authorities as poor and near-poor but are not covered by Jamkesmas	- Financed by local government	- Benefits are provided only in certain provinces and districts and vary from one to the other.	33 million people	- Lack of detailed information about beneficiaries and how they use health care
				(14% of the population)	- Beneficiaries of Jamkesda may overlap with those of Jamkesmas
Askes	- Civil servants and their dependants	- 2% of basic salary that is matched by the government	- Comprehensive out- and in-patient care, no additional payment needed for prescribed medicine	17 million people	- There is no official information either on the exact number of beneficiaries covered or on the amount of benefits paid out
		- Mandatory scheme	- There is only one state-owned hospital that provides services for Askes card holders in each municipality	(7% of the population)	- The quality of service received varies considerably according to the rank of the civil servant treated
Jamsostek	- Formal sector workers and their families who work in private enterprises with at least ten workers and a turnover of at least IDR 1 million	- Either 3% of the salary for single employees and 6% for married employees - Not mandatory (companies can opt out if they offer comparable or better health insurance)	- Generous health care package that includes a wide range of medical services, drugs, and treatment for out-patients and in-patients	6 million people (2% of the population)	- Governance and management are of better quality than in other publicly managed programmes (e.g. Askes), and it is consequently more efficient and transparent

Source: OECD Development Centre's compilation based on ILO Social Security Department, www.ilo.org/dyn/ilossi/ssimain.schemes?p_lang=en&p_geoaid=360; Widjaja and Simanjuntak (2010); OECD, 2010a.

Although *Jamkesmas* and *Jamkesda* reach much of their target population, there are serious deficiencies. The poor co-ordination between planning and implementation leads to overlaps, with some people covered by both schemes. Another issue is the lack of detailed information about beneficiaries and how they use health care. There are some, for instance, who are covered but were not originally so – and *vice versa* – while most people do not know to what services they are entitled.

The two publicly managed but privately financed programmes, *Askes* and *Jamsostek*, insure civil servants and their dependents and formal sector workers (and their families). While *Askes* is a mandatory scheme, employers can opt out of *Jamsostek* if they offer comparable or better health insurance policies. Although Askes insurance premiums (2% of the salary matched by the government) are more attractive, the benefit package offered by *Jamsostek* is more generous. The programmes also differ with respect to their performance. *Askes* provides official information neither on its exact number of beneficiaries nor the amount of benefits it pays out, while its quality of service varies widely according to beneficiaries' rank in the civil service. *Jamsostek*, however, is more efficient and transparent in its governance and management practices.

Recent policies address health care and other social security reforms

Since Indonesia began its decentralisation process in 2001, local authorities have had the power to manage public health-care facilities and medical personnel by setting fees and user charges for public health services and allocating the transfers received from central government to finance provision. However, control over medical personnel's employment and pay conditions and over the health insurance scheme for the poor has remained in the hands of the central government (OECD, 2010a).

In 2004, the National Social Security System (SJSN) Law provided a blueprint for the future shape of the social security system and envisaged a comprehensive system of social protection with universal coverage. In addition to health insurance, the framework included pensions, old-age savings, workers' compensation, and death benefits – all financed by workers' contributions, with the exception of provisions for the poor, which are funded by the state. As for informal workers' contributions, the SJSN Law states that nominal amounts instead of a percentage of wages should be collected. With respect to implementation, it specifies that the health-care programme should be put in place first. The sustainability of the future system was also taken into account, as the law stated explicitly that the programmes had to be affordable for the state budget. In terms of governance, social security administrative bodies (BPJS) would manage the social security funds attached to each programme. A monitoring and research body, the National Social Security Council (DJSN), would be created to formulate policies, synchronise the SJSN system, conduct research into social security, and monitor the social security administrative bodies. However, the law did not address such issues as the amount of benefits, contribution rates, or the exact governance structure of the system (Rachmatarwata and Ginting, 2010).

In 2011, in a major step towards the actual implementation of the National Social Security System Law, a regulation spelled out the status of the BPJS, BPJS Health and BPJS Employment administering health as well as work accident, old-age, pension and death related programmes. The BPJS are to be managed as trust funds on a non-profit, compulsory-participation basis and are to be externally monitored by the DJSN. When the BPJS's health programme becomes operational on 1 January 2014, current health insurance schemes will be dissolved and managed by the new administrative body, BPJS Health.

Health-system reforms need to look further ahead

While public spending on health care needs to be increased, the medium- and long-term fiscal sustainability of the reformed health-care system also deserves consideration. Another challenge, in addition to the objective of universal coverage, is that the ageing of Indonesian society will further increase the strain on the system in the long term (Box 2.2.4).

Although the final benefit and contribution levels are still pending, the 2004 BPJS Law was an important step towards creating a financially viable system that is based on compulsory participation and so ensures adequate risk pooling. Nevertheless, further efforts are needed to achieve fiscal sustainability. Cost-effectiveness in treatment procedures as well as the administrative and managerial capacities of local governments need to be enhanced in order to increase spending efficiency.

The issue of fiscal sustainability is closely linked to the balance between the benefit package offered and the level of contribution required. As the different health-care schemes will be dissolved under BPJS Health, it is important to define an adequate but fiscally sustainable basic benefit package that can be supplemented with further private health insurance providing extra services. As regards contributions, there is a need to define the different premiums of employees working in different sectors (i.e. civil servants covered by *Askes* and private-sector employees by *Jamsostek*), while the government should continue to fund health insurance for the poor and near-poor. For the informal sector, a tax-based financing scheme or a government-funded one similar to the arrangement for the poor and near-poor could be considered as the administrative and enforcement costs of collecting contributions may be high.

The capacity of the new administrative body, BPJS Health – its funding, its personnel's technical skills (e.g. actuarial and modelling abilities) and data collection and electronic registration system – needs to be enhanced. On the supply side, physical infrastructure and service provision could be improved to cope with growing demand prompted by coverage for all and – simply – to improve the general quality of services. To ease supply-side constraints, more investment is required in physical infrastructure such as hospitals and medical appliances, especially in rural areas. In terms of service provision, local authorities should be granted greater powers to monitor and sanction staff, e.g. medical personnel for absenteeism (OECD, 2010a).

Box 2.2.4. **Improving health care under a budget constraint: Examples from OECD countries**

In OECD countries, total health-care spending as percentage of GDP has risen significantly from 5% in 1970 to 9.5% in 2007. Total health-care expenditure per capita also increased more than 70% in real terms between 1990 and 2007. In the meantime, public spending on health care, which accounts for 15% of general government expenditure on average in 2007, is projected to increase by 3.5 to 6 percentage points of GDP between 2005 and 2050.

Across OECD countries, but also in Southeast Asian countries, population ageing, rapidly rising health-care prices and costly developments in medical technology are major contributors to upward pressure on health-care budgets.

In order to achieve two competing goals – enhancing the health-care system and maintaining fiscal sustainability – OECD countries use various policy instruments to govern the behaviour of users, providers and payers of health care.

As regards users, many OECD countries try to steer patient demand by restricting their choice (e.g. the requirement to register with a general practitioner and/or limitations on choosing a primary care physician, a specialist and a hospital).

Belgium, **Canada**, **France**, **Germany**, **Japan** and **Switzerland** have introduced powerful incentives to encourage them to adjust to demand by relying on fee-for-services and payment per procedure. There is a risk, however, that such provider payment schemes may lead to supply-induced demand owing to information asymmetry between patients and doctors.

As for payers, competition across insurers has been introduced in some countries. In **Switzerland**, free choice among insurers for basic health-care coverage and open enrolment were introduced in 1996. Overall, OECD countries have relied both on market mechanisms and on regulations, which often play a complementary role.

OECD countries have more specific and practical examples of programmes that can be lessons for Southeast Asian countries. The **United Kingdom** is implementing a programme of health checks for everyone aged between 40 and 74 to prevent heart disease, stroke, diabetes and kidney disease. According to estimates from the Department of Health, the health check programme will cost GBP 332 million (British pounds) a year, but generate an annual benefit of GBP 3 678 million, save around 650 lives, and prevent 1 600 strokes and heart attacks.

Japan introduced mandatory long-term care insurance system in 2000. It is reviewed or revised every five years, to improve health-care services to elderly people and reduce costs. After the first review in 2005, “hotel costs” (i.e. room and board fees for long-term care residents) were introduced to give people incentives to stay at home and receive community-based services rather than go into more costly long-term care facilities. Japan also expanded the preventative service provision to prevent people from becoming dependent.

Sources: OECD (2010b) and OECD (2011c).

Notes

1. The LEG study, prepared by KPPOD (Komite Pemantauan Pelaksanaan Otonomi Daerah, or Regional Autonomy Watch) and The Asia Foundation, aims to measure the quality of local economic governance in 245 regencies/municipalities in 19 provinces in Indonesia by surveying business community`s perceptions. Local infrastructure is one of the nine indicators included in- the report. The final LEG Index is the weighted average of the nine sub-indices.
2. See Asia-Pacific page on the World Bank website, http://web.worldbank.org/WBSITE/EXTERNAL/COUNTRIES/EASTASIAPACIFICEXT/0,,contentMDK:23186158~pagePK:146736~piPK:146830~theSitePK:226301,00.html#5.
3. In 2010, public spending on education in Indonesia was only 3% of total GDP.

Malaysia

A. Medium-term economic outlook (forecast, 2013-17 average):

GDP growth (percentage change):	5.1
Current account balance (% of GDP):	6.2
Fiscal balance (% of GDP):	-4.8

B. Medium-term plan

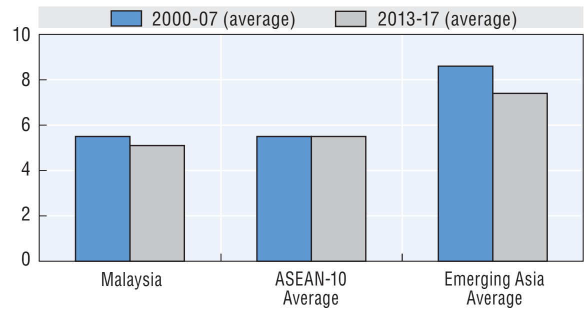
Period:	2011-15
Theme:	Charting development towards a high-income nation

C. Basic data (in 2011)

Total population:	29 million*
Population of Kuala Lumpur:	1.7 million (in 2010)
GDP per capita at PPP:	15 568 (current USD)

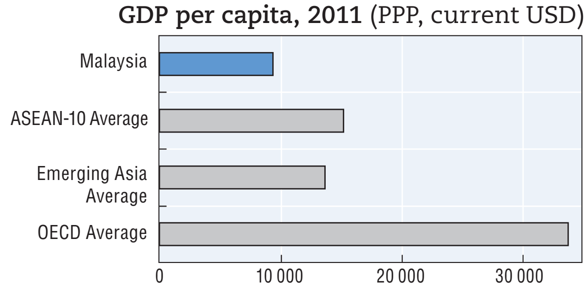
Note: *Total population data for 2011 is an estimate.
Sources: OECD Development Centre, MPF-2013, national sources and IMF.

GDP growth rates (percentage change)



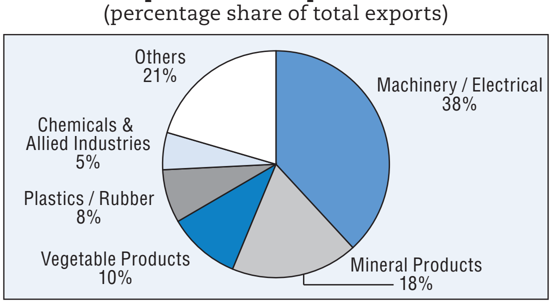
Source: OECD Development Centre, MPF-2013.

GDP per capita, 2011 (PPP, current USD)

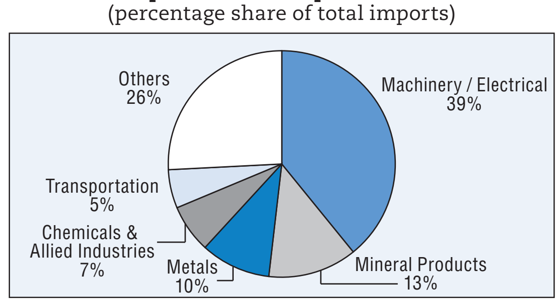


Source: IMF and national sources.

Composition of exports in 2011
(percentage share of total exports)



Composition of imports in 2011
(percentage share of total imports)



Source: Trademap.

Malaysia will need to address some important long-standing economic weaknesses in the medium term in order to progress toward becoming an advanced economy within the next decade. Skill shortages and mismatches and the deficiencies in the education system that underlie them and the low participation of women in the workforce particularly need to be remedied. Measures to improve small and medium enterprise (SME) productivity and to reduce gaps between rural and urban SMEs will also be needed.

Malaysia's medium-term policy challenges and responses

- Strengthen TVET and the education system to address skills shortages
- Address weaknesses in labour market functioning
- Enhance productivity of SMEs

POLICY FOCUS

Strengthen TVET and the education system to address skills shortages

Intensifying human capital development is a critical need

The Malaysian government has introduced a national transformation framework which aims to drive the country toward an advanced nation by 2020. Three pillars of the framework, the New Economic Model (NEM), the Economic Transformation Programme (ETP), and the 10th Malaysia Plan (2011-2015), have underscored the critical role of a highly skilled, creative and innovative workforce in achieving a high income economy that is both inclusive and sustainable.

Presently, the talent base of the workforce of Malaysia has lagged behind the standard of high-income nations.[1] The country suffers from a shortage of skilled workers, weak productivity growth stemming from a lack of creativity and innovation in the workforce, and an over-reliance on unskilled and low-wage migrant workers (National Economic Advisory Council, 2010).

In 2010, 58.0% of the Malaysian labour force had only a secondary level education, 13.2% had primary level education and 2.6% had no formal education. That implies nearly three-quarters (73.8%) of the Malaysian labour force in 2010 is low-skilled. An also noteworthy point is that more than 47% of non-Malaysian citizens in the labour force, i.e. migrant workers, had only a primary level education.

The Malaysian government has realised that the present education system needs a complete overhaul if the country is to transform itself into a knowledge- and innovation-based high income economy. The Malaysia Education Blueprint 2013-2025 was launched in September 2012 as the latest initiative of the government to transform the education system into one that produces thinking and innovative students to meet the needs of the new economy.

Employers' over-reliance on unskilled and cheap foreign labour has led to inadequate growth of skilled workers in the labour market. As a result, only 25% of Malaysia's labour force is composed of highly skilled workers, as compared to significantly higher proportions in Singapore, Chinese Taipei and Korea. The inadequately educated labour force of Malaysia has become the main obstacle to business operations and growth. Businesses in Malaysia, including SMEs, face increasing difficulties in recruiting and retaining skilled workers at the technical, supervisory and managerial levels (National SME Development Council, 2012).

Such difficulty has intensified as the mismatch between skills needed by the labour market and those acquired by job seekers has worsened. More than 40% of firms have reported vacancies for skilled production worker positions, and the average time required to fill a vacancy is about four weeks (World Bank, 2009b). The main reason given by the firms for this long process is that the applicants did not have the required basic skills or the right technical skills needed to carry out the jobs in question. The evidence of skills mismatch is further indicated by the relatively high unemployment rate of graduates (Table 2.3.1). A survey by the Ministry of Higher Education (MOHE) in 2008 shows that about a quarter of graduates of university and colleges remained unemployed six months after completion of their studies. For those who secured jobs, almost one-third were in jobs at a lower skill level than they were trained for (National Economic Advisory Council, 2010).

Table 2.3.1. **Employment status of 2006 and 2007 graduates at the end of 2008 in Malaysia, by institution type and level**
(percentage)

Employment Status	Institut Pengajian Tinggi Awam (IPTA)*		Institut Pengajian Tinggi Swasta (IPTS)**	
	Bachelor's level	Below Bachelor's level	Bachelor's level	Below Bachelor's level
Employed	73.1	46.8	77.5	57.2
Waiting for placement	3.1	0.7	0.4	0.5
Pursuing further study	6.6	27.4	2.9	11.4
Unemployed	17.1	25.1	19.1	30.8

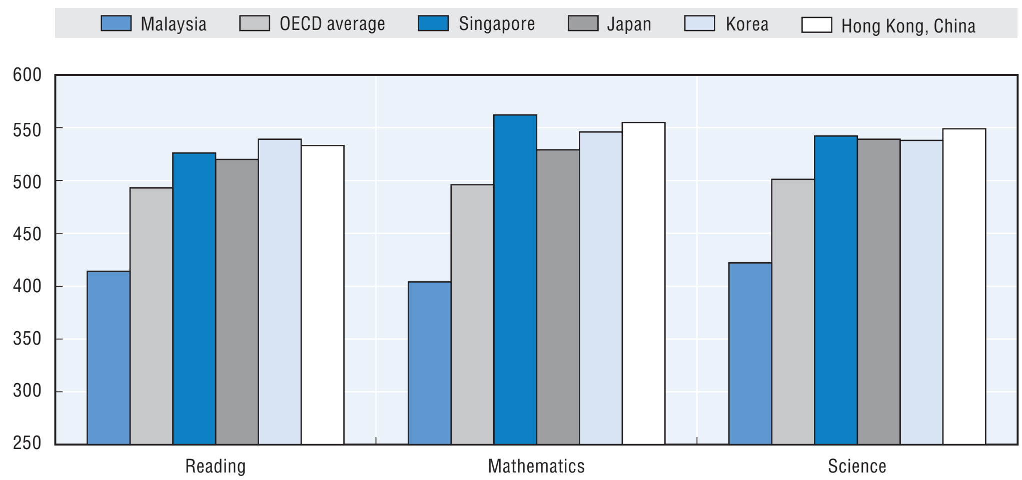
Notes:
* Public Higher Education Institution.
** Private Higher Education Institution.
Source: Malaysia Economic Monitor 2011, Table 16, p.57.

While the government has been trying to raise the skill-level of the labour force by broadening the access to technical and vocational education and training (TVET), the take-up rate is still low. Only 10% of students enrol in upper level secondary technical and vocational education, much lower than the average enrolment rate of 44% for OECD countries (EPU, 2010). Moreover, as a recent assessment of the Malaysian National Dual Training system by Pang (2010) shows, skill-training programmes remain mismatched with industry requirements in Malaysia, partly because the private sector has not been given a sufficient role in shaping the programmes.

The education system needs to be reformed to produce students with strong analytical and problem-solving capabilities, a good command of English, and effective social networking skills. These qualities are of great importance in the adoption of cutting edge technology and in the promotion of knowledge generation and innovation. Malaysia is increasingly at risk of falling behind competitor countries as the quality of its education is declining. In 1999, Malaysia's performance in the Trends in International Mathematics and Science Study (TIMSS) 8th Grade Mathematics and Science was well above the international average. The 2007 results, however, fell below the international average. In the three types of cognitive skills assessed (knowledge recall, the application of knowledge in solving problems and the ability to reason in working through problems), Malaysian students have lagged behind the performance of their counterparts in the high-income economies in the region.

According to the OECD's Programme for International Student Assessment (PISA) 2009 Plus assessment, Malaysia performed in the bottom third for reading, mathematics and science, well below the international and OECD average in all three areas (Figure 2.3.1). Malaysia's performance was at least 100 points below that of regional peers such as Singapore, Japan, Korea and Hong Kong, China on all three dimensions. Almost 60% of Malaysian students did not meet the minimum benchmarks in mathematics – the baseline proficiency required for students to participate effectively and productively in life. Similarly, 44% and 43% of students do not meet minimum proficiency levels in reading and science respectively (Ministry of Education Malaysia, 2012).

Figure 2.3.1. **OECD PISA 2009 Plus results in Malaysia and other Asian economies**
(score)



Note: PISA scale was set such that approximately two-thirds of students across OECD countries score between 400 and 600 points. Gaps of 72, 62 and 75 points in reading, mathematics and science scores, respectively, are equivalent to one proficiency level.

Source: Walker, M. (2011), *PISA 2009 Plus Results: Performance of 15-Year-Olds in Reading, Mathematics and Science for 10 Additional Participants*, Australian Council for Educational Research (ACER), Victoria.

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The quality of an education system is to a large extent dependent on the quality of its teachers. Weaknesses in teacher competencies are a serious impediment to overall education quality in Malaysia. A 2011 research study found that only 50% of lessons were being delivered in an effective manner. The other 50% of the lessons were focused on achieving superficial content understanding, instead of higher-order thinking skills. The study also reported that in a sample of over 7 500 English teachers taking the Cambridge Placement Test, a significant number did not meet the minimum proficiency standard required for teaching English. The relatively low quality of applicants to teacher education institutes is probably partly responsible for the weakness in teacher competencies. In 2010, 93% of Bachelor of Education applicants at Teacher Education Institutes scored below the minimum academic requirement (Ministry of Education Malaysia, 2012).

Malaysia has achieved high participation rates at primary and secondary levels. In 2011, Malaysia achieved near universal enrolment at the primary level at 96% and 82% at upper secondary level (Ministry of Education Malaysia, 2012). Nevertheless, these rates are lower than that of the developed countries in the region. The participation rates of primary level for Japan and Korea have reached almost 100%; and the participation rates of upper secondary level for the two countries have consistently exceeded 90% (Ministry of Education Malaysia, 2012).

The achievement gaps between urban and rural schools remain a critical issue to be resolved. States with a relatively high proportion of students in rural schools, such as Sabah and Sarawak, perform more poorly than states with a lower proportion of students in rural schools. In the *Ujian Penilaian Sekolah Rendah* (UPSR, Primary School Evaluation Test) examinations, the gap between urban and rural students is almost 4 percentage points in favour of the urban schools. At the Sijil Pelajaran Malaysia (SPM, Malaysian Certificate of Education) level, the gap appears to have widened to 8 percentage points (Ministry of Education Malaysia, 2012). Evidence suggests that students from poor families are likely to perform less well compared to students from middle- and high-income families. This socio-economic gap may help to widen the urban-rural disparity since rural income levels are generally below those of urban areas.

The government has instituted new reforms to address the weaknesses

The government of Malaysia recognises the need for bold measures to improve the country's human capital weaknesses in order to develop a workforce talent base comparable to the standards of regional peers and high income nations. Initiatives to address the problems of skills shortages and mismatches and declining education quality are central in many of the ongoing and more recent government initiatives.

The 10th Malaysia Plan details an integrated human capital and talent development framework which streamlines the major policy measures introduced in various initiatives (Table 2.3.2).

Table 2.3.2. **The Integrated Human Capital and Talent Development Framework in Malaysia**

Theme	Strategy
a) Revamping the education system to significantly raise student outcomes	• Ensure that every child can succeed • Hold schools accountable for changes in student outcomes • Invest in head teachers and principals as the primary drivers of change • Attract and develop top talent in the teaching profession
b) Raising the skills of Malaysians to increase employability	• Mainstream and broaden access to quality technical and vocational training • Enhance the competencies of tertiary graduates to prepare them for entering the labour market
c) Reforming the labour market	• Make the labour market more flexible • Upgrade the skills and capabilities of Malaysia's existing workforce • Enhance Malaysia's ability to attract and retain top talent

Source: 10th Malaysia Plan.

The newly released Preliminary Report for Malaysia Education Blueprint 2013-2025 marks the latest government initiative to revamp the education system. The Blueprint establishes the visions and aspirations for the Malaysian education system and lays out a roadmap of policies and initiatives that will be undertaken in order to achieve these goals (see Appendix).

Stronger efforts are needed on TVET and education reforms to improve workforce competencies

The pivotal need is to improve the competencies of the workforce. This will require direct measures to improve workforce skills and broader reforms to enhance the performance of the education system.

Given the need to improve workforce capabilities at a rapid pace, policies to raise the skills of Malaysians need to focus on three areas. First, the participation rate in TVET needs to be raised and the quality of the TVET curriculum needs to be upgraded. The presently low enrolment rate for TVET in Malaysia suggests that there is huge untapped potential to expand TVET training and thereby increase the supply of skilled workers. Towards this end, the government should carry out campaigns to increase the awareness of students and parents about the benefits of TVET. In addition, the TVET curriculum needs to be upgraded to bring it into better alignment with industry requirements. Broadening collaboration and networking of TVET programmes with industry players will expose TVET students to up-to-date technological skills in the workplace and thus increase their employability.

Second, the competency of graduates in technical skills as well as soft skills needs to be enhanced. Industry players should be engaged in TVET programmes and research collaboration, as these initiatives will enhance the practical knowledge and business skills of TVET graduates as well as faculty members' awareness of industry needs. The effectiveness of the current Knowledge Transfer Partnership (KTP) programme also can be improved by deepening the engagement of industry players. In addition, course curricula of higher education institutions should be revised to place greater emphasis on soft skills development of students.

Third, the excessive reliance by businesses on unskilled foreign labour needs to be corrected by enforcing equal labour standards for local and foreign labour. When firms have access to large pool of low-cost workers, they tend to focus on short-term profits instead of striving to move up the value chain. This in turn undermines the creation of skilled job opportunities, which can impede productivity growth. The government should provide incentives for companies to upgrade their workforce.

To reverse the severe longstanding fall in standards and outcomes, policies to raise the performance of the education system should focus on the following areas.

First, the quality of those entering the teaching professions needs to be improved by making teaching a profession of choice instead of a profession of last resort. Incentives should be given to attract the best graduates who have a passion for teaching to join the profession. The proposal by the Ministry of Education to raise the entry bar for joining the teaching profession to the top 30% of graduates, as outlined in the Preliminary Report for Malaysia Education Blueprint 2013-2025, is a useful step in this direction. Second, performance incentives of teachers need to be strengthened by replacing the current system of permanent tenure for teachers with performance-based contractual employment. The present life-time employment system fails to adequately encourage teachers to constantly upgrade their teaching abilities. Introducing performance-based contractual employment to new recruits would provide flexibility to dismiss poorly performing teachers. Third, pre-school enrolment needs to be expanded and the quality of the pre-school programme improved. Research shows that children who enrol in pre-school programmes tend to be more committed to learning and earn higher incomes in later years. More efforts should be channelled into getting the children of poor rural families into pre-school programmes by raising the awareness of their parents about the importance of pre-school education and by providing financial assistance to the families. Fourth, more resources need to be allocated to poorer performing rural schools in order to narrow the achievement gaps between urban and rural schools. The performance of rural schools has been at the bottom quartile for all schools. The long-standing problems of rural schools, including poor infrastructure and teacher shortages, have contributed to the low performance of rural schools. More resources for infrastructure upgrading should be given to rural schools. Financial incentives should be given to attract teachers to teach at rural schools.

POLICY FOCUS

Address weaknesses in labour market functioning

A number of steps to address weaknesses in labour market performance would enhance the benefits of the efforts to improve human capital. Measures to encourage greater female participation in the work force would be particularly beneficial. Other useful policies include steps to reduce barriers to hiring and firing to improve labour market flexibility and policies to improve service sector productivity.

Greater female labour force participation is needed

According to the Labour Force Survey Report 2010, Malaysia's overall labour force participation rate in 2010 was 62.7%. However the male participation rate, at about 77%, is much higher than the female participation rate of 44%. Malaysia's female participation rate is the lowest in the Southeast Asian region and well below that of China (68%) although above that of India (29%). Urban-based females in Malaysia have a higher rate of participation (48.5%), compared to their counterparts in the rural areas (41.2%), an indication of more job options for women in the urban areas, but the rate is still low by international standards.

The low female participation rate in the Malaysian labour force is due to, among other reasons, inflexible working arrangements and a lack of appropriate means to allow women to return to the workforce after leaving, for example to attend to family commitments. The benefits to Malaysia's economy from making better use of women's talents by improving female participation in the labour force are potentially very large. The government could institute policies to, among other things, reduce the inflexibility of working arrangements for females, and encourage the setting up of arrangements that make it easier for females to remain in the workforce and to return to the workforce after tending to family commitments.

Tangible steps to facilitate childcare centres in the workplace could help greatly to encourage greater female participation. Childcare centres contribute to overall labour productivity in three ways.

1. Increased labour force participation, both in terms of the number of jobs and hours worked per employee.

2. Higher lifetime earnings. Childcare centres allow parents to sustain greater continuity of employment, thereby helping them to maintain and improve their skills and to reduce absences from work that would otherwise reduce their incomes.

3. Lower absenteeism and turnover rates. By providing a reliable source of care, childcare centres can contribute to a stable and predictable workforce.

However, despite several government efforts, childcare centres in the workplace have not taken off as originally planned. More incentives may be necessary.

Other issues also need to be addressed

In addition to policies to improve female participation, three other areas need to be addressed. First, hiring and firing practices need to be made less cumbersome so that employers can adjust their labour forces to changing market conditions at a reasonable cost. Malaysia's labour regulations related to hiring and firing are relatively cumbersome, which undermines efficiency and competitiveness. For example, Malaysian employers are required to pay 24 weeks of wages to employees being made redundant, compared to three weeks in Singapore. Policies that make the process less cumbersome and less costly would thus provide a more conducive environment for businesses to operate.

A second important issue is the emigration of skilled workers and professionals from Malaysia to other countries ("brain drain"). According to a World Bank report, the Malaysian brain drain has contributed to the narrowing of an already narrow skill base and deterioration in its overall quality. This has worsened the mismatch between skills supplied and needed, and has resulted in sub-optimal hiring policies and productivity losses at the firm level.

To address the brain drain and the problems it creates, the government has put in place measures aimed at enhancing Malaysia's ability to attract and retain top talent. A serious attempt to stem brain drain would however require moving Malaysia's controversial affirmative action policies to a need-based system.

Finally, policies are also needed to boost productivity growth, especially in the services sector. The majority of employed persons (57% in 2010) in Malaysia are employed in the services sector, which contributes about 55% of national output. There has been almost no growth in labour productivity in the services sector (as measured by value added per unit of worker) during the 1993-2005 period. In 2005, labour productivity was about USD 7 700 (in 2000 USD), virtually the same as its level in 2003. In addition, labour productivity in the Malaysian services sector in 2005 was less than half that of Korea, and 10% that of Japan.

Policies may also be needed to reinvigorate productivity growth in manufacturing. Labour productivity growth in the nine major manufacturing industries slowed during 2004-06, increasing by only 2.2% per annum, compared to 5.5% per annum during the 1999-2001 period. However, Malaysia's labour productivity in the manufacturing sector is still noticeably higher than that of most other countries in Southeast Asia, notably that of Thailand, the Philippines and Indonesia.

The new minimum wage law will benefit low income workers

The Minimum Wage Order 2012, which has been gazetted, will take effect on 1 January 2013 for employers who employ six or more workers. The national minimum wage has been set at MYR 900 (Malaysian ringgit) in Peninsular Malaysia and at MYR 800 in East Malaysia (Sabah, Sarawak and Labuan). The institution of the minimum wage will help to reduce poverty and improve incomes of lower skilled workers but it could have adverse impacts on some firms now on the margin of profitability.

Assuming that current firm productivity levels (at the national level) are similar to the levels that existed during the period when the Census of Establishments and Enterprises 2005 (see Table 2.3.3 below) was being undertaken by the Department of Statistics Malaysia, most firms in the manufacturing, services and agricultural sectors are unlikely to face much impact from the implementation of national minimum wage. That is because the maximum wage the firms in each of these three sectors would be able to pay their workers without making an operating loss, which would be equivalent to the value added per worker, are way above minimum wage.

Table 2.3.3. **Value added per worker in Malaysia, by sector and state**

	Value added per worker (MYR) per annum		
State	**Agriculture**	**Manufacturing**	**Services**
Total	**34 756**	**60 174**	**46 848**
Johor	42 484	67 509	43 771
Kedah	9 684	33 903	27 301
Kelantan	8 170	16 439	15 861
Melaka	41 244	48 965	36 766
Negeri Sembilan	30 394	55 556	23 831
Pahang	45 450	90 491	31 114
P Pinang	34 701	59 487	38 014
Perak	37 498	40 154	21 327
Perlis	9 226	26 786	45 836
Selangor	32 770	61 609	29 259
Terengganu	13 291	56 035	35 523
Sabah	61 809	49 025	61 586
Sarawak	52 883	136 489	18 592
W.P. Kuala Lumpur	73 333	43 997	62 863

Source: Census of Establishments and Enterprises 2005 - Profile of Small and Medium Enterprises, DOSM.

When considering state-level impact of national minimum wage implementation, however, there could be material impact on agricultural firms based in the less developed states, notably Kelantan, Perlis and Kedah, where agriculture productivity levels are considerably below the national average.

Table 2.3.4 below shows that workers in the following job categories - skilled agricultural and fishery workers, plant and machine-operators and assemblers, and elementary workers – are expected to benefit most in terms of higher wages arising from the implementation of a national minimum wage.

As indicated in the table, females are paid on average less than males in the workplace. Due to family responsibilities, females are less mobile compared to men and therefore have a narrower set of employment options. These limitations depress their earning opportunities; they are also more vulnerable than men to the monopsony power of employers. A well-regulated minimum wage policy should thus benefit women relatively more than men, by increasing their average monthly pay, and by at last partly offsetting their relatively weaker bargaining power relative to that of their employers.

Table 2.3.4. **Average monthly basic wage of workers in Malaysia, by gender and job category**

Job category	Male (MYR)	Female (MYR)
Senior officials and managers	4 296	2 522
Professionals	3 670	2 848
Technicians and associate professionals	2 007	1 957
Clerical workers	1 407	1 325
Service workers, shop and sales workers	924	802
Skilled agricultural and fishery workers	730	513
Craft and related trades workers	1 081	727
Plant and machine operators and assemblers	860	623
Elementary workers	693	561
Total	**1 473**	**1 239**

Source: National Employment Returns Report 2008, Ministry of Human Resource.

The introduction of a national minimum wage will increase the marginal cost of producing a given level of output. Producers who are significantly affected will need to charge higher prices, resulting in a lower amount of demand for their products. This in turn could reduce the demand for capital and depress investment.

However, whether a national minimum wage will reduce foreign direct investments (FDI) and/or domestic investments (DI) will depend on the characteristics of the industry and of its business operations, in particular whether the operations are low-skilled low-wage labour-intensive or high-tech high-skilled high-wage capital-intensive type.

Only the former industries are likely to experience significant cost increases from the minimum wage. Considering that Malaysia's current development strategy aimed at Vision 2020 calls for investments in high-tech high value-adding industries that require high-skilled labour, the impact on investment at the aggregate level is not likely to be significant.

POLICY FOCUS

Enhance productivity of SMEs

Of the total business establishments in Malaysia, 99.2% are SMEs. SMEs are very important contributors to the Malaysian economy, accounting for 32% of national GDP, 59% of employment and 19% of exports.

A wide range of businesses, differing in dynamism, technical advancement and risk attitude, make up the SME sector. The services sector in Malaysia has the largest share of SMEs – 87%. The manufacturing sector has 7%, while agriculture has 6%.

Microenterprises make up the bulk of SMEs (79%). By location, the Klang Valley (located in the state of Selangor and the federal territory of Kuala Lumpur) has the largest number of SMEs (35.7% of the national total), followed by Johor (10.3%), Perak (8%) and Kedah (6.8%).

Compared to its regional peers as well as those in the more developed nations, Malaysian SMEs are characterised by: *i)* relatively low productivity; *ii)* lower business formation rates than in high income nations; *iii)* concentration of output and employment in a relatively small number of firms; and *iv)* a high share of SMEs operating in the informal sector.

Disparities in productivity between of urban and rural SMEs are large

According to the SME Masterplan, SME labour productivity in Malaysia is low relative to productivity levels in the Southeast Asian region and in more advanced countries. In 2010, the productivity of Malaysian SMEs is estimated to average MYR 67 174 per worker (about USD 22 100); SMEs in Singapore and the United States, on the other hand, were four times and seven times more productive respectively.

Not only are there disparities in performance between Malaysian SMEs and their counterparts overseas, especially in the more advanced countries, there are also disparities between rural- and urban-based firms.

Studies have shown that the effect of location on productivity can vary with type of industry, its size, and the timing of a firm's entry into the industry. Because of the many factors that can influence the effect of location on productivity, the reasons for the rural-urban disparity in SME productivity is not clear from available statistical data. For example, value added per worker in the federal territory of Kuala Lumpur, the nation's capital, is below the national average; it is even below that of the state of Sabah, a relatively less developed state in East Malaysia. Sarawak, another relatively less developed state in East Malaysia, on the other hand, registered a value of more than twice that of the national average.

The results of an unpublished Vistage Malaysia survey highlight the disparities between rural and urban SMEs in Malaysia and provide insight into the factors behind them. According to the survey results, urban-based Malaysian SMEs place high priority on productivity improvements owing to their focus on breaking into export markets. There is a great need to employ advanced technology and become more competitive in order to be able to meet the quality requirements of their customers – particularly multinational companies, as well as large local companies.

Rural-based SMEs, on the other hand, tend to cater mainly to the domestic market, whose requirements are less sophisticated than those of export markets. Hence, rural-based SMEs find traditional, low-volume, low-cost modes of production using low-technology machinery sufficient for their business operations. These differences are partly explained by the generally lower entrepreneurial and managerial skills of owners off rural versus urban-based SMEs. The result is lower productivity levels.

Table 2.3.5. **Principal statistics of SMEs in the manufacturing sector in Malaysia, by state**

State	Number of establishments	Value added (MYR mn)	Number of persons engaged during December or the last day period, 2003	Value added per worker (MYR)	Value of assets owned as at 31 December (MYR mn)
Total	**39 373**	**45 760**	**760 459**	**60 174.18**	**50 799**
Johor	5 311	9 572	141 789	67 508.76	8 004
Kedah	2 637	1 740	51 323	33 902.93	1 765
Kelantan	1 845	318	19 344	16 439.21	414
Melaka	1 468	1 492	30 471	48 964.59	1 425
Negeri Sembilan	1 300	1 545	27 810	55 555.56	1 752
Pahang	1 632	2 304	25 461	90 491.34	2 680
P Pinang	2 456	3 506	58 937	59 487.25	3 544
Perak	4 023	2 601	64 775	40 154.38	2 823
Perlis	323	87	3 248	26 785.71	80
Selangor	7 747	10 805	175 379	61 609.43	10 673
Terengganu	1 784	1 012	18 060	56 035.44	1 584
Sabah	1 540	1 915	39 062	49 024.63	2 469
Sarawak	2 355	6 264	45 773	136 849.23	11 406
W.P. Kuala Lumpur	4 952	2 597	59 027	43 996.82	2 180

Source: Census of Establishments and Enterprises 2005 - Profile of Small and Medium Enterprises, Department of Statistics Malaysia.

According to the Vistage survey results, there is no noticeable difference between rural- and urban-based SMEs in terms of ease of access to credit facilities. As for awareness of government grants and incentives extended to SMEs, industry associations like the Federation of Malaysian Manufacturers, SME and trade associations are instrumental in helping disseminate such information. However, many SMEs, both rural- and urban-based, have not been successful in their applications for government grants and incentives because of deficiencies in the management of their businesses. Also, many non-bumiputra owned SMEs shy away from applying for government grants and incentives because the application forms, besides being complicated, require sensitive information that owners are not willing to divulge.

The SME Master plan 2012-2020 will improve the situation

During the 1960s, policies aimed at developing and promoting SMEs in Malaysia were mainly residual in nature. SMEs were given prominence only after the launching of the First Industrial Master Plan (1986–1995) to support Malaysia's industrialisation process. For example, the development strategies for SMEs under the First Industrial Master Plan focused on building linkages with larger firms and penetrating the export market.

The vision of the SME Masterplan, launched in July 2012, is to produce SMEs that can effectively compete on the global stage. The Masterplan seeks to raise the sector's GDP contribution to 41% from the current 32%. The Masterplan's four main objectives are: *i)* to increase business formation rate; *ii)* to expand the number of high-growth and innovative companies; *iii)* to raise productivity; and *iv)* to intensify re-entry of SMEs into the formal sector ("formalisation").

The SME development framework (the "Framework") as set out under the SME Masterplan is aligned to the broader national aspirations of achieving the Vision 2020, which specifies a pathway of innovation-led and productivity-driven growth. The Framework has the following five elements: *i)* the vision for SME development moving forward; *ii)* the strategic goals towards achieving this Vision; *iii)* areas of focus for policy intervention to enhance SME performance; *iv)* an action plan to address the current challenges to growth; and *v)* the institutional capacity to support the implementation of the SME Masterplan.

The Framework specifies six areas of focus for policy intervention to enhance SME performance (Table 2.3.6).

Table 2.3.6. **Focus areas to enhance SME performance in Malaysia**

Focus areas	Policy measures
Innovation and technology adoption	Encourage greater innovation and technology adoption by SMEs.
Human capital development	Enhance human capital and entrepreneurship development among SMEs.
Access to financing	Ensure that creditworthy SMEs have access to financing for working capital and investment.
Market access	Expand market access for goods and services produced by SMEs.
Legal and regulatory environment	Ensure that the legal and regulatory environment is conducive for the formation and growth of SMEs, while protecting the broader interests of society.
Infrastructure	Improve the infrastructure required for SMEs to operate effectively.

Source: SME Masterplan 2012-2020.

A comprehensive action plan comprising 32 initiatives has been developed to overcome the challenges faced by SMEs in the above six focus areas. Each of the 32 initiatives will contribute towards achieving one or more of the SME Masterplan's four objectives.

Supporting institutions and the business environment for SMEs need to be improved

Surveys and other information indicate that efforts in four areas are likely to be critical to the overall success of SME development in Malaysia.

First, there is a need to inculcate a productivity mind-set. The results of the Associated Chinese Chambers of Commerce & Industry of Malaysia (ACCCIM) 2012 SME Survey, in which only 11% of respondents indicated that the main focus of their innovation activities is to improve productivity, suggest that productivity is given too low a priority in SMEs. Measures should thus be put in place to change this attitude. OECD experiences provide potential lessons for helping SMEs to innovate through reforms to intellectual property regimes (IPR) that make it easier for smaller firms to obtain and use patents (see Box 2.3.1).

Second, the presence and role of supporting institutions, especially in rural areas, need to be increased. There is evidence to suggest that supporting institutions are not doing enough. The ACCCIM 2012 SME Survey revealed that 67% of respondents did not get any assistance from the key institutions tasked with promoting R&D and innovation activities, namely: *i)* SIRIM;[2] *ii)* the Multimedia Development Corporation; *iii)* the Technology Park Malaysia; *iv)* the Malaysian Technology Development Corporation; *v)* the SME Corporation Malaysia; and *vi)* local universities/colleges.

In addition, the same survey revealed that a surprising 22% of respondents did not know of the existence of SME Corporation Malaysia, which is the central point of reference for information and advisory services for all SMEs in Malaysia. In the northern rural state of Kedah, for example, 39% of respondents indicated that they did not know of the institution's existence. Another noteworthy survey finding is that among those who were aware of the institution's existence, only 38% agreed with the statement that SME Corporation Malaysia is playing an active role in assisting SMEs.

Third, the services sectors need to be a key focus of the overall SME development strategy. The services sector is expected to remain as the main growth engine during the 10th Malaysia Plan period. And as SMEs have the biggest presence in the services sector (87%), SME development efforts must be skewed towards the services sector. This is not to suggest that the other sectors can be ignored. Also, since each sector is different, policy makers should be cognisant of the fact that there is no "one-size fits all" solution in SME development efforts.

Fourth, efforts need to be made to improve demand for SME products and services. One of the 32 initiatives in the Action Plan is to "mandate a specific Government procurement policy for SMEs", under which it is proposed that "Government-linked companies should be encouraged to procure from SMEs and invest in supplier development programmes targeting at locally owned SMEs". Such supplier development programmes should focus on rural-based SMEs, as well as industries "with characteristics that predispose them to the locations being supported".

Fifth, policy makers need to ensure that SMEs and other businesses can compete on a level playing field. This is the objective of Malaysia's Competition Act (2010) that came into effect on 1 January 2012. The Act is supposed to "ensure fair and healthy competition" and that "all will be protected, including the small and medium enterprises (SMEs)".

However, evidence suggests that open competition in Malaysia remains elusive. The following is a case in point. Some industry players have alleged that the government's "adoption" of some bumiputra pharmaceutical companies has resulted in the adopted companies being given five-year contracts to exclusively provide specific medication to the Health Ministry. These companies, which do not have to participate in an open tender for the product, also negotiate directly on price with the ministry.

Finally, SMEs would benefit from improvement in the e-commerce infrastructure. According to the ACCCIM 2012 SME Survey, 30% of survey respondents indicated that the main obstacle to them adopting e-commerce is poor bandwidth, followed by cost (25%) and concerns about e-payment security (20%). Respondents in Sabah and Sarawak meanwhile blamed limited network coverage for difficulties in adopting e-commerce.

Box 2.3.1. **Increase SME's innovation potential through intellectual property rights: Examples from OECD countries**

In a knowledge-based economy, SMEs play an important role in supporting innovation and as knowledge sources, thereby enhancing productivity growth. Thus, SMEs' management of intellectual property rights (IPRs) that facilitate the process of value creation from intellectual assets is critical. However SMEs face greater problems in benefiting from IPRs than larger firms due to the often complicated and lengthy procedures required by IPR frameworks.

OECD country experiences with "SME-friendly" initiatives within the intellectual property (IP) regulatory framework provide some potential lessons as to how these problems can be reduced.

In **Australia**, an alternative and simplified patent filing system was introduced (Innovation Patent System) in 2001, in order to protect inventions that do not meet the threshold required for standard patents.

In the **United Kingdom**, similarly to Australia, recent reforms have aimed at creating a more simplified, streamlined and user friendly IP system. In 2003, the option for a streamlined procedure was introduced in order to speed up dispute resolution. Since 2005, the United Kingdom Patent Office has been providing key information to potential patent applicants in order to improve the quality of applications. In 2010, new procedures aimed at further simplifying and reducing the cost of the patent litigation process were introduced by the Patent County Court (PCC).

In the **United States**, the United States Patent and Trademark Office (USPTO) has implemented several measures to enhance its capacity and speed up the process of patent applications. For instance, an Ombudsman programme has been created to resolve breakdowns in the normal prosecution process, with senior examiners supporting applicants with unresolved issues. Furthermore, the 2011 reform bill gives the patent office the right to set its own fees and keep the proceeds to hire more examiners in order to increase the capacity to respond rapidly to applicants.

Based on OECD experience, the main policy recommendations for SMEs in order to exploit better their innovative and creative capacity are:

- Foster intellectual property education and training, bringing services and expertise closer to SMEs.
- Address SMEs' financial constraints in accessing intellectual property rights and provide strategic support.
- Make the intellectual property right system overall more "SME-friendly" by streamlining procedures and reducing application time, adequately structuring fees and costs, improving litigation and enforcement mechanisms.
- Improve cross-border information, co-ordination and enforcement.

Source: OECD (2011d).

Notes

1. According to the 10th Malaysia Plan (Chart 5-1, p.192), the percentage of labour force with tertiary education in Malaysia is 23.4% compared to OECD average 27.4%; only 28% of Malaysia's labour force is composed of skilled workers compared to OECD average 37.6%; labour productivity (USD PPP '000 per employee) is 26.6 compared to OECD average 64.8.
2. SIRIM, which is under the Ministry of Finance, is the agency responsible for research and technology development (www.sirim.my).

Appendix

Table 2.3.A1. **The Education Transformation 2013-2025 in Malaysia: Five System Aspirations, Six Student Aspirations, and Eleven Shifts to Transform the System**

Five System Aspirations	
Access	100% enrolment across all levels from pre-school to upper secondary by 2020
Quality	Top third of countries in international assessment such as PISA and TIMSS in 15 years
Equity	50% reduction in achievement gaps (urban-rural, socio-economic and gender) by 2020
Unity	An education system that gives children shared values and experiences by embracing diversity
Efficiency	A system which maximises student outcomes within current budget
Six Student Aspirations	
Knowledge	Student will be fully literate and numerate, be able to master core subjects such as mathematics and science, and is informed with a rounded knowledge of Malaysia, Asia and the world.
Thinking skills	Student will develop the ability to acquire new knowledge, to connect different pieces of knowledge, and to create new knowledge. S/he will master important cognitive skills, including problem-solving, reasoning, creative thinking and innovation.
Leadership skills	The education system will assist student to develop leadership skills that encompass entrepreneurship, resilience, emotional intelligence and communication skills.
Bilingual proficiency	Student should be operationally proficient in Bahasa Malaysia and English.
Ethics and spirituality	The education system will inculcate strong ethics and spirituality in every student to prepare them to rise to challenges, to resolve conflicts, to employ sound judgement and principles during critical moments, and to have courage to do what is right.
National identity	Every student will proudly identify as Malaysian, irrespective of ethnicity, religion or socio-economic status.
Eleven Shifts to Transform the System	
1. Provide equal access to quality education of an international standard.	
2. Ensure every child is proficient in Bahasa Melayu and English language.	
3. Develop values-driven Malaysians.	
4. Transform teaching into a profession of choice.	
5. Ensure high-performing school leaders in every school.	
6. Empower JPNs, PPDs and schools to customise solutions based on need.	
7. Leverage ICT to scale up quality learning across Malaysia.	
8. Transform ministry delivery capabilities and capacity.	
9. Partner with parents, community and private schools at scale.	
10. Maximise students' outcomes for every ringgit.	
11. Increase transparency for direct public accountability.	

Source: Preliminary Report Malaysia Education Blueprint 2013-2025.

Philippines

A. Medium- term economic outlook (forecast, 2013-17 average):

GDP growth (percentage change):	5.5
Current account balance (% of GDP):	2.7
Fiscal balance (% of GDP):	-1.7

B. Medium-term plan

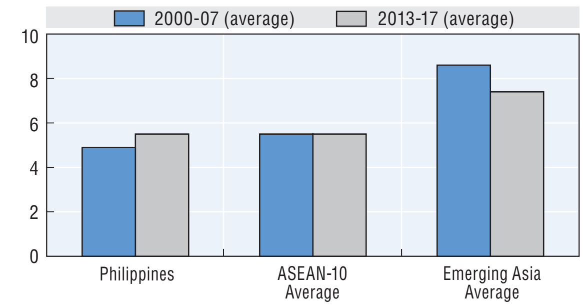
Period:	2011-16
Theme:	In pursuit of inclusive growth

C. Basic data (in 2011)

Total population:	96 million*
Population of Manila:	11.9 million (in 2010)
GDP per capita at PPP:	4 073 (current USD)

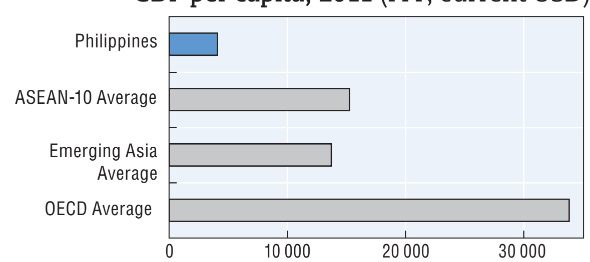
Note: *Total population data for 2011 are an estimate.
Sources: OECD Development Centre, MPF-2013, national sources and IMF.

GDP growth rates (percentage change)



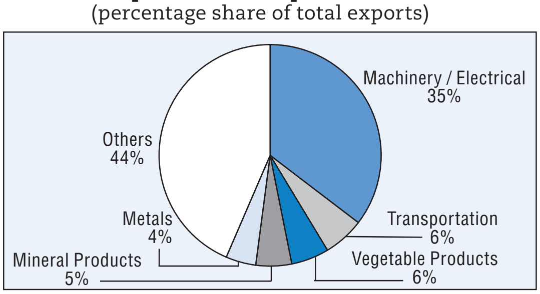
Source: OECD Development Centre, MPF-2013.

GDP per capita, 2011 (PPP, current USD)



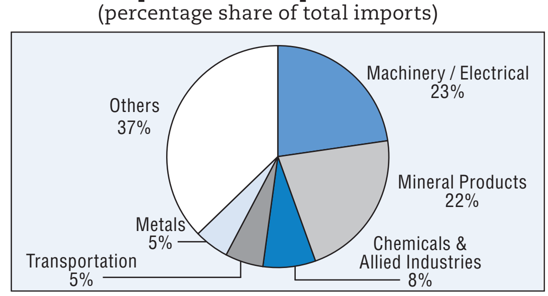
Source: IMF and national sources.

Composition of exports in 2011
(percentage share of total exports)



Source: Trademap.

Composition of imports in 2011
(percentage share of total imports)



The major policy challenge the Philippines faces in its Medium-Term Development Plan is improving its infrastructure, access to education and development resources, and ensuring jobs for all. Both road transport and power are critical to a more closely integrated Philippine economy, helping to attract widely dispersed private-sector investment. Increasing secondary enrolment and improving the standards of teachers and pupils are vital reforms, without which there can be no human and economic development or job creation. Establishment of appropriate job creation strategies is vital for the Philippines.

Philippines' medium-term policy challenges and responses

- Improve road transport, power and energy infrastructure and strengthen public and private investment
- Focus sharply on job creation strategies
- Improve access to quality education and training by strengthening the K+12 programme

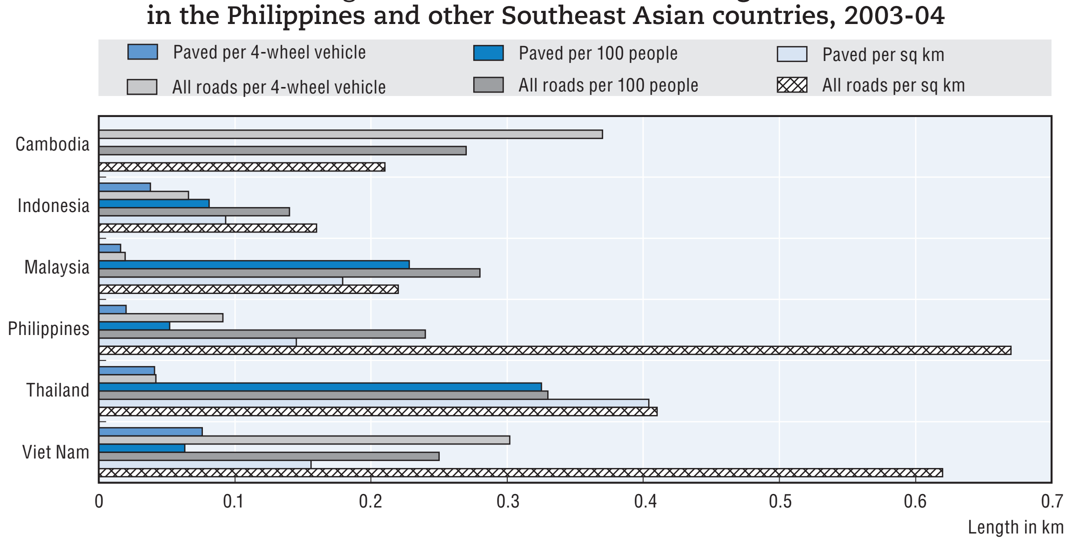
POLICY FOCUS

Improve road transport, power and energy infrastructure and strengthen public and private investment

More and better road networks key to rekindling the economy…

Infrastructure is a critical enabler of economic development of the Philippines. However, the Philippines lags behind other countries in Southeast Asia in quality infrastructure.[1] Its road network, to take that example again, is one of the longest, yet it is also of poor quality and thus unable to provide connectivity and efficiency in the delivery of goods. The Philippines also has the highest road density (number of kilometres of road for every square kilometre of land), but fewer kilometres of paved road per 100 people than Indonesia, Malaysia, Thailand and Viet Nam. (Data for Cambodia are too limited for comparability). Figure 2.4.1 compares road network coverage in Southeast Asian countries.

Figure 2.4.1. **Road network coverage in the Philippines and other Southeast Asian countries, 2003-04**



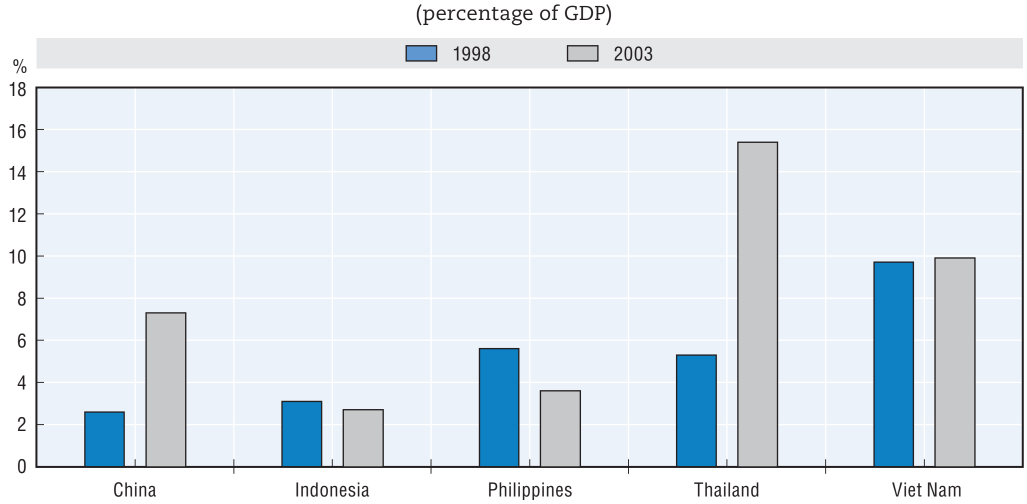
Notes: Total length is for 2003-04 for all countries. Paved length data for Indonesia are for year 2002, Viet Nam for 1998, and for all other countries for 2003. Paved length data for Cambodia are not available.
Source: World Bank, Philippines Meeting Infrastructure Challenges, and WDI.
StatLink http://dx.doi.org/10.1787/888932774414

The data show that the Philippines are committed to building roads, but without matching their quantity with quality. Of the total road network, only 21.7% is paved (asphalt and concrete), which compares poorly to Indonesia's 57.6% and Thailand's 97.1%.[2] The 2011 data from the country's infrastructure agency (Department of Public Works and Highways) show a higher proportion, 43.7%, of the road network is paved (which excludes those classified as paved but in poor or bad condition). The department's data also consider only the country's primary and secondary national roads which account for slightly over 10% of the overall road network (for the comparable data shown in Figure 2.4.1 above). Given that the overall average stands at 21.7%, local roads are clearly less paved and poorly maintained.

Infrastructure is the outcome of public and private investments in infrastructure facilities in the same way as economic growth is partly driven by gross domestic capital formation. The percentage of infrastructure expenditure to gross domestic product (GDP) captures the extent of the Philippines investment in building road networks. Figure 2.4.2 shows the country's total expenditure on infrastructure, along with comparable data for China, Indonesia, Thailand and Viet Nam between 1998 and 2003.

Figure 2.4.2. **Infrastructure expenditure in the Philippines and other Southeast Asian countries, 1998-2003**

(percentage of GDP)

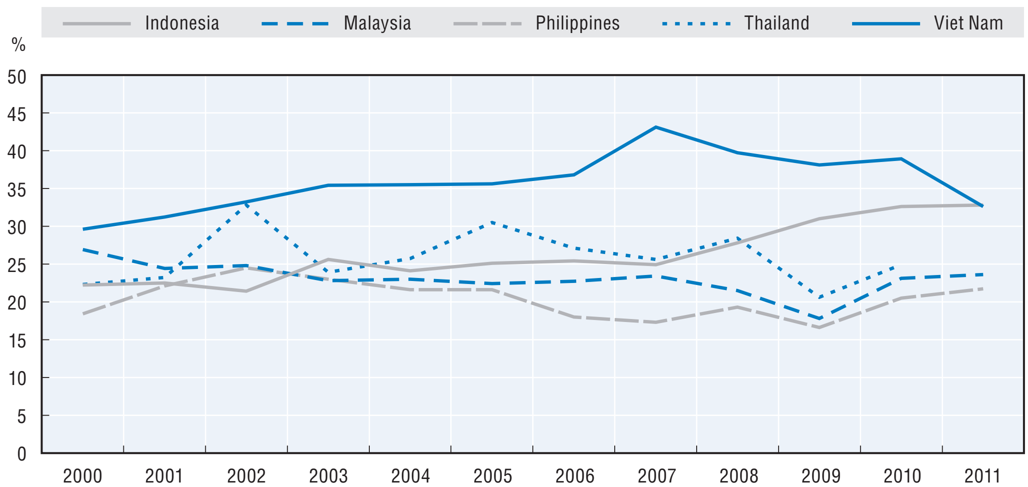


Source: World Bank.

StatLink http://dx.doi.org/10.1787/888932774433

Infrastructure expenditure as a share of the Philippines' GDP declined from 5.6% in 1998 to 3.6% in 2003, while other countries, especially China and Thailand (whose 2003 expenditure nearly tripled their 1998 figure), managed to increase theirs. So the fall in the Philippines' spending was actually a relative decline.[3] Figure 2.4.3 shows the investment ratio of the Philippines at aggregate level from 2000 to 2011 in comparison with other countries. Its ratio (defined as the share of gross domestic capital formation in current US dollars to GDP in current US dollars) is actually the lowest during the 12-year time series (with the exception of Indonesia in 2002). Investment rates hardly exceeded 20% in most years, while other countries exceeded 25% despite the dip in 2009 associated with the global financial crisis. Lethargic investment, coupled with inadequate infrastructure expenditure, partly explain the country's low growth rate.

Figure 2.4.3. **Investment rates in the Philippines and other Southeast Asian countries**
(percentage of GDP)



Source: ADB Key Indicators (2012a).
StatLink http://dx.doi.org/10.1787/888932774452

Going back another decade does not change the overall low investment rate in the Philippines. It only highlights an underlying constraint and policy challenge. Unlike other countries in Asia – or the selected countries in Figures 2.4.1, 2.4.2, and 2.4.3 with the exception of Indonesia – the Philippines is an archipelago with many inhabited islands that is more than 1 800 kilometres long. Although the largest three island groups (Luzon, Visayas and Mindanao) make up most of the country, its aggregate growth is not as evenly distributed as it might be if the islands were more contiguous. One part of the country lies along the path of Pacific storms, while its southern part is drier – a configuration that requires varied infrastructure provisions. Fostering more inclusive growth becomes a more formidable task than those faced by Thailand, Viet Nam or even Indonesia.[4]

Infrastructure encompasses more than roads – it includes power and energy, water resources, flood and drainage management, sewerage and sanitation, telecommunications, and digital infrastructure. With the country scattered across 16 administrative regions,[5] the distribution of infrastructure resources tends to be uneven. While it is not possible to examine them in detail, the impacts of their inequalities suggest some policy responses towards more inclusiveness. This policy challenge considers the most important types of infrastructure.

The pattern of gross regional domestic product (GRDP) in the Philippines has always showed a bias towards the National Capital Region, which accounted for 35% of GRDP in 2011, followed by Southern Luzon with 17%, and Central Luzon with 9%.[6] These three regions thus account for more than 60% of the country's annual output and, when the remaining regions in the main island group are added, their share rises to more than 70%. The GRDP figures should be set against regions' areas: Luzon represents 47% of the Philippines' land area, followed by Mindanao with 34% and Visayas with 19%. The right way to examine the validity of the GRDP bias is to relate it to the regions' resources.

Road transport is only one of four modes of transport that can connect different parts of the archipelago. Without dwelling on the air, rail and sea systems it is important to point out their development and policy challenges. Sea-going transport is essential for connecting island groups to inter- and multi-modal transport system. In addition to the primary and secondary highways that underlie road connections, the country's transport infrastructure embarked on its nautical highway through roll-on/roll-off terminals that link the major island groups where some 22 ports have been built or rehabilitated. These are reported to have reduced travel time by 12 hours and transport costs by between 24% and 43% (NEDA, 2010). The extension of existing expressways in the north and south of Manila has opened up transport arteries to more provinces in Region 3 (Central Luzon) and Region 4 (Southern Luzon). On the other hand, the government's transport objective of separating the operations and regulatory functions of transport agencies remains to be achieved, especially in the rail and ports networks.

The infrastructure policy agenda remains essentially nationwide – the need for better project preparation, execution and monitoring to avoid delays; the integration of local and national plans to reduce the gaps in transport network, which includes building local government capacity to finance and manage local projects, particularly roads; the design of a transport policy framework; and the associated institutional structure for all of the above. Yet what the agenda fails to address directly is how to achieve greater inclusiveness in infrastructure and redress the apparent inequality in access and inequity in growth which characterise archipelagic Philippines. While it is obvious that attention to this array of policy issues would eventually impact on inclusiveness, it is also important to face the pressing matter of more even regional development.

Infrastructure development in the power and energy sector is key

Power and energy are a form of infrastructure that impinges on economic growth. Their availability and lack thereof impact the effectiveness of transport and related infrastructure.[7] And where there are location differences in sources and use, they may affect the country's goal of more inclusive growth.

The Philippines experienced its worst power crisis in the early 1990s, which it took the country two years to address – through emergency powers to the President, government restructuring (which created the Department of Energy), comprehensive legislation to restructure the energy sector through the Electric Power Industry Reform Act (EPIRA) that only came into force later, and separate laws to encourage private sector participation (build-operate-transfer laws). There is both government and independent analysis of the country's power and energy sector (e.g. NEDA, 2004; Del Mundo and Espos, 2011) which need no further summary. Suffice it to say that assessments seem to concur that the various measures taken during the power crisis laid the foundations of long-term power and energy development, averting imbalances and encouraging private sector participation in energy generation and distribution in a more competitive environment.

However, since many measures – particularly those that enhance competition, which includes pricing – have not been implemented a decade after they were introduced, the sector continues to be vulnerable (NEDA, 2010). What is more, another power and energy crisis looms, its seeds sewn in the Visayas and Mindanao island groups. And because it is located in less developed regions of the country, it threatens the inclusive growth that is the government's stated objective. It also nips in the bud the economic potential that has yet to bear fruit and sets back efforts to increase resource flows into the other parts of the country. It would seem that the conditions are similar to those that triggered the first crisis and that lessons have not been learned.

According to the 2009-2030 Power Development Plan (PDP), the dependable capacity of each major island group is already entering a critical period where supply becomes tight to very tight. Projections to 2030 suggest that additional power plant capacity will be required. Table 2.4.1 reproduces the PDP for Luzon, Visayas, and Mindanao minus the detailed capacity needs during the critical periods identified by the government.

Table 2.4.1. **Power supply and demand outlook in the Philippines, 2009-30**

GRID	Dependable Capacity (MW)	Peak Demand (MW) 2008	Avg. Annual Growth Rate (%)	Commited Capacity (MW)	Critical Period	Required Additional Capacity (MW) 2009-30	Indicative Capacity (MW) 2009-30
Luzon	10 030	6 822	4.5	600	2011	11 900	3 449
Visayas	1 505	1 176	4.6	654	2009	2 150	182
Mindanao	1 682	1 228	4.6	100	2010	2 500	581
PHILIPPINES	13 217		4.6	1 354		16 550	4 211

Notes:
Dependable Capacity is based on the reports of power plant owners, i.e. National Power Corporation (NPC), NPC-Independent Power Producers (IPPs), and Non-NPC IPPs.
Peak Demand is based on the System Operator (SO) recorded peak demand by grid for the year.
The AAGR is based on the energy and demand forecasts of the distribution utilities (DU) as indicated in their respective Distribution Development Plan (DDP).
Critical Period is the year when existing generating capacity will not be able to meet the peak demand and the required reserve margin (23.4% above the peak demand for Luzon and Visayas, 21% above the peak demand in Mindanao).
Required Additional Capacity is the necessary generating capacity (on the top of the committed) to meet the system requirement (including reserve). These are indicative capacities that are open for private sector investments.

Source: NEDA 2010.

It is, of course, true that even as installed capacities across the three main islands remained the same in 2010 and 2011, there was only feeble improvement in their dependable capacity. At the same time, the mix of energy supplies has seen significant declines in the oil and coal traditional sources and the emergence of renewable sources such as natural gas, hydropower and geothermal energy. The required grid interconnection has not materialised owing to the different forms of energy the island groups use – natural gas in Luzon, thermal energy in the Visayas and hydro energy in Mindanao.[8]

Off-grid infrastructure is needed in order to bring electrification into some 3.3 million households that are either not completely energised, use undependable capacity, or have only up to 12 hours daily of electricity.[9] Off-grid electrification may not be economically unviable as it would serve remote areas and islands and systems would have to be self-contained. However, the government's commitment of 100% *barangay* (village) electrification will not be a challenge. The current effort, being undertaken through the Missionary Electrification Programme (and the attendant Five-Year Missionary Electrification Development Programme) goes in the right direction by seeking to reach unserved parts of the country. However implementation is hampered by a shortage of funds and, more critically, the lack of additional transmission lines, new generating sets (where half of existing sets are more than 10 years old), fuel efficiency to meet Energy Regulatory Commission standards, and continued support for sustainability.

The framework set out in the aftermath of the energy crisis in the 1990s appears to be adequate. Further reforms are nevertheless needed and, while they may not be drastic (See Del Mundo and Espos, 2011, Part IV), they do need special attention to avert a potential power crisis.

Both road transport and power are highly critical to a more integrated Philippine economy: they support enhanced private-sector investment that is widely dispersed and contribute to the narrowing of development gaps that preclude an inclusive economic growth. A firmer policy focus on these two important pillars of the development process will not only address the unevenness of the country's economic directions, but allow other infrastructures to achieve greater efficiencies.

POLICY FOCUS

Focus sharply on job creation strategies

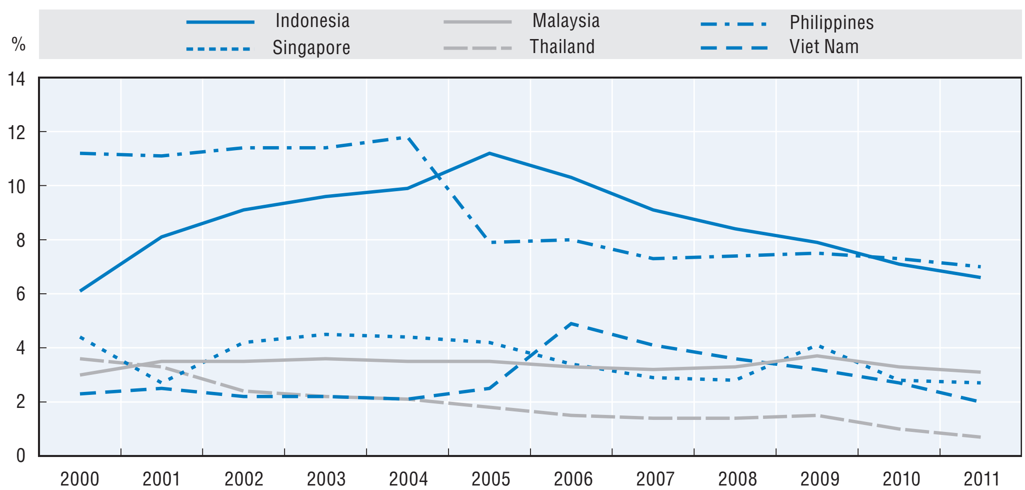
Job creation – the ability of the economy to generate employment on a scale that reduces unemployment rates to acceptable levels – is now emerging as a critical structural problem in both developing and developed regions of the world.

Unemployment and the job creation problem are not new to the Philippines. In fact, they seem endemic to the country. High unemployment and joblessness have plagued it for decades, which explains why many Filipinos opt to work overseas. The employment response to structural changes in growth defies expectations that are based on empirical evidence. Sectoral shifts from agriculture to industry to services have been accompanied by the emergence of vibrant industries and rises in employment in other countries. Not, though, in the Philippines. Rapid falls in real relative agricultural output in neighbouring countries such as Indonesia, Malaysia and Thailand have been more than matched by increases in both output and employment in their manufacturing sectors. At the same time as sectoral changes have unfolded in these countries, productivity has risen, so staving off adverse terms of trade and potential crisis. Unemployment in the Philippines, on the other hand, is even more serious than the stubbornly high figures suggest, since jobless rates vary considerably across the regions and between rural and urban areas. And the poor underlying infrastructure further erodes the market connectivity that could even out employment opportunities. Aggregate unemployment rates thus tend to hide pockets of associated structural problems that need to be equally attended to. However, comparing average unemployment rates alone may not reveal related underlying problems that are not found in other economies. Figure 2.4.4 shows unemployment rates for the Philippines between 2000 and 2011 compared with Indonesia, Malaysia, Singapore, Thailand, and Viet Nam.

The unemployment rates of Malaysia, Singapore, Thailand and Viet Nam cluster at around 4%, while Indonesia's and the Philippines' exceed 6%. What distinguishes the Philippines from the rest, though, is how little its yearly unemployment levels seem to have varied throughout the decade in the data. The sharp drop in 2005 was due to the adoption of a different definition of unemployment.[10] Otherwise, the stickiness around a modal value is remarkable. This characteristic does not seem to be as pervasive in the other countries, even if they, too, have had steady unemployment rates for some years. In short, unemployment has not responded properly to either good or bad times (indicated, for example, by GDP growth rates).

The other measure of job creation is the underemployment rate. In the Philippines, underemployment refers to workers who are employed but still wish to work longer hours ("visibly underemployed" means those working less than 40 hours per week). This measure depends on workers' perceptions and may therefore be quantitatively biased. But it does give an idea of job environments and the underlying labour market. It points, in particular, to the likelihood that high underemployment rates reflect less than satisfactory working conditions, e.g. informal jobs and short-term or piecemeal contracts. Underemployment provides a reference point from which employment policies are crafted.

Figure 2.4.4. **Unemployment rates in the Philippines and other Southeast Asian countries**



Source: ADB Key Indicators (2012a).

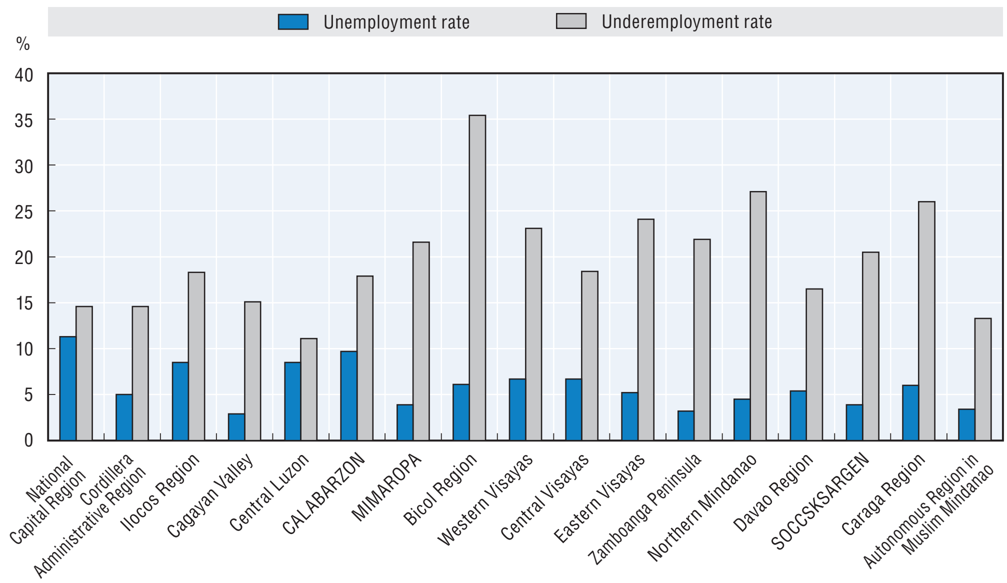
StatLink http://dx.doi.org/10.1787/888932774471

The results of labour force surveys (LFSs) over the years reveal meagre increases in job creation relative to the increases in the size of the labour force (the population aged 15 years and above). For example, the April 2012 LFS found that the labour force increased by 68 000 workers, which hardly made a dent in the number of unemployed – 2.8 million at the time[11] – and did not take into account the increase in the number of underemployed workers. And when variations in unemployment and underemployment by region are considered, the magnitude of the job creation problem becomes even greater. Figure 2.4.5 tracks the scale of unemployment and underemployment rates by region which indicates fragmented labour and job markets.

Fluctuations in regional unemployment and particularly underemployment rates need to be rigorously examined and understood both within a period of time and across time. They roughly reflect some of the structural inadequacies in a country's job creation. High underemployment rates coupled with below-average unemployment rates, for example, signify poor quality jobs (Bicol Region and Eastern Visayas in Figure 2.4.5). To the extent that agricultural employment dominates in the regions these results are understandable.

There may indeed be mismatches between supply of labour and industry demand. People with high school education account for close to half of the unemployed (44.5% in the April 2012 LFS) and those with college education constitutes one-third (34.8%). The combined share of those with secondary and tertiary education among the unemployed thus reaches 79%. The underlying reason – be it the content of their education, their inability to complete their education, their age (and thus experience), or other causes – cannot be derived from these shares alone. In fact, individuals who did not finish high school or college account for a lower share of the unemployed than those who easily completed their education. Moreover, much of the secondary-educated workforce belongs to the age group that lacks experience and is likely to be unemployed – the 15-24 year-olds have the highest unemployment rates, which then fall sharply in the 25-34 age bracket.

Figure 2.4.5. **Unemployment and underemployment rates in the Philippines, by region, 2011**



Note: CALABARZON, MIMAROPA and SOCCSKSARGEN are acronyms, combining the names of the provinces. The CALABARZON region is composed of CAvite, LAguna, BAtangas, Rizal and QueZON. The MIMAROPA region is composed of Occidental Mindoro, Oriental Mindoro, Marinduque, Romblon and Palawan. The SOCCSKSARGEN region is composed of four provinces and one city: South Cotabato, Cotabato, Sultan Kudarat, Sarangani and General Santos City.

Source: National Statistics Office, LFS.

StatLink *http://dx.doi.org/10.1787/888932774490*

Unless there are unemployment rates by level of education (elementary, high school, post-secondary, college) which use standard measures, it is difficult to draw any conclusion about the pervasiveness of the uneducated unemployed. The supposed solution proposed by the Basic Education Sector Reform Agenda (BESRA) and its flagship strategy, Enhanced K12, has to be viewed with guarded optimism.

What has been, and is still, challenging to the government is how to bring the high unemployment rates down to acceptable levels, alter the environment to achieve tighter labour markets, and raise real incomes and reduce poverty. The task is enormous, has been long delayed, and is pressing. In 2012, the economy generated 1.021 million jobs to absorb the new 953 000-strong labour force entrants, so reducing the number of unemployed by 68 000.[12] In the last four years, the net reduction in the total number of unemployed was just above 100 000 workers, a paltry amount against the huge numbers of unemployed. Such a low net reduction in unemployment spread over four years suggests it would take many, many more years before the unemployment rate falls to Thailand's level of 4% or lower. The country's labour force's over-reliance on overseas work has to be seriously re-examined, if not abandoned, especially against the background of conflict and tension affecting many of the countries that host overseas Filipino workers (OFWs).[13] With the fluctuations in unemployment rates across the Philippines' regions, it is important to identify various ways of creating jobs and narrowing regional disparities at the same time (see Box 2.4.1).

Box 2.4.1. **The search for inclusive job creation**

Whatever employment policies the Philippines designs and implements, they have to satisfy at least two important conditions. First, they must generate a substantial volume of jobs that are capable not only of absorbing new labour entrants every year, but of reducing over a reasonable period of time the large pool of unemployed workers. In April 2012, the number reached 2.8 million people. Second, they must spread job generation to the less developed parts of the country – i.e. the different regions and the rural areas.

It appears that job creation and related employment have been weak responses to the aggregate economic growth of the country over the last few years. It would take not only new investment to stimulate mass employment, but the kinds of investments that break with historical patterns – e.g. away from consumer-oriented industries for incremental investments.

SMEs absorb workers better than large firms and may be important contributors to job creation. At the same time, large-scale investment (from both domestic and foreign sources) of the kind that big organisations can provide would likewise contribute to job creation. And in the more recent times, the spread of Business Process Outsourcing (BPO) also has potential for labour absorption. Neither SMEs nor investment should be purely market-driven, but helped along by appropriate policies. Industries which have high employment elasticities are obvious candidates. One study identifies industries such as jewellery, luggage and bags, sports goods, knitted fabrics, made-up textiles, fabricated metals and stone products (Das and Kalita, 2009).

One industry that fits the bill on most accounts and is often assumed to cater to foreigners is tourism. The tourism industry is not only capable of generating a wide variety of jobs, many of which do not require great skills or higher education, but also absorbs primary and secondary school leavers. In the Philippines, the tourism industry absorbs close to 10% of employment and is patronised mostly by domestic tourists – for example, more than 90% of visitors to Baguio and 65% of to Boracay are local tourists (NSCB, 2009).

In addition to its job creation potential, tourism also qualifies as an inclusive employment industry. As incomes rise (favouring cities and urban areas) tourism expenditure normally rises faster. Domestic tourists are more likely to spend their time and money in the provinces, attractive rural areas, and traditional locations in the regions away from the cities. Add to this foreign tourism, and the magnitude of the multipliers is bound to be greater.

Indirect job creation could also be substantial if there were private investment in the related industries – e.g. food and beverages, transportation, accommodation and indigenous products. Local governments would have to beef up their capacity to spruce up localities, develop local areas of interest and allocate resources for associated infrastructure through public investments

In an archipelagic country like the Philippines with its fragmented pockets of development and weak geographical integration, there are not too many sources for generating jobs with their ability to provide equal opportunities and, in the process, narrow employment access gaps and reduce welfare dependence.

One direction is to mobilise small and medium-sized enterprises (SMEs) as vehicles for generating jobs through self-employment. It is an approach that could work as government funding opens more windows. But how far it could make inroads into the magnitude of unemployment remains to be seen. With the country's limited track record of creating mass employment through SMEs, the direction of policy is more towards ensuring that SME development involves more than encouraging ambulant traders, sidewalk vending and buy-and-sell activities. It should encourage real small-scale production that can potentially grow in size and contribute to reducing unemployment. However, it is also important that such an approach fosters the kind of quality job that is likely to reduce underemployment.

What could effectively reduce the ranks of the unemployed and underemployed is a massive injection of investment, both domestic and foreign, to generate formal jobs. Unfortunately the country has a poor record of attracting foreign investment and encouraging domestic savings. There is also a need for determining the kinds of industries that not only contribute to job creation, but offer prospects for increasing international trade. While some of the existing programmes for enticing investment may be appropriate, it is sheer numbers that matter – e.g. small factories that can employ sufficiently large aggregate workforces of sufficient size to reduce unemployment.

POLICY FOCUS

Improve access to quality education and training by strengthening the K+12 programme

Improving the access to education and enhancing quality of education are one of the most important challenges in the Philippines. Universal education (or the Universal Kindergarten Education Law) is an important stepping stone to universal primary education. There is concrete evidence that primary schooling itself already reduces poverty rates, substantially redressing inequality and providing access to secondary and tertiary education. In fact, the poverty reduction momentum is maintained up to university, when it starts to falter (see Table 2.4.2).

Table 2.4.2. **Poverty reduction* in the Philippines, by education differential**
(percentage points)

Education differential	2000	2006
Between no schooling and completed primary course	19.9	21.4
Between completed primary and completed high school course	17.1	21
Between completed high school course and higher education	11.7	12

Note: *Poverty by education level of household head (percentage of household heads).
Source: World Bank (2011).

Table 2.4.2 shows that, irrespective of the poverty rate (headcount), individuals who completed primary school experience much steeper poverty reduction than those who never attended. And that reduction is maintained between pupils who complete primary school and those who complete high school.

Short of complete 100% primary net enrolment and completion, there will always tend to be variations across regions or between rural and urban areas in the country, with the geography of the Philippines possibly accentuating such variations. Indeed, while education inequality appeared to fall between 1980 and 2000 and between and within provinces (when an aggregate indicator such as average year of schooling is used), the fall does not capture the likely inequalities by level of education (Mesa, 2007). There are wide regional variations in percentages of children in school: children in Mindanao enjoy relatively less access to schooling than in Luzon (and, within Luzon, the National Capital Region) or in the Visayas.[14] One way of reducing access disparities and evening out imbalances between urban and rural areas and among regions is to universalise secondary education as well as primary.

The feeble increase in the country's net enrolment rate for over a decade was redeemed only by its head start over other countries, which put it comparatively closer to the Millennium Development Goal (MDG) 2. The low rise in enrolment rates is coupled with the dismal quality of the country's primary education system. A readiness assessment test administered to pupils entering public primary school (Grade 1) in academic year 2006-07 indicated that only 40% to 45% were ready to begin the curriculum. Furthermore, a National Elementary Achievement Test (NEAT) given to all Grade 6 pupils completing elementary education in public and private schools in academic year 2000-01 showed an achievement rate of 51.7% (UNESCO, 2011). At 75%, the standard achievement rate of Philippine students leaves much to be desired. Even if broken down by subject or location, achievement in each subject remains below standard or just above it – only 38% of the 131 competencies and skills were learned.

Nevertheless, the 2006-07 NEAT scores do show some improvement over previous years despite being below standard. The mean percentage score (MPS) for all subjects in 2007 was 59.9%, an improvement over the 51.7% in 2001. There were improvements in English, science and mathematics. In general, urban areas still had an edge over rural areas in most of the subjects.

Comparisons with other countries, however, throw into relief the Philippines' relatively poor performance in both primary and secondary education. For example, tests in 2003 for Grade IV primary students in 25 countries ranked the country 23rd in both mathematics and science scores – just above Tunisia and Morocco.[15] Among the OECD countries, Japan was placed 3rd in mathematics and science, while the United States was 12th and 6th.

As for technical and vocational education and training (TVET), it falls under the responsibility of the Technical Education and Skills Development Authority (TESDA) in the three-pronged Philippine education system. TESDA's constituency is supposed to include people already in the labour market who wish to upgrade their skills or learn new skills, high school graduates, secondary school leavers, and college undergraduates and graduates seeking to acquire competencies in different fields. TVET operates through school-based programmes, TESDA training centres in various regions and provinces, community-based training (mainly for self-employment), and firm-based schemes such as apprenticeships, understudies or dual training among others. There are more than 4 500 TVET institutions, of which 1 710 are public and 121 TESDA establishments – 57 schools, 15 regional training centres, 45 provincial training centres and 4 specialised training centres. The remaining ones are in state universities and colleges, local colleges, local government units, other government agencies offering skills training, and Department of Education (DepEd) supervised schools (UNESCO, 2011).

The Commission on Higher Education (CHED) is the third of the three prongs in the Philippine education system. It is mandated, under the terms of Republic Act 7722, to formulate and implement policies, plans, and programmes for the development of higher education; set minimum standards for programmes and institutions of higher learning and monitor and evaluate their performance. CHED covers both public and private higher educational institutions (HEI).

The close relationship between educational attainment and poverty reduction, the need for redressing and balancing accessibility to education for all, and the importance of raising the standards of learners and students are strong underlying reasons for crafting and implementing the BESRA with the K+12 as the flagship reform strategy. The reform's efforts are consistent with MDG 2 in that they seek to increase cohort survival at primary and secondary levels of education and to correct skills mismatches through further specialisation at secondary level. The K+12 strategy came into effect in school year 2012-13 for Grade 1 junior high school entrants.

If K+12 is to meet the BESRA objectives, it will have to be closely monitored, regularly evaluated, and recalibrated for any mid-course correction. Several concerns have been expressed about K+12. For one, it is not clear how it will address the problems it is intended to solve, i.e. universal pre-schooling, increased cohort survival and better performance in critical subjects such as mathematics and science. Nor is it clear how the flagship strategy will contribute to reducing poverty.

While primary education is within the immediate supervisory and management remit of the DepEd, other levels of education are firmly in the hands of the private sector. And if the universal kindergarten is to materialise, common standards, stricter regulations and tighter co-ordination have to be addressed in accordance with the Early Childhood Care and Development (ECCD) Law. Many day-care centres and homes, pre-schools, and related facilities are privately run. Government agencies, too, provide pre-primary schooling facilities: local government through barangay (village) centres, the Department of Social Welfare and Development (DSWD) through day-care centres, municipal health centres through clinic-based child care facilities that include pre-school activities, and the DepEd itself. Universal kindergarten, designed to increase children's readiness for primary school, is a critical part of the flagship strategy.

Table 2.4.3 shows the private sector's share of enrolment and schools in the Philippines as parameters in the flagship strategy. It is difficult to determine the precise number of pre-primary schools or centres since they are not standardised and no data are therefore provided.

An issue that needs addressing is the financing of the K+12 flagship strategy in light of DepED's diminishing real budget measured in expenditure per pupil. As reported in Luistro (2012), there has been a continued rise in nominal expenditure. In real terms, however, expenditure per pupil in the 2009-10 academic year is even lower (in 2000 prices) than in school year 1997-98. At the same time, even if future poverty reduction may be inferred in K+12, extending schooling for two more years will place an additional cost burden on students, even if they are not charged tuition and related fees.

In summary, the Philippines' path to improving tertiary education may require more than BESRA is expected to deliver. The K+12 flagship strategy has to consider not only the direct policy and administrative instruments it should use, but the role of the private sector in all components of the strategy.

Table 2.4.3. **Private sector share of enrolment and schools in the Philippines**

	Enrolment		Schools	
Level of education	Number	Private (share %)	Number	Private (share %)
Pre-school	1 474 644	420 444 (28.5)		
Primary level	13 934 172	1 134 456 (8.1)	44 486	7 084 (15.9)
Secondary level	6 806 079	1 340 456 (19.7)	10 384	4 707 (45.3)
Tertiary level	2 770 965	1 687 771 (60.9)	2 180	1 573 (72.1)
TVET	1 680 402	1 344 322 (80.0)	4 500	2 790 (62.0)

Note: Data are for school year 2009/10 with the exception of Technical and Vocational Education and Training (TVET) where data are for 2007.
Source: UNESCO (2011).

Box 2.4.2. **Enhancing teachers' capacities and effectiveness by induction programmes with mentoring: Examples from OECD countries**

High quality, effective teachers are the single most important factor in improving students' performances, especially in disadvantaged schools. Thus, in addition to attracting high quality teachers, it is also essential to give them further support by providing induction and mentoring programmes.

OECD experience shows that induction and mentoring improve teacher effectiveness and increase the retention of novice teachers by offsetting the negative effects of inexperience. Mentor teachers help their novice colleagues to understand the main challenges of a particular school and its students and to develop appropriate pedagogical and relational strategies in response to students' needs. Furthermore, while mentoring is especially important for new teachers – because it helps them become competent and effective faster – it is also considered to be beneficial for experienced teachers.

Selected OECD examples of induction programmes with mentoring:

In **Japan**, induction centres provide in-service training to all new teachers, while in schools teachers regularly observe and evaluate each other against criteria set out in specific demonstration lessons. Teachers also need to complete an action research project on a classroom lesson.

In **New Zealand**, teachers receive substantial release time during their first two years in accordance with the Advice and Guidance programme. In release time, an experienced teacher leads a peer support group of new teachers and novices regularly observe other teachers.

In **Switzerland**, new teachers take part in collaborative practice groups led by experienced teachers, have access to counselling services, and take regular voluntary and required courses to improve their practice.

Source: OECD (2012a).

Notes

1. The Global Competitiveness Report of the World Economic Forum (WEF) for 133 countries ranks the Philippines 104th in road infrastructure and 87th in electricity (WEF, 2011).
2. The latest available comparative data from the World Bank are for 2003. Indonesia and Viet Nam are more comparable to the Philippines in total road network: Indonesia has 368 263 kilometres, Viet Nam 229 488, and the Philippines 202 205, while Thailand has just 63 370 kilometres (World Bank, Transport Data and Statistics,).
3. Numbers in Figure 2.4.2 are indicative. The Philippines reports only capital outlays. For all countries expenditure includes all types of infrastructure, although data may be omitted, deleted, or from other years.
4. It is possible to analyse the notion of inclusive growth by using regional, rural and urban categories or city and municipality criteria. What is considered here is the regional configuration, as primary data on GRDP are by regions.
5. National Capital Region, Cordillera Administrative Region (CAR), Ilocos (Region 1), Cagayan Valley (Region 2), Central Luzon (Region 3), Southern Luzon, Mindoro, Marinduque, Romblon, Palawan (Region 4), Bicol (Region 5), Western Visayas (Region 6), Central Visayas (Region 7), Eastern Visayas (Region 8), Western Mindanao (Region 9), Northern Mindanao (Region 10), Eastern Mindanao (Region 11), Southern Mindanao (Region 12), Caraga Region, and Muslim Mindanao Region.
6. Many aggregate data on the Philippines can be decomposed into administrative regions. However, because some administrative regions have been split up (Caraga and CAR were originally parts of other regions, for example) some have been scattered. What is particularly difficult with decomposed data is attributing them to the associated region and not by virtue of the reporting system.
7. Transport accounted for the largest share of energy consumption (36.5%) between 2009 and 2016 (NEDA, 2011).
8. There is over-reliance in each island grid on a single energy source, which makes island groups more vulnerable to security risks and the mounting incidence of poverty. For example, the average poverty headcount in the Visayas and Mindanao is significantly higher than in Luzon and the average for the country (World Bank 2011; Del Mundo and Espos, 2011).
9. The estimate of unenergised households is the residual between the total number of households and the connection reach as of 2010 (NEDA, 2011).
10. Beginning with the Labour Force Survey (LFS) of April 2005, an additional criterion (the so-called "availability criterion") was added to the two others. See NSCB (2005) for details.
11. The use of the April LFS may overestimate the number of unemployed, since graduates are entering the labour force for the first time. The use of LFS from other times of the year may remove some seasonality but is not likely to change the drift of the above text.
12. These are derived from the April 2012 LFS (BLES, 2012).
13. The World Bank (2011) estimates that OFWs constitute 2% to 3% of the working labour force (15-64 years old). It is doubtful there will be any further increases. On the contrary, if OFWs return to the domestic workforce, the need for more jobs becomes greater.
14. This variation is driven by the definition of children in school as being 16 years of age and under. A stratification by children aged 5 years or under (for pre-school) and those who are 9 years and under (for primary school) would likely yield less variation owing to the higher enrolment rates.
15. The Philippines did not participate in the 2007 Trends in International Mathematics and Science Study (34 countries for Grade 4).

Singapore

A. Medium-term economic outlook (forecast, 2013-17 average):

GDP growth (percentage change):	3.1
Current account balance (% of GDP):	18.9
Fiscal balance (% of GDP):	4.2

B. Medium-term plan

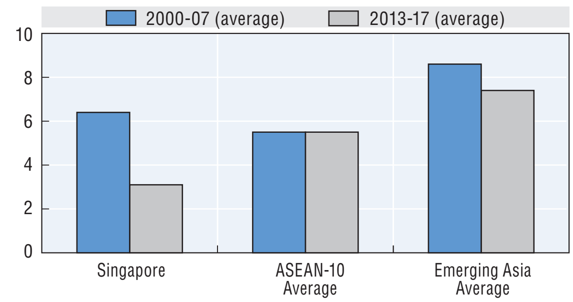
Period:	2010-20
Theme:	High-skilled people, innovative economy and distinctive global city

C. Basic data (in 2011)

Total population:	5.5 million*
GDP per capita at PPP:	59 711 (current USD)

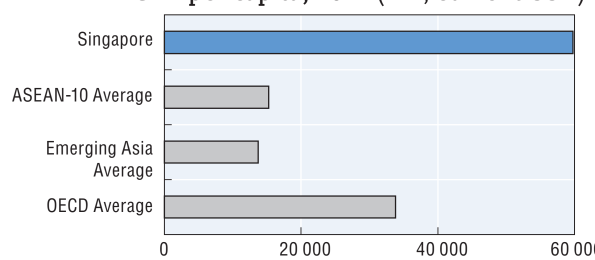
Note: *Total population data for 2011 are an estimate.
Sources: OECD Development Centre, MPF-2013, national sources and IMF.

GDP growth rates (percentage change)



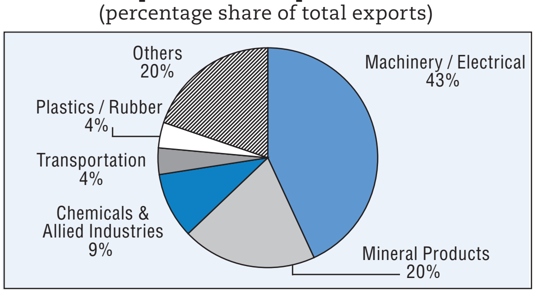
Source: OECD Development Centre, MPF-2013.

GDP per capita, 2011 (PPP, current USD)

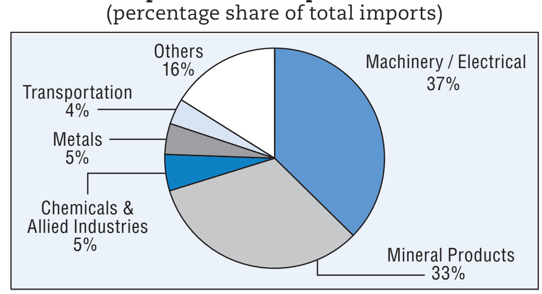


Source: IMF and national sources.

Composition of exports in 2011
(percentage share of total exports)



Composition of imports in 2011
(percentage share of total imports)



Source: Trademap.

Singapore is aiming to undertake a number of reforms to be a hub of the global economy. Political pressure is forcing Singapore to rethink the liberal immigration policy that was part of its drive to be a global city. Although creative foreign workers have contributed greatly to economic development, at the same time liberal immigration policy creates several non-negligible issues the society needs to cope with. The government is tightening entry conditions for foreign workers while encouraging foreign entrepreneurs and investing heavily in developing the human capital of indigenous workers and encouraging businesses to upgrade their technology and production methods.

As part of that investment effort, the government has lent strong backing to small and medium-sized enterprises (SMEs). They account for over half of total enterprise value and employ nearly 70% of the workforce. Their rise, though, has been largely driven by government policy which has funded them and boosted the growth of their domestic market. There are now questions as to how sustainable this state's SME policy is in the long term.

Research and Development (R&D) is considered an important component of Singapore's policy of productivity-driven economic growth. In the last two years, the government has brought local SMEs into R&D with cash incentives to help them develop innovation. Combined public and private R&D expenditure has put Singapore among the most R&D-intensive countries. Nevertheless, it lags behind in private R&D spending. Government policy aims to make up the gap by increasing expenditure to levels similar to 3.5% of gross expenditure.

Singapore's medium-term policy challenges and responses

- Manage foreign worker dependence by increasing the productivity of local workforce
- Sustain SME growth through fostering entrepreneurial environment
- Enhance the innovation capabilities of local enterprises

POLICY FOCUS

Manage foreign worker dependence by increasing the productivity of local workforce

As a small city state with no natural resources, Singapore has long been careful in managing its human capital, seeing such management as an important source of competitiveness and strength for the economy. Over the years, public expenditure on education has consistently been the second highest (after defence) in the government's annual fiscal budgets. In the 2012 budget, for example, expenditure on education claimed a 17.9% share, compared with 20.8% for defence. Such emphasis on education has helped contribute to Singapore's stronger record in human capital development than other countries in the region (Table 2.5.1).

Over the past decade, a major force shaping the human capital landscape in Singapore has been the increased presence of foreign workers. As part of the strategy to transform Singapore into a global city, the government had aggressively liberalised the foreign worker and immigration policy.[1] From 2000 to 2011, the number of non-residents rose from 754 500 to 1 394 400, representing a jump from 18.7% to 26.9% of the total population. In contrast, the share of Singapore citizens (excluding permanent residents and non-residents) in the population steadily declined from 74.1% in 2000 to 62.8% in 2011 (Department of Statistics Singapore, 2011).

The aggressive pursuit of the global city vision has transformed not only the physical look of the city state, but also its business environment and production structure. Together with these changes, the composition of the labour force has also been significantly altered – both in terms of the local-foreign mix and the mix between workers in "old" and "new" industries. While the open-door labour policy brought in a large number of highly skilled, high wage foreign workers, it has also led to a huge influx of low-skilled, low-wage foreign workers. Whereas the former could potentially expand the economy's range of skill sets and raise its productivity level, the latter could substantially offset such positive effects. Indeed, with the ready availability of low-wage foreign workers, firms in Singapore might not find many incentives to upgrade their technologies and production structures, or to invest in training or upgrading the skills of their workers.

Table 2.5.1. **Human capital development indicators in Asia**

	Per capita GDP (USD)	Adult literacy rate (above 15 in age)		Gross enrolment ratio (%)							Human Development Index (New Scale)	
		Female	Male	Primary School		Higher School		Tertiary education		Year	HDI	Ranking
	2010	2005-09	2005-09	Female	Male	Female	Male	Female	Male		2010	2010
Singapore	35 022	91	97	95	95	73	75	40	47	2008	0.846	27
Hong Kong, China	24 626	91	97	105	105	86	86	34	33	2008	0.862	21
China	3 556	87	95	111	111	78	77	23	23	2008	0.663	91
Japan	32 600	99	99	100	100	101	101	54	62	2008	0.884	11
Korea	16 491	98	99	104	104	94	98	69	65	2008	0.877	12
Chinese Taipei	15 552	89	96	102	102	99	98	85	79	2008	-	-
Indonesia	2 142	89	95	116	116	74	73	32	19	2007	0.600	111
Malaysia	8 065	86	93	100	100	72	70	33	27	2007	0.744	59
Philippines	1 639	94	94	109	109	87	79	32	25	2007	0.638	100
Thailand	4 036	92	96	108	108	88	79	45	38	2007	0.654	87
India	946	51	75	109	114	49	53	10	14	2006	0.519	122

Source: CIA World Fact Book 2011, United Nations Database, Asian Development Bank.

Overall, the impact on productivity growth has not been encouraging. From 2000 to 2011, GDP in Singapore grew on average by 5.93% a year. But the total factor productivity (TFP) grew only at 1.80% a year on average. In some years, the TFP level actually declined. Likewise, labour productivity averaged a growth of only 0.57% a year from 2006 to 2011, with a decline in 2001, 2008 and 2009.[2]

Recognising the possible adverse impact that the liberal foreign worker and immigration policy might have on the human capital profile and the productivity growth in the economy, the Singapore government began to review and make adjustments to the policy from early 2011.[3] In the meantime, it continues to find ways to upgrade the skills of the local workforce and raise its productivity.

Upgrade the skills of the local workforce

A key consideration in the government's human capital development policy in the past two years has been to help local workers adjust to the changing needs in the market so that they can remain "employable" over a longer period. This involves identifying industries that are seen to be sustainable over the long run and then providing workers with the necessary skill sets to stay employed within them.

A key initiative in recent years was the Workfare Training Support Scheme (WTS) rolled out in 2010. The WTS provides subsidies, absentee payroll funding and other incentives for employers to encourage them to send low-wage workers for training. Employers can receive subsidies that pay for up to 95% of the course fees and the absentee payroll. WTS also offers training commitment awards of up to SGD 400 (Singaporean dollars) a year for workers who successfully complete the requisite training modules.

In 2011, the government extended the Continuing Education and Training (CET) scheme to the professionals, managers, executives and technicians (PMETs) who make up more than 50% of the workforce. The CET scheme was previously available only for older, low-wage workers. A wide range of degree- and diploma-level programmes were made available for the PMETs. In addition, the government significantly raised the subsidies to full time student grant levels for PMETs who choose to pursue their first degrees or diplomas on a part-time basis.

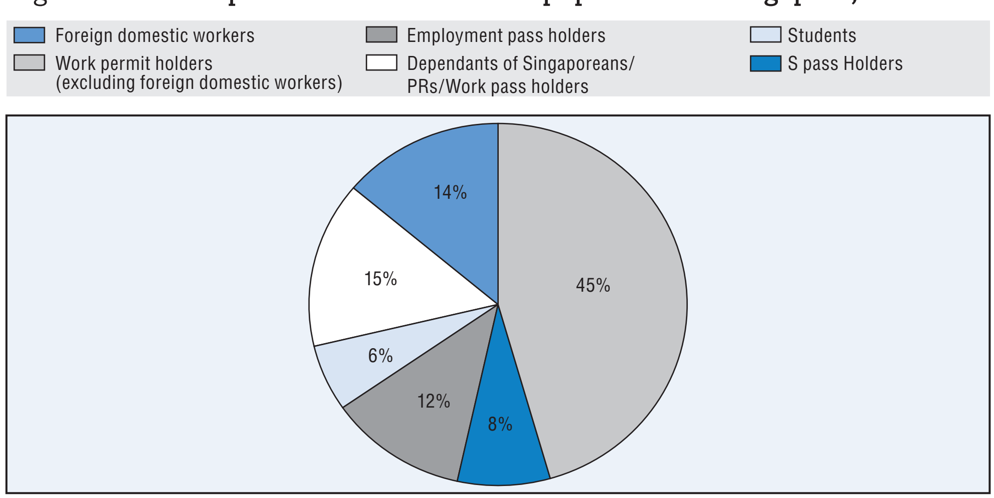
At the same time, the government continues to beef up human capital through investment in infrastructure for education and training. In 2009, the fourth university, the Singapore University of Technology and Design (SUTD) was set up with a strong focus on innovation and entrepreneurship. SUTD has strategic partnerships with the Massachusetts Institute of Technology (MIT) in the US and Zhejiang University in China as ways of tapping into the opportunities offered by the two largest economies in the world. In 2012, the Yale-National University of Singapore joint campus was opened as part of the policy to provide more high-quality tertiary education choices for Singaporeans.

At a lower level, the government continues to expand the polytechnics and the Institutes of Technical Education (ITEs) which equip non-graduates with a wide range of technical skills at a diploma level. Under the new "One ITE System, Three Colleges" plan, multiple ITEs will be consolidated to form a new ITE network to enhance the competitiveness and attractiveness of ITE education. The third and final ITE college central campus will be ready in 2013 to complete the network. The Ministry of Education has committed USD 2 billion to further growing the ITEs over the next five years.

Managing foreign worker dependence

Over the past two years, the government has been carefully calibrating the inflow of foreign workers and new immigrants, both in terms of quantity and quality. In 2011, there were 27 521 new permanent residents (PRs) and 15 777 new citizens, down from 79 167 new PRs and 20 513 new citizens in 2008. A much larger majority of the new residents now possess post-secondary educational qualifications than in previous years.[4] Over the long run, the government's objective is to keep the total number of foreign workers at one-third of the total workforce in Singapore.[5] Currently, holders of employment passes and S passes (issued to highly skilled foreign workers who earn higher salaries) account for 20% of the total number of the non-resident population, while work-permit holders (low-wage foreign workers and foreign domestic workers) make up 60% (Figure 2.5.1).

Figure 2.5.1. **Composition of non-resident population in Singapore, 2011**



Source: Department of Statistics, Ministry of Manpower.

StatLink http://dx.doi.org/10.1787/888932774509

A number of price-based and quantity-based measures have been used in the last two years to calibrate the inflow of foreign workers. They include higher levies on foreign workers, stricter approval criteria for work permits and employment pass applications, and lower employment quotas.

To encourage companies to reduce their dependence on low-skilled foreign workers, for example, the qualifying salaries for employment pass (EPs) and S pass holders were raised in July 2011. The qualifying monthly salary for S-pass holders was increased to SGD 2 000 from SGD 1 800, while those for the Q1, P2 and P1 categories of employment pass were raised to SGD 2 800, SGG 4 000 and SGD 8 000, respectively (Table 2.5.2).[6]

The Ministry of Manpower will also continue to raise the foreign worker levies steadily in six-monthly intervals up to July 2013. At the same time, the government also introduced various programmes under the Workforce Skills Qualification (WSQ) framework to help enterprises assess and certify the skill levels of potential foreign workers, so that they better match the wages and productivity of the foreign workers employed.

The 2012 budget saw further tightening on the employment of foreign workers. The dependency ratio ceiling which specifies the number of foreign workers (as a proportion of total number of workers) that a company can hire was reduced for the manufacturing and service sectors. Meanwhile, the man-year entitlement (MYE) quota for the construction sector which measures the number of foreign workers that can be hired within one project was also reduced by 5%.

Table 2.5.2. **The schedule of foreign workers levy changes in Singapore**

		Current		01-Jul-11		01-Jan-12		01-Jul-12		01-Jan-13		01-Jul-13	
		DR	Levy USD Skilled/ Unskilled	DR	Levy USD Skilled/ Unskilled	DR	Levy USD Skilled/ Unskilled	DR	Levy USD Skilled/ Unskilled	DR	Levy USD Skilled/ Unskilled	DR	Levy USD Skilled/ Unskilled
All Sectors													
	Tier 1	≤20%	110	≤15%	120	≤15%	160	≤10%	200	≤10%	250	≤10%	300
S Pass	Tier 2	>20-25%	150	>15-25%	180	>15-25%	250	>10-25%	320	>10-25%	390	>10-25%	450
Manufacturing	Tier 1	≤35%	170/270	≤30%	180/280	≤30%	190/290	≤25%	210/310	≤25%	230/330	≤25%	250/350
(Work permits)	Tier 2	>35-55%	210/310	>30-50%	240/340	>30-50%	270/370	>25-50%	300/400	>25-50%	330/430	>25-50%	350/450
	Tier 3	>55-65%	450	>50-65%	450	>50-65%	450	>50-65%	470	>50-65%	500	>50-65%	550
Services	Tier 1	≤25%	170/270	≤20%	180/280	≤20%	210/310	≤15%	240/340	≤15%	270/370	≤15%	300/400
(Work permits)	Tier 2	>25-40%	300	>20-35%	300/400	>20-30%	330/430	>15-25%	360/460	>15-25%	380/480	>15-25%	400/500
	Tier 3	>40-50%	450	>35-50%	450	>30-50%	470	>25-50%	500	>25-50%	550	>25-50%	600
Construction	MYE	≤87.5%	160/470	≤87.5%	180/230	≤87.5%	200/300	≤87.5%	250/350	≤87.5%	280/400	≤87.5%	300/450
(Work permits)	MYE-waiver		310		380		450		500		550		600
Process	MYE	≤87.5%	160/470	≤87.5%	180/300	≤87.5%	180/300	≤87.5%	210/310	≤87.5%	230/330	≤87.5%	250/350
(Work permits)	MYE-waiver		310		380		380		470		500		550
Marine (Work permits)		≤83.3%	170/300	≤83.3%	180/300	≤83.3%	190/300	≤83.3%	210/310	≤83.3%	230/330	≤83.3%	250/350

Source: Ministry of Manpower, Republic of Singapore.

Political pressure for restrictions on foreign workers and upgrading local workers

The Singapore government will likely find it increasingly more challenging in the future to rely on foreign workers and new immigrants to augment Singapore's human capital stock and change its human capital profile. The liberal foreign worker and immigration policy has been seen by many as contributing to a number of social, political and economic woes such as widening income inequality, rising social tensions among the new and old residents, and the loss of social cohesion, etc. Despite the government's efforts to convince Singaporeans to be receptive to new arrivals and to integrate them, political pressure for tightening the foreign labour inflows is likely to persist. The government will face increasingly greater pressure to upgrade the local workforce and increase their productivity and hence wages. This will also entail encouraging companies to increase their investment in new technology and production structures.

Box 2.5.1. **Enhancing integration policies: Examples from OECD countries**

In OECD countries exposed to large scale immigration there has been a recent trend of enhancing integration programmes to further refine their well-established integration systems.

In **Australia**, a new Multicultural Council was created in 2011 to foster multiculturalism and provide advice to the government on multicultural affairs. Similarly, there has been greater emphasis in tackling racism. A national anti-racism partnership was set up in order to develop a comprehensive anti-racism strategy.

In **Canada**, the funding of integration programmes has been reformed to bring together separate settlement programmes, such as Language Instruction for Newcomers to Canada, Immigration Settlement, and the Adaptation Program. The administrative process for immigrant support organisations has thus been simplified for greater flexibility in assisting immigrants. As a result of the reform, newcomers' use of settlement services has increased by 8%.

In **Luxembourg**, an optional two-year contract (the Welcome and Integration Contract [CAI]) is offered to all foreign newcomers aged 16 or older. The foreign arrivals who take up the CAI are bound to attend a half-day orientation and information session on daily life in Luxembourg, a six-hour civics course, and language training that is available in Luxembourgish, French or German. In return, acceptance of the CAI includes an exemption from the mandatory course for acquiring Luxembourg nationality, positive consideration of applications for permanent residence and priority access to national integration measures.

In **Sweden**, co-ordination of new arrivals was centralised under the Public Employment Service in 2010. There is also a uniform public allowance scheme for newly arrived migrants. Eligibility for the allowance scheme is conditional on active participation in introductory measures. Furthermore, a civic orientation programme and a new introductory guide are also meant to assist new immigrants in their integration efforts. The new national integration strategy aims at formulating general measures based more on the needs of the whole population less on the country of origin. The Swedish government has also announced its intention to increase ethnic and cultural diversity among public-sector employees.

Source: OECD (2012c).

POLICY FOCUS

Sustain SME growth through fostering entrepreneurial environment

Singapore has traditionally relied on multinational corporations (MNCs) and the large government-linked companies (GLCs) as the main drivers for economic growth. Most economic policy measures in the past were geared towards facilitating the operations of the MNCs and the GLCs, especially those of the former. In contrast, much less attention was given to promoting the growth of SMEs. As a result, SMEs in Singapore have not been able to play as significant a role in innovation and productivity growth as their counterparts in other countries.

Over the past few years, SMEs have come more to the fore. Their contribution to total enterprise value rose from about 30% in late 1990s to about 46% in 2004. By 2010, the contribution had risen further to 58%. Meanwhile, SME employment as a share of total employment to 67% in 2010 from 56% in 2006. Various surveys have consistently ranked Singapore as having among the most conducive environments for doing business (World Bank, 2012d).

The enhanced contribution of the SMEs reflects changes both in policy orientation and in the economic environment, as well as the impact of specific government policies. As international competition for foreign direct investment heightened in recent years, there has been increased recognition among policy makers of the need to build up Singapore's indigenous productive capabilities – especially those of its SMEs. In a report released in 2010, the Economic Strategies Committee (ESC) – a government committee set up to help provide strategic direction for the economy's growth in the coming decade – identified SMEs as a key driver of productivity-driven growth. The ESC report set a target of doubling the number of local SMEs with revenues of over SGD 100 million to 1 000 in the next ten years.

The gradual rise of the SMEs unfolded against the background of policies the government had redesigned in its quest to transform Singapore into a global city. The focus of policy shifted from attracting and serving the needs of MNCs to attracting a critical mass of creative foreign workers who were able to help develop and grow new, innovation-driven industries. An outcome of this policy shift was a rapid expansion of the population base which significantly enlarged the domestic market for SMEs – especially those in the service industries – and contributed significantly to their growth.

The growth of the SME sector in recent years has also benefited from targeted government measures in a few areas such as access to finance, the development of human resources and the internationalisation of SMEs' operations.

Array of new funding arrangements for SMEs

Various surveys suggest that the constraints that restricted SMEs' access to finance for local business has eased significantly in recent years.[7] Government involvement, both in debt- and equity-financing, play a significant role in reducing funding constraints. However, the government is anxious to avoid potential moral hazards in extending its help. In debt-financing schemes, it provides funding for SMEs only once commercial banks and financial institutions have agreed to lend to these enterprises after the relevant due diligence process. In equity financing, the government does not take equity stakes in SMEs alone, but only matches private sector investment. Direct government funding for SMEs through grants or other assistance schemes often takes a targeted approach and is restricted to certain business activities in SMEs' development, such as international expansion, workforce training and technology adoption. Over the years, the government has also encouraged the formation of credit bureaux which propose advanced credit-scoring facilities to help banks and financial institutions improve their assessment of SMEs' creditworthiness.[8]

Financing for cross-border businesses remains an issue as overseas expansion typically requires longer times and a larger amount of financing. Such a constraint could put Singaporean SMEs at a disadvantage compared to their counterparts in some countries in the region who enjoy the support of government-backed export-import banks (EXIMs) and other export credit agencies. To address this concern, state-owned investment company Temasek Holdings, together with a consortium of financial institutions (including banks and insurance corporations), set up a new project finance company (PFC), called Clifford Capital, in 2012. The PFC focuses on providing longer-term financing for local companies engaged in projects in emerging markets, especially in infrastructure (power, waste and water treatment, transport, etc.), marine sector-related projects where Singapore is seen to enjoy a competitive advantage. About SGD 400 million of credit is expected to be provided annually, which could help catalyse some SGD 23 billions' worth of offshore projects for SMEs.[9]

Human resource development in SMEs stepped up

A new three-year initiative for Enhanced Training Support (ETS) was unveiled in the 2012 budget to provide a wider choice of training programmes available to workers, especially those in the SME sector. The Workforce Development Agency (WDA) estimated that about 8 400 courses could come under the umbrella of the new ETS scheme. Workers who attend training courses under ETS (and employers who send them) are eligible for the same subsidies they receive under the WTS scheme.[10] In addition to the various incentives for training and skills upgrading, the government also tries to enhance SMEs' access to external human capital by building up a network of "mentors" who could provide strategic and expert advice to them. This is done through a number of platforms, such as SPRING Singapore.[11]

SME business operations on an increasingly international footing

The 2012 budget provided a further boost to the Double Tax Deduction ("DTD") scheme for SMEs with overseas operations. It allows them to claim up to 200% tax deduction on four types of expenditure incurred in market expansion and investment-related activities.[12] The DTD scheme was also simplified for SMEs by removing the need to apply for approval from IE Singapore (formerly the Singapore Trade Development Board) or the Singapore Tourism Board (STB). In addition, it provides for increased tax rebates as well as an automatic claim feature that helps reduce the administrative costs for SMEs venturing overseas.

Work is also underway to help SMEs mitigate non-payment and other risks when they venture abroad. The government plans to revamp risk assessment procedures in order to help provide better trade finance solutions for SMEs (see Budget 2012). A number of commercial banks, together with the International Finance Corporation (IFC) and the Asian Development Bank (ADB), are actively exploring ways to help SMEs better manage their risks in offshore businesses. Since 2011, IE Singapore has also engaged in discussions with various partners to help design schemes that offer SMEs more affordable insurance coverage for political risks in overseas markets.

Further reforms needed

Singapore has made significant progress in promoting the growth of SMEs in recent years. Much of the impetus appears to have come from the government. Even the expansion of the domestic market was a result of the strategic shift in its growth approach. To its credit, the government has tried to keep the interventions at the macro-level and to preserve as much of the market mechanism as possible. However, questions remain over the long-term sustainability of such a government-driven approach. It is not clear, for example, how much more the domestic market could continue to expand, given the strong political pressures against the liberal foreign workers and immigration policy.

A more fundamental issue pertains to the oft-mentioned lack of entrepreneurial and risk-taking culture in Singapore. Studies consistently indicate that Singaporeans lack entrepreneurial drive. A recent survey showed that less than 16% of Singaporean workers have considered setting up their own businesses, compared with 40% in Hong Kong, China (and 33% in Chinese Taipei), even though the World Bank ranks Singapore along with Hong Kong, China as one the best places in the world for doing business.[13] One of the immigration policy's objectives in introducing the S pass was to take in foreigners who are potential entrepreneurs but lack the necessary educational qualifications as the employment pass holders. In recent years, there has been talk about offering incentives to SMEs from neighbouring countries to relocate to Singapore. Whether this is feasible remains to be seen.

POLICY FOCUS

Enhance the innovation capabilities of local enterprises

The key thrust of the 2010 ESC Report which mapped out Singapore's new economic growth strategy in the coming decade was that economic growth in Singapore must be productivity-driven. Fostering innovations is central to this growth strategy. Over the years, Singapore has been trying to build a comprehensive R&D ecosystem comprising public sector research bodies (e.g. A*STAR), academic research institutes and corporate R&D laboratories.

R&D is not, however, an end in itself. It is considered a driver of economic growth and it is important that enterprises create value from R&D investment and the intellectual properties generated. Traditionally large (domestic and foreign) corporations which enjoy strong government backing carry out the bulk of innovation and commercialisation activities in Singapore. For many years, for example, the Economic Development Board has been offering incentives to large foreign corporations to either relocate to or build their regional R&D centres in Singapore. As a result, foreign corporations and large local enterprises accounted for 85.7% of industry R&D expenditure from 2002 to 2010.[14] SMEs' innovation capabilities have developed chiefly through collaborative test-bedding for commercialisation and other forms of spillover effect.

In the last two years, however, the government has put a growing emphasis on broadening the base of innovative activities in the economy and brining in local enterprises, especially SMEs. It has launched a number of initiatives to help integrate local enterprises with public R&D capabilities through various platforms such as SPRING Singapore.

One such programme is the Innovation Voucher Scheme (IVS) first introduced in the 2010 budget. The initial objective is to connect knowledge institutions (KIs) with local enterprises to facilitate the transfer of know-how and technology from the former to the latter. Qualifying enterprises can obtain innovation vouchers from SPRING Singapore, which can be used to support projects or procure services from approved KIs. The IVS has set relatively low application criteria to make the programme more widely available for local enterprises. The 2012 budget further expanded the IVS to cover three new areas – productivity, human resource development, and financial management – in addition to technology- related projects.

Table 2.5.3. **Summary of deductions/allowances under the Productivity and Innovation Credit (PIC) provision of Singapore**

Qualifying activities	Brief description of qualifying expenditures under the PIC	Total deductions/allowances under the PIC (as a % of qualifying expenditure)	Examples of qualifying expenditures
Acquisition or leasing of PIC automation equipment	Costs incurred to acquire/ lease PIC automation equipment	400% allowance/deduction for qualifying expenditure subject to the expenditure cap, 100% allowance/deduction for the balance of expenditure exceeding the cap	Cost/lease expenses of IT equipment such as fax machine, laser printer, computer, lap-tops and software;
Training expenditure	Costs incurred on: 1. In-house training (e.g. Singapore Workforce Development Agency (WDA) certified, Institute of Technical Education (ITE) certified) In-house training not accredited by WDA or approved/certified by ITE, subject to a cap of USD10,000 per year for YA 2012 to YA 2015 2. All external training	400% tax deduction for qualifying expenditure subject to the expenditure cap, 100% deduction for the balance of expenditure exceeding the cap	Cloud computing payment External course fees for staff; costs incurred on internal Workforce Skills Qualification (WSQ) courses for employee skills upgrading Training of agents from YA 2012
Acquisition of intellectual property rights (IPRs)	Costs incurred to acquire IPRs for use in a trade or business (exclude EDB-approved IPRs and IPRs relating to media and digital entertainment content)	400% allowance for qualifying expenditure subject to the expenditure cap, and 100% allowance for the balance of expenditure exceeding the cap	Payment to buy a patented technology for use in manufacturing process Price paid for trademark
Registration of intellectual property rights (IPRs)	Costs incurred to register patents, trademarks, designs, and plant varieties	400% tax deduction for qualifying expenditure subject to the expenditure cap, 100% deduction for the balance of expenditure exceeding the cap	Fees paid to Intellectual Property Office of Singapore (IPOS) to register trademark
Research & development (R&D)	Costs incurred on staff costs and consumables for qualifying R&D activities carried out in Singapore or overseas if the R&D performed overseas is related to the taxpayer's Singapore trade or business	400% tax deduction for qualifying expenditure subject to the expenditure cap. For the balance of qualifying expenditure exceeding the cap for R&D performed in Singapore, deduction will be 150%. For balance of all other expenses, including expenses for R&D performed overseas, deduction will be 100%	Salaries for R&D personnel and fees to R&D body for creating a novel product
Design expenditure	Costs incurred to create new products and industrial designs where the activities are primarily carried out in Singapore	400% tax deduction for qualifying expenditure subject to the expenditure cap, 100% deduction for the balance of expenditure exceeding the cap	R&D cost sharing from YA 2012 Fees to engage in-house eligible designers or outsourced to eligible design service providers to carry out approved design activities

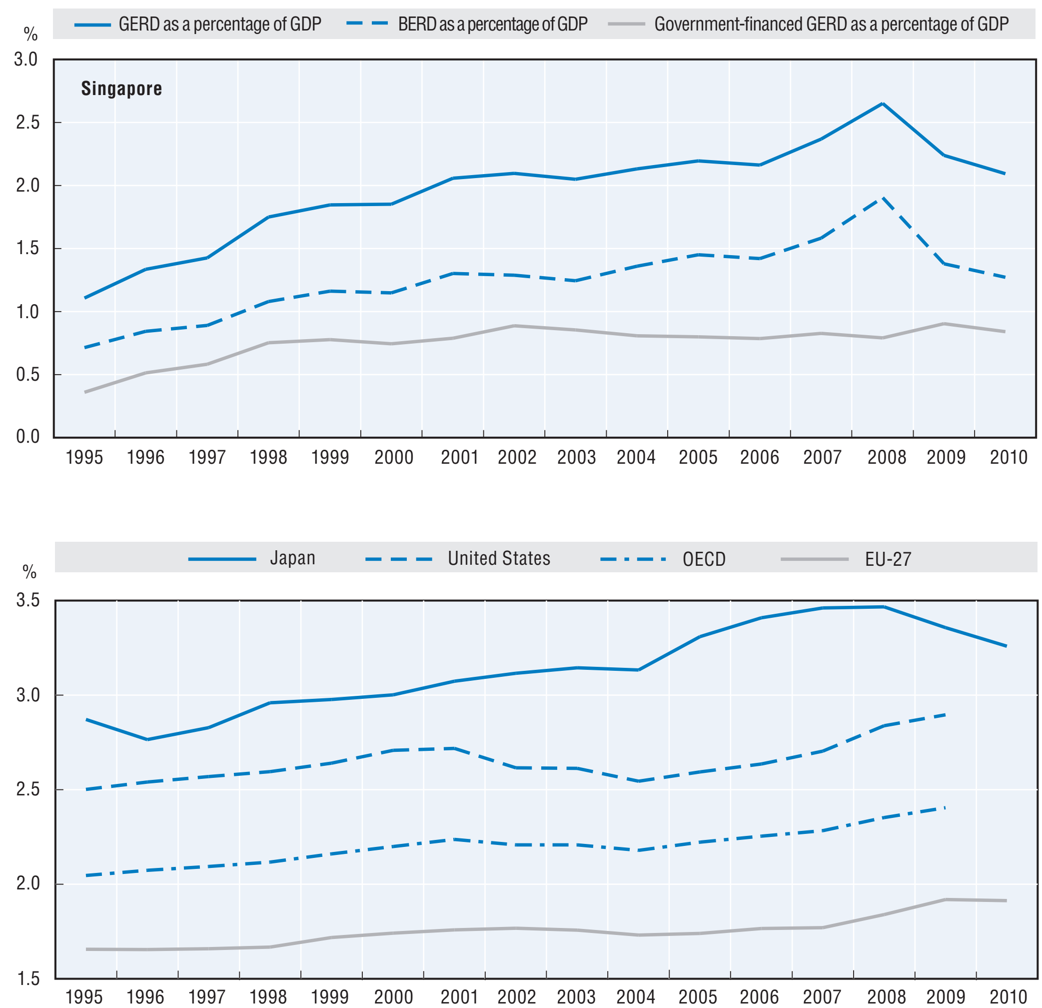
Source: Inland Revenue of Authority Singapore.

In both the 2011 and 2012 budgets, the Productivity and Innovation Credit (PIC) provision was broadened to cover tax credits not only for actual innovations but also for other innovation-related activities such as training, the acquisition of intellectual property rights and R&D activities (see Table 2.5.3). Other cash incentives are available in the Technology Innovation Programme (TIP), introduced in 2011 to subsidise projects that help local enterprises develop new products, business processes and business models, or to improve on existing products, processes and business models.

In 2012, a new collaborative initiative between the government and industry, PRIME (Productivity, Resilience and Innovation for Manpower Excellence), was launched to help companies build up their innovation capabilities. The new programme is meant to be a one-stop shop for industry conferences, project consultancy and relevant government training schemes to facilitate holistic solutions for innovation and industry upgrading.

Figure 2.5.2. **Gross expenditure on R&D in Singapore and other selected countries, 1995-2011**

(percentage of GDP)



Source: National Survey of R&D 2010, OECD Main Science and Technology Indicator s Database, June 2012.

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While official efforts to spread innovation across the whole corporate spectrum are relatively new, it is noteworthy that total business expenditure on R&D as a share of GDP has been rising over the years. In fact, it has accounted for a large part of the rise in gross expenditure on R&D, although much of the business expenditure was likely to have been carried out by large corporations (Figure 2.5.2).[15] Combined spending on R&D by the public sector and the business community represented 2.14% of GDP in 2010, putting Singapore in the top division of R&D-intensive countries such as the US and Germany.

Commensurate with the increase in the total R&D expenditure was the expansion of human resources in R&D. Total research manpower – which includes researchers, post-graduate students, technicians and support staff – has increased at a compound annual growth rate of 6.1% since 2000.

Some concerns for the future

R&D spending by business enterprise in Singapore still lags behind levels in other R&D-intensive nations such as the OECD member countries, particularly Japan. However, over time, as innovation culture becomes more pervasive, SMEs and large enterprises in Singapore might be expected to play an increasingly larger role in R&D and innovation activities. Over the next five years, the government intends to increase gross expenditure on R&D to 3.5% of GDP, a level similar to those in other R&D-intensive nations.

Notes

1. See Reports by the Economic Review Committee (ERC) 2002, and the Economic Strategy Committee (ESC), 2010. Also see K.S. Tan's "From MNC Hub to Global City: Managing Singapore's Comparative Advantage"; presentation at Singapore Management University, 2012.
2. Source: Department of Statistics, Singapore.
3. The liberal foreign worker/immigration policy was also seen to have contributed to other adverse economic, social and political impacts including a fast widening income gap, raising tensions among new and old residents.
4. Source: National Population and Talent Division, Singapore.
5. For details, see speech by Gan Kim Yong, Manpower Minister, at the budget debate on 9 March 2011.
6. Source: Ministry of Manpower, Singapore.
7. See SME Development Survey by DP Information Group for the period of 2009, 2010 and 2011 and SME index released by the Singapore Business Federation (SBF)
8. Research shows that credit scoring facility provides better assessment for credit risk.
9. See press release from Ministry of Finance, Singapore, February 2012.
10. See Section on Human Capital Development above.
11. SPRING Singapore is the government agency tasked to help develop and grow the local enterprises in Singapore.
12. These activities include overseas business development trips/missions, overseas investment study trips/missions, participation in overseas trade fairs, and participation in approved local trade fairs.
13. See Survey conducted by Gallup in 2010.
14. Calculated using data from National Survey of R&D in Singapore (various years).
15. The decline of GERD/GDP ratio in 2009 and 2010 was due mainly to the exceptionally strong GDP growth (13.9%) – marking a rebound from the global financial crisis – which surpassed the GERD growth (7.4%). The actual expenditure on GERD had actually increased during this period – USD 6 billion in 2009 and USD 6.5 billion in 2010. In 2009 and 2010, public expenditure on R&D accounted for a larger share of overall R&D growth than business expenditure mainly owing to the economic crisis and the contraction of R&D activities in the private sector.

Thailand

A. Medium-term economic outlook (forecast, 2013-17 average)

GDP growth (percentage change):	5.1
Current account balance (% of GDP):	0.8
Fiscal balance (% of GDP):	-2.6

B. Medium-term plan

Period: 2012-16

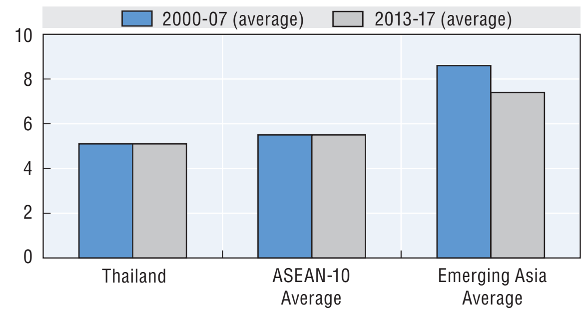
Theme: Philosophy of Sufficiency Economy

C. Basic data (in 2011)

Total population:	64 million
Population of Bangkok:	8.3 million (in 2010)
GDP per capita at PPP:	9 396 (current USD)

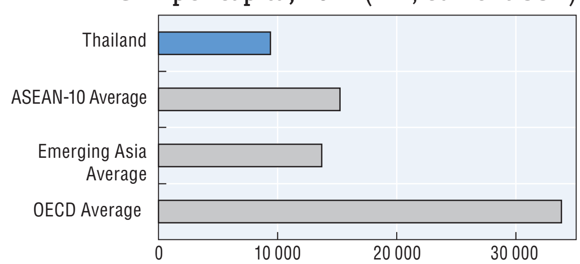
Sources: OECD Development Centre, MPF-2013, national sources and IMF.

GDP growth rates (percentage change)



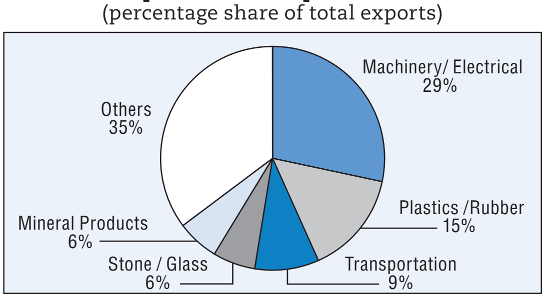
Source: OECD Development Centre, MPF-2013.

GDP per capita, 2011 (PPP, current USD)



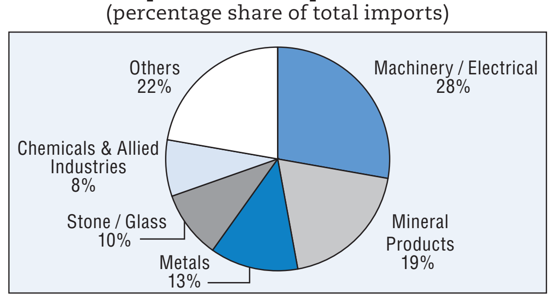
Source: IMF and national sources.

Composition of exports in 2011
(percentage share of total exports)



Source: Trademap.

Composition of imports in 2011
(percentage share of total imports)



Thailand faces challenges to further improve its education and health-care systems while addressing the accumulated environmental damage from its rapid growth. The country has made impressive progress in providing education and health care to most of the population. However significant disparities in access remain, especially for poorer households and between rural and urban areas that need to be addressed. Education quality needs to be improved, particularly the quality of teachers, and rising health-care costs need to be contained through reforms to improve efficiency in the delivery of services.

Thailand also needs to address environmental damage from past growth and achieve greener growth in the future by reducing carbon emissions and other forms of pollution. This will require commitment to greener growth by government, business and the public and new policies, including increased use of fiscal incentives to encourage more environmentally friendly activities and behaviour.

Thailand's medium-term policy challenges and responses

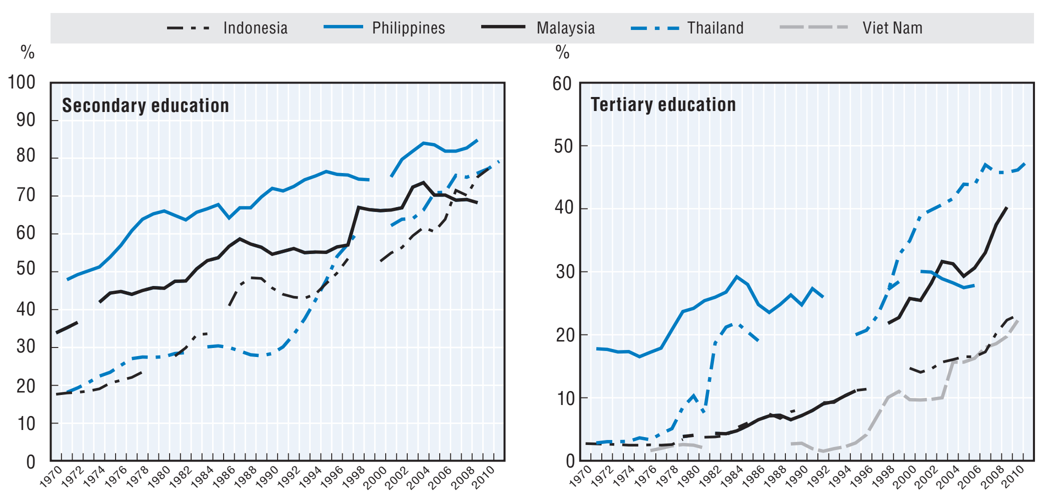
- Raise the quality of education and reduce disparities
- Achieve a more equitable health-care system
- Foster green growth through investment and fiscal reform

POLICY FOCUS

Raise the quality of education and reduce disparities

Thailand has successfully addressed much of its problem of low access to education that existed before the 1990s by increasing education enrolment rates at almost every education level (see Figure 2.6.1). Indeed, the tertiary enrolment rate in Thailand is now among the highest in ASEAN.

Figure 2.6.1. **Gross school enrolment rate in Thailand and other Southeast Asian countries**



Source: UNESCO Education Statistics.

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Access is still more unequal and quality lower than is desirable

A closer look at participation in the education system reveals one of the key current problems with Thai education (see Table 2.6.1 for a brief description of Thai education system): the unequal education chances for the poor. Figure 2.6.2 shows that the gaps in college enrolment rates between the rich (highest quartile) and the three lower quartiles of the income distribution, and especially with the lowest quartile, have widened greatly. This has happened despite the government's active policy to foster education loans for poor college students.

Table 2.6.1. **Thai education system**

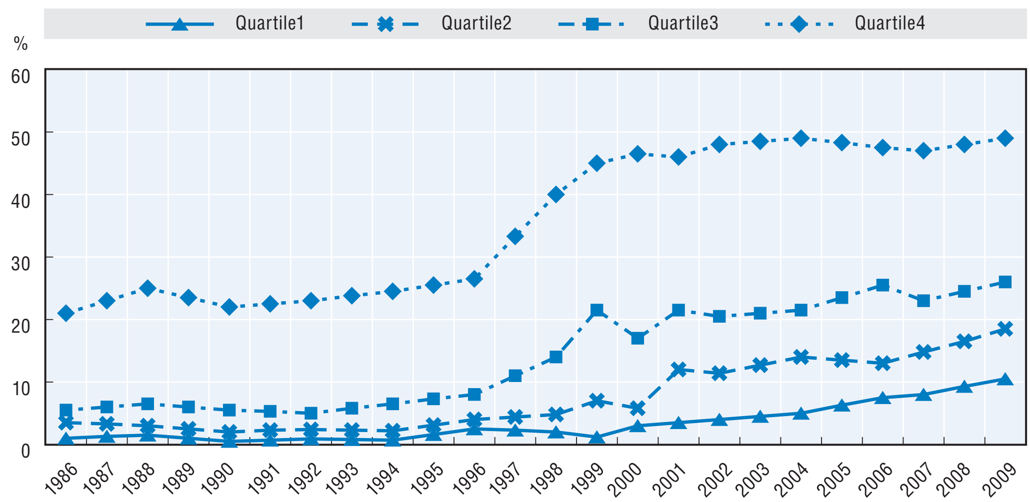
Approximate age	Grade	Level of education	Vocational education	Free education
3				
4		Pre-elementary		
5				
6	1			
7	2			
8	3	Primary		
9	4			
10	5			
11	6			
12	7			
13	8	Lower-secondary		
14	9			
15	10			
16	11	Upper-secondary	Lower vocational and technical	
17	12			
18	13		Tertiary vocational	
19	14	Undergraduate		
20	15			
21	16			

Note: Thai education is a -6-3-3 system for basic education and normally 4 years at the tertiary level. The first 9 years of basic education are compulsory. The government subsidises the 3 years of pre-elementary level education as well.

Source: Adapted from Ministry of Education.

The implication is that addressing short-term financial constraints is not enough to eliminate inequalities in education and that other interventions must be made much earlier. To this end, the 15-year free education policy introduced in 2009 is a good step toward a solution. Unfortunately, many students living in poverty still cannot attend schools, owing to financial difficulties other than the direct cost of school enrolment. For example, beside tuition fees, transportation cost, which is not covered by the new policy, is a major cost of attending school, especially for poor students living far away from the schools. Students of public schools, who tend to come from low or middle income families, have to pay transportation costs averaging THB 3 500 (Thai baht) per year per student in 2009 (see Table 2.6.2), which is equivalent to 6% of the annual rural poverty line income for a family of 3.5 persons. This cost represents a significant burden for poor familes and could lead them to keep their children out of school to avoid the cost. Drop-out rates, although not too high overall, remain an issue in particular, at secondary school in Thailand (see Table 2.6.3).

Figure 2.6.2. **Trends in college enrolment rates for 19-25 year-olds in Thailand, by income quartile**



Source: Lathapipat, Dilaka (2011), "The Inequality of Access to Education in Thailand, 1986–2009", paper presented at the conference ANU-DBU Economics of Education Policy: Access and Equity at Dhurakij Pundit University, Bangkok, Thailand, 14–16 June 2011.

StatLink http://dx.doi.org/10.1787/888932774566

Table 2.6.2. **Household education expenditure in Thailand, by education levels and school type, 2009**

(average THB per head per year)

	Private School				Public School			
	Tuition Fees	Uniform	Books and equipment	Transport	Tuition Fees	Uniform	Books and equipment	Transport
Pre-primary	8 703	980	823	3 612	1 546	708	456	2 317
Primary	11 031	1 315	1 454	4 794	1 976	880	761	2 837
Lower Secondary	10 894	1 507	1 600	5 022	2 562	1 139	1 122	3 580
Upper Secondary	23 643	1 430	1 809	5 898	4 615	1 238	1 416	3 927
Vocational	12 604	1 770	2 303	6 578	4 565	1 443	1 528	4 645
Tertiary	37 683	1 978	3 346	8 510	14 461	1 636	2 459	6 231
Informal Education	2 426	692	559	2 418	-	-	-	-
Total	**13 824**	**1 272**	**1 500**	**5 052**	**5 120**	**970**	**973**	**3 533**

Source: OECD Development Centre`s calculation based on Socio-Economic Survey (SES) data and National Statistical Office (NSO).

Table 2.6.3. **Drop-out rates among students in basic education in Thailand, 2010**

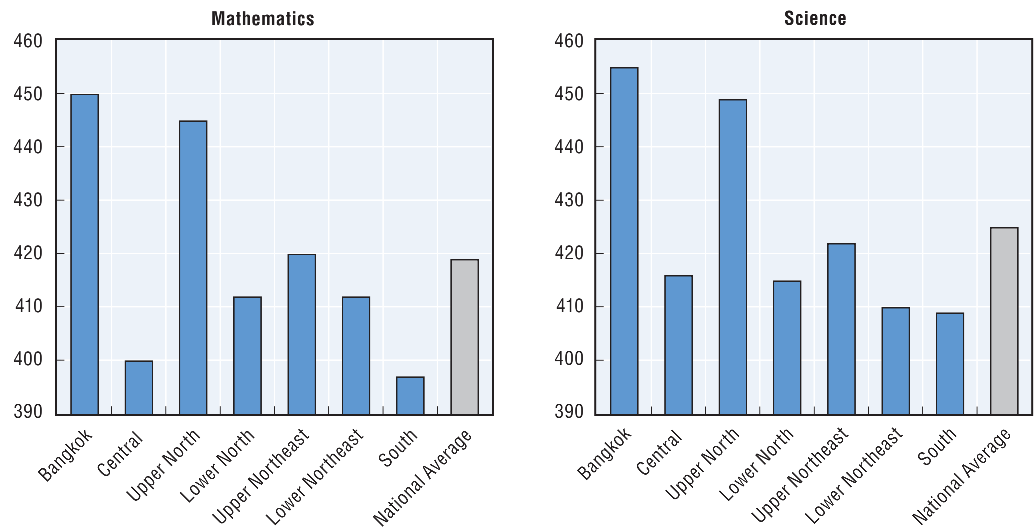
Grade	Enrolment in initial academic year 2007 (persons)	No. of drop-outs (persons)	Drop-out rate (%)
Grand Total	**6 850 181**	**47 809**	**0.70**
Grade 1	595 814	1 653	0.28
Grade 2	573 858	1 213	0.21
Grade 3	592 525	1 033	0.17
Grade 4	600 484	1 000	0.17
Grade 5	614 904	1 502	0.24
Grade 6	674 028	2 071	0.31
Total Primary	**3 651 613**	**8 472**	**0.23**
Grade 7	756 824	8 115	1.07
Grade 8	726 893	9 971	1.37
Grade 9	688 570	10 439	1.52
Total Lower Secondary	**2 172 287**	**28 525**	**1.31**
Grade 10	380 478	5 710	1.50
Grade 11	332 168	3 192	0.96
Grade 12	313 635	1 910	0.61
Total Upper Secondary	**1 026 218**	**10 812**	**1.05**

Source: Educational Statistics from the Office of Basic Education Commission, 2010.

An even more important challenge is education quality, both its overall level and the distribution of higher-quality education. High quality education contributes to students' performance both in schools and later in the labour market. Students' cognitive skills, as measured by appropriate tests, have been found to determine individual earnings, the distribution of income, and thereby influence overall economic growth (Hanushek, 2011). Hanushek (2011) also points out that while both basic skills and advanced skills are important for developing countries, advanced skills matter more in helping a country to escape the middle-income trap.

Research finds that school quality matters and can explain performance differentials between students in urban and rural areas in Thailand (Lounkaew (2011). A recent assessment by the Office for National Education Standards and Quality Assessment (ONESQA) reveals that about 3 243 out of 15 515 schools assessed did not pass minimum quality requirements (ONESQA, 2008), and that the majority of low-performing schools were in rural areas. The latest Programme for International Student Assessment (PISA) test also reveals similar results, with students in small-size schools or in remote areas getting much lower scores than those in cities (Figure 2.6.3). Unfortunately, there has so far been only little effort made to narrow the quality gaps among schools, and those efforts that have been taken have not yielded much success. Low quality schools have been asked to improve themselves, but without much tangible financial or non-financial help from the government. Worse, there have been attempts to lower standards so that more schools can pass without any real improvements (TDRI, 2012).

Figure 2.6.3. **PISA scores in Thailand, by subject and region**
(score)



Note: PISA scale was set such that approximately two-thirds of students across OECD countries score between 400 and 600 points. Gaps of 72, 62 and 75 points in reading, mathematics and science scores, respectively, are equivalent to one proficiency level.

Source: The Institute for the Promotion of Teaching Science and Technology (IPST).

StatLink *http://dx.doi.org/10.1787/888932774585*

Teacher quality needs to be improved

Teacher quality is also an important factor in school quality. A recent study confirms this proposition (Lathapipat, 2011). Singapore and Finland are often cited as success case studies in this respect. They have had different patterns of economic development, but both have achieved successful outcomes. Good institutions and incentive structures are key policy levers for sustaining high quality teaching. These levers include encouraging competition and accountability (for example, through central exit exams) and expanding choice for students and their parents (for example, by increasing the quality of private schools). A quality tracking system and performance-based teachers' salaries are important ingredients.

Recent studies suggest that the most important management reform to enhance education quality is to establish a solid accountability system at all levels of education management: teachers, school management, district education units, ministry executives, the education minister and finally the prime minister.

In recognition of the need for improvement, the government of Thailand has established quality improvement as the focus of the second phase of the education reform programme, which was approved in August 2009. Box 2.6.1 gives examples of measures to enhance teacher quality. Various funds and mechanisms will also be introduced to support the teaching profession. At the same time, higher skills and vocational training will be highlighted. As for the poor and the underprivileged, the 15-year free education programme will be reinforced with provision of greater and fairer educational opportunities and quality.

Box 2.6.1. **The Thai Government's plan to enhance teacher quality**

On 8 December 2009, Thailand's cabinet approved, a five-year (2010-15) "New Breed of Teachers Project" Pongwat (2012). The main leaders of the project are the Ministry of Education's Basic and Vocational Education Commissions. In five years' time, the project aims to produce 30 000 teachers, especially in scarce and most-needed subject areas. The project comprises two components. First, the regular five-year teacher training programmes at state universities' faculties of education are to enrol qualified high school graduates or third-year students of the Lower Vocational Certificate Programme. Second, the 4+1 programme takes in graduates from undergraduate schools with degrees in areas deemed scarce and greatly needed, notably science and mathematics, who are interested in becoming school teachers. Student teachers in the programme must maintain rigorous academic standards. Successful graduates of the programme are not required to take competitive examinations for teaching positions, as is normally the case for other candidates, and they generally have little difficulty in finding jobs. If this and other related programmes are successful, basic and vocational schools should soon benefit from the infusion of the first group of the "New Breed of Teachers". This 'new breed' is expected to make a real difference, qualitatively speaking, in the nation's classrooms, schools, colleges and in the entire educational system. More importantly, prospective "new-breed" teachers will have to pay serious attention to "knowledge-based" education, which is the key to improving the overall quality of education in Thailand and also crucial for further self-directed and lifelong learning.

Further reforms are needed in several areas

Highest priority should be put on narrowing the gap in school quality and teacher quality between urban and rural areas. For example, smaller schools and schools in remote areas should receive a greater allocation from the national education budget than their size would otherwise imply.

Education reform should not focus mainly on increasing the education budget, but more on improving education management, especially in establishing a sound and comprehensive accountability system. Rewards to teachers and management should be linked directly to students' performance, which should be measured as objectively as possible and without compromise of standards.

Teacher quality needs urgent improvement, through better incentives and evaluation processes.

POLICY FOCUS

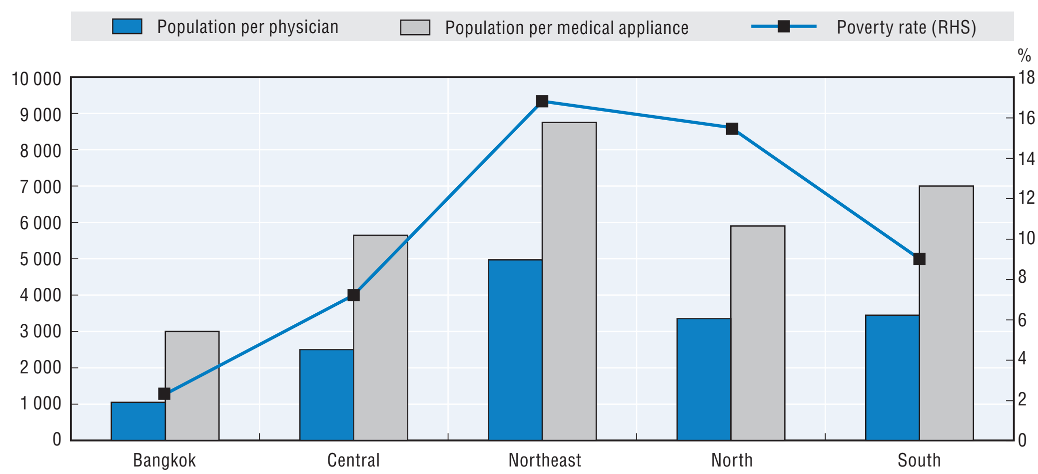
Achieve a more equitable health-care system

The Thai health system has developed relatively well since 2000. This development reflects the universal coverage of the health insurance and health protection systems within a manageable cost. The quality of service has also been improving, to the point that the perceived quality difference between services under the social security health scheme (SSS) and under the universal health care (UC) have narrowed rapidly. This narrowing is important because most of the country's poor are registered with the UC.

Health-care access is unevenly distributed

One key remaining area of concern is the distribution of health services across regions. Residents of Bangkok have much greater access to medical services, as measured by the number of physicians and the number of medical appliances per person, than residents of other regions of the country (Figure 2.6.4). By the same measure, poor people in urban areas have less access to medical services than better-off urban residents. As a result, poor people are more vulnerable to receiving inadequate medical care.

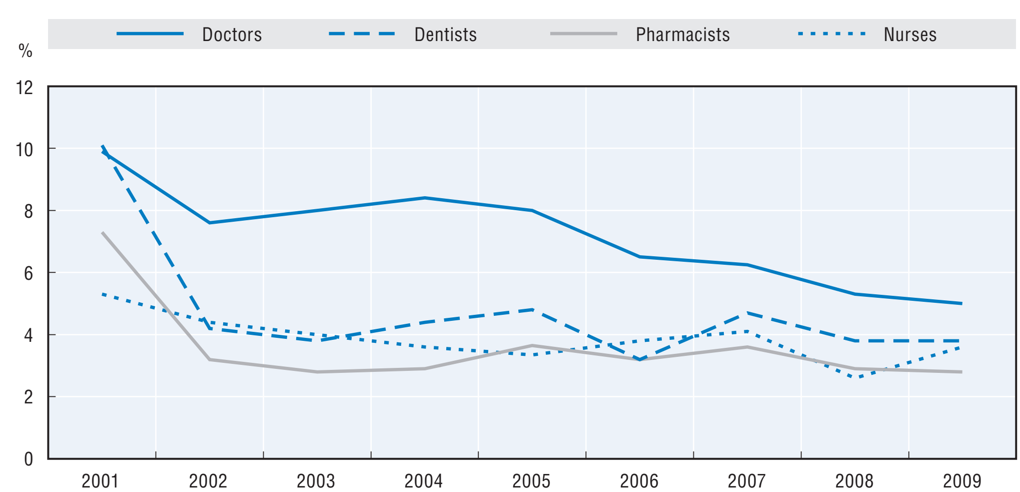
Figure 2.6.4. **Access to health services and poverty rates in Thailand, by region, 2010**



Source: Ministry of Health, Thailand Development Research Institute (TDRI) (2012), "Revamping Thai Education System: Quality for All", paper presented at the TDRI Year-End Conference 2012, February.

StatLink http://dx.doi.org/10.1787/888932774604

Figure 2.6.5. **Difference in the ratio of health personnel per capita between Bangkok and Northeast Thailand**



Source: Author's calculation using data from Ministry of Health's website.

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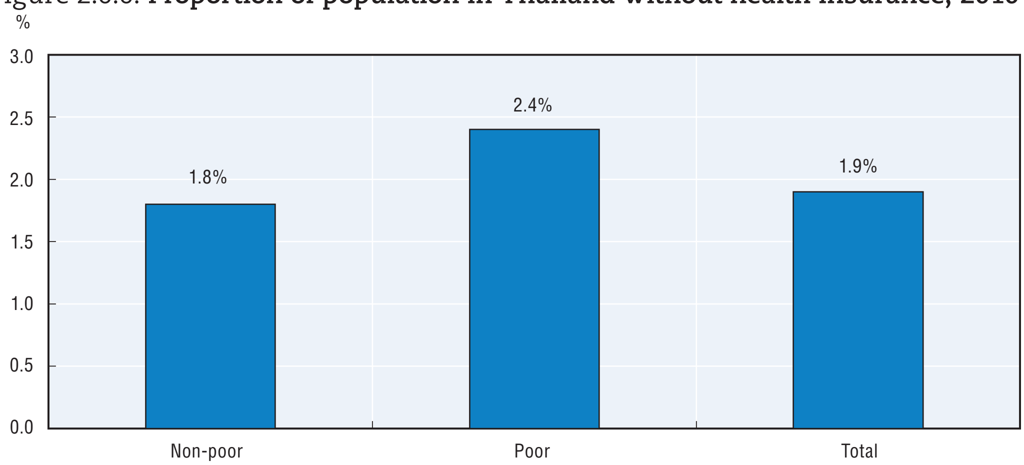
The situation has improved over time as the differential availability of medical personnel between the most abundant area (Bangkok) and the scarcest area (the Northeast) has become smaller (Figure 2.6.5). This is probably due to the introduction of the UC. But this improvement on the medical supply side has not provided all of the population with adequate access to medical care. Figure 2.6.6 shows that a small fraction of the population reports not having any health insurance and that the lack was more likely to occur among those who were poor.

There are many reasons for the lack of health insurance for some people in Thailand. Some uninsured, including some born in Thailand and to Thai parents, may lack documents needed to prove their citizenship. Other uninsured are foreign residents of Thailand (such as low-skilled foreign workers) to whom the government has only recently begun to provide health services and who sometimes have to pay fees for their insurance and are still far from getting full coverage. The uninsured may also include small numbers of Thai citizens who are not aware of their right to free health insurance

Figure 2.6.6. **Proportion of population in Thailand without health insurance, 2010**

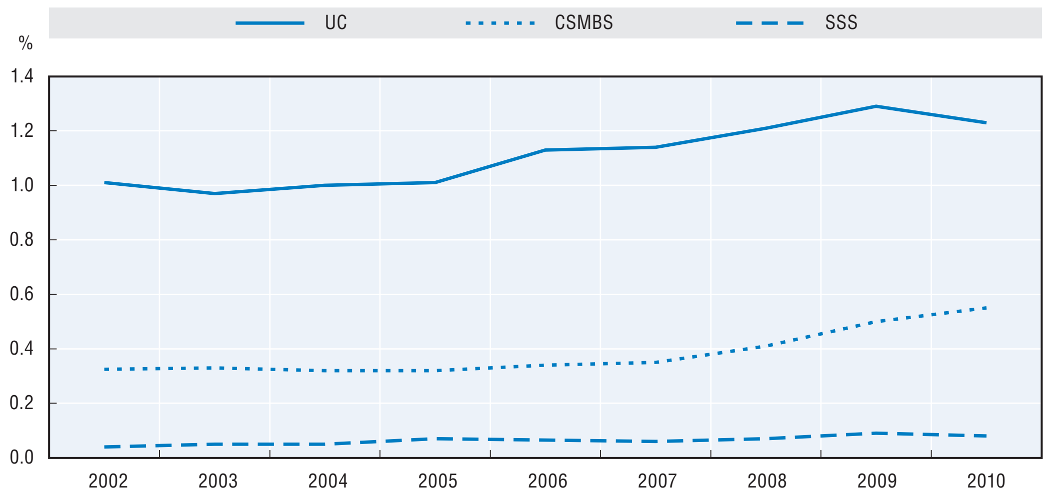


Source: Calculated from the socio-economic survey, 2010, National Statistical Office.
StatLink http://dx.doi.org/10.1787/888932774642

Financing reforms will also be required to improve access and quality

Narrowing the gap in access to health services will require more financing, which remains a cause for concern. Figure 2.6.7 indicates that health costs paid by the government have increased in relation to GDP over the past five years. The biggest cost is the UC, which accounts for around 65-72% of total fiscal outlays for health care. Most worrisome is the increase in health-care costs for civil servants, who are covered under the Civil Servant Medical Benefit Scheme (CSMBS). This cost commands an increasing share of government outlays on health care. The main cause is the increased use of expensive medications. Recent attempts to control the cost of the CSMBS have had at best marginal success. In this regard, OECD lessons might be helpful, such as the "pay for performance system" used in a number of OECD countries (Box 2.6.2).

Figure 2.6.7. **Fiscal cost of the main health insurance schemes in Thailand**
(percentage of GDP)



Source: National Health Account.
StatLink http://dx.doi.org/10.1787/888932774661

Another health inequality issue concerns care for the dependent elderly, who are those older persons who require constant care because of their fragile health status. The dependent elderly are estimated to be around 3.6% of all the elderly. As Thai society ages, the numbers of these dependent elderly will increase rapidly. The total cost for caring for them (both medical and non-medical care) is estimated to be around 2.4% of total public medical expenses. Currently, this cost is borne mostly by families. This cost can put a great financial burden on the families, especially poor ones, as it can be as high as 2.5 times the poverty line. It is expected that the government will eventually have to bear these costs, which will put more pressure on the overall government budget for health.

Box 2.6.2. **Pay for performance systems in healthcare provision: Lessons from OECD countries**

Many OECD countries provide public health-care services. However, fiscal constraints and unsatisfied health-care needs have forced governments to focus on how to reduce health-care spending while enhancing the efficiency and effectiveness of the services provided. This has led some countries to experiment with new methods of paying health-care providers and, sometimes, patients, based more on the outcomes than in the traditional fee-for-service payment model, an approach known as pay for performance (P4P).

Supply-side policies to increase cost efficiency have shown positive results. Under P4P, health-care providers receive a payment based on quality of services provided and cost savings. The **United States** began to experiment with such a system, The Physician Group Practice (PGP) Demonstration, in 2005. For each PGP, Medicare savings from the Demonstration are calculated by comparing actual spending to a target. The PGP is eligible to receive 80% of the savings that are above a given threshold. Two out of ten physician groups had at least 2% lower Medicare spending growth rates as compared to control groups.

Box 2.6.2. (contd.)

The largest P4P scheme in the world is the Quality and Outcomes Framework (QOF) begun in the **United Kingdom** in 2004. The objective of the QOF is to reward service providers for how well they care for patients and not just how many patients they have on their list. The QOF covers four main areas: clinical practice, organisation, patient experience and additional services. Indicators for each area define the specific process or outcome that practices participating in the QOF are asked to achieve for their patients. There is some evidence that the programme has improved quality outcomes.

Demand-side policies give patients financial incentives to improve the quality of health care. This helps patients to prevent disease proactively and reduces the abuse of free medical care resources. The **Australian** Government provides incentives for child patients. This includes the Maternity Immunisation Allowance.

Penalties as well as rewards are indispensable. In 2007, **Korea** launched the Value Incentive Programme covering 43 tertiary hospitals providing secondary care services. High performers and performance improvers received bonuses amounting to 1% of reimbursements from the National Health Insurance Corporation (totalling USD 375 million) while performers below the 2007 baseline were penalised 1% of payments. The programme brought about a decrease in the variation of quality among providers and a marked improvement in the lowest performing group.

Source: OECD (2010c).

Awareness needs to be increased and costs better controlled and shared

Strengthening and where necessary modification of current reforms are needed to achieve greater access to health-care services in a more cost-effective manner. The government should attempt to improve awareness among the public, especially the poor and underprivileged, about the existence of the health insurance system and its services. The registration system for foreign workers needs to be improved so that they can get access to health services at an affordable fee. Cost control of CSMBS should be more strenuous so that the overall fiscal health cost is manageable and more resources become available for reducing disparities in access to health services. The cost of care for the dependent elderly, especially for those in poorer households, should be gradually transferred to the government.

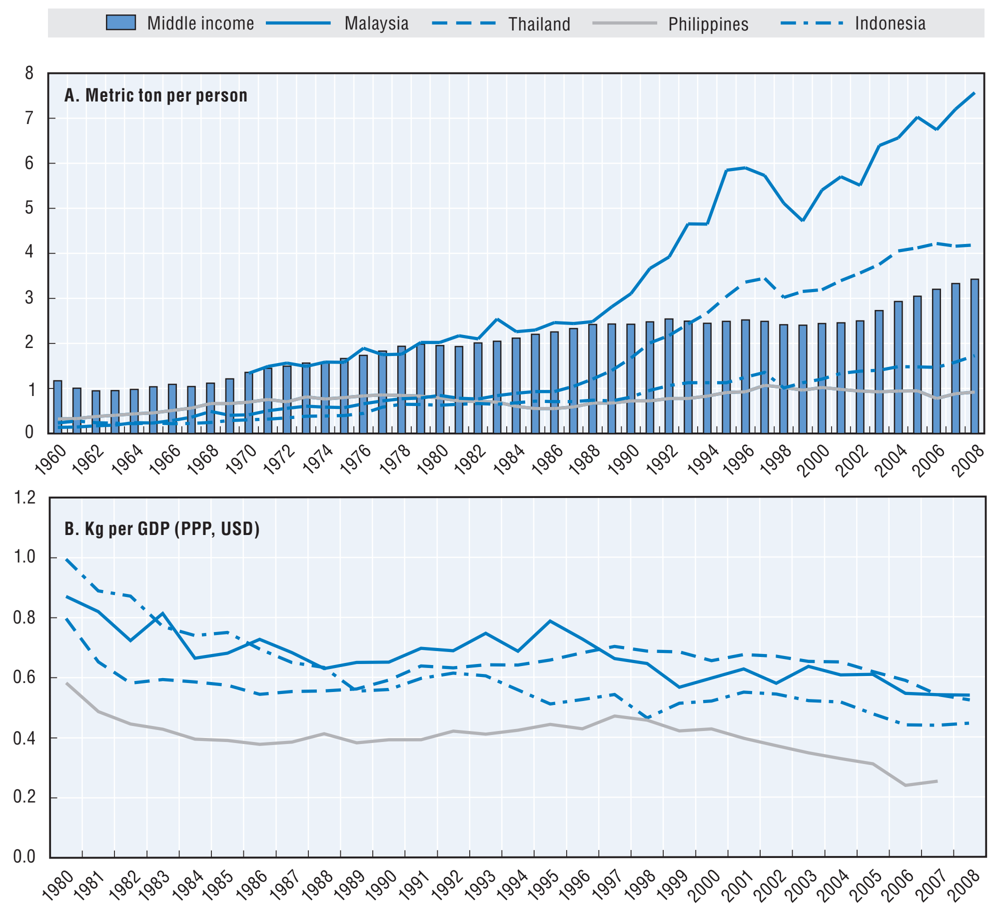
POLICY FOCUS

Foster green growth through investment and fiscal reform

During the past decades, the economic development model of Thailand can be characterised as "grow first, clean later". This is clear from the increase in CO^2 emissions over the past 50 years. Figure 2.6.8A shows that Thailand's CO^2 emission level increased constantly and rapidly, especially after the mid-1980s, and surpassed the average level among middle-income countries after the early 1990s. Although the rise in emissions is partly explained by the country's development and increasing per-capita income, Thailand's CO^2 emissions are noticeably higher than those of some other Southeast Asian countries at a comparable development level, such as Indonesia and the Philippines. As indicated in Figure 2.6.8B, Thailand as well as Malaysia emits more CO^2 per dollar of GDP than either Indonesia or the Philippines.

The comparatively high CO^2 emission per GDP of Thailand and Malaysia lead one to look for common characteristics of the two countries.

Figure 2.6.8. **CO^2 emission in Thailand and other Southeast Asian countries**



Source: World Development Indicator database, 2012.

StatLink http://dx.doi.org/10.1787/888932774680

Greener growth has now become imperative

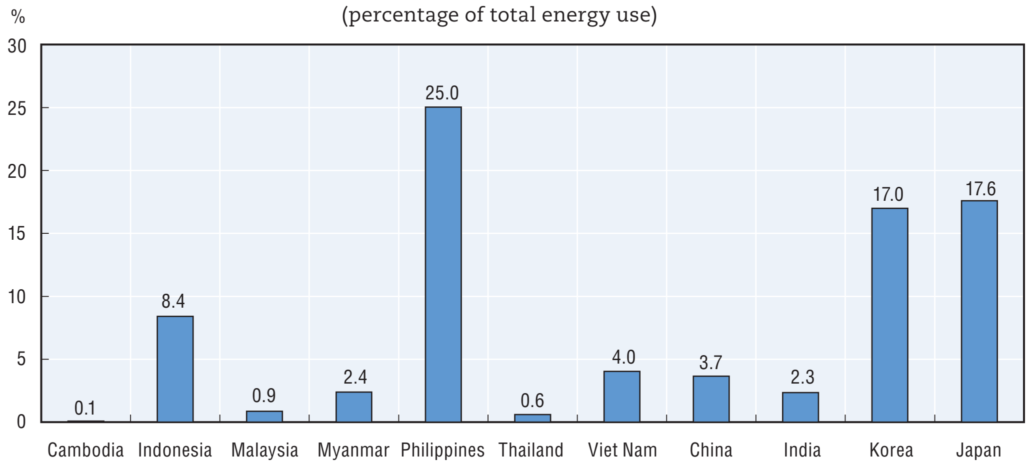
It is clear from these trends that Thailand should rethink its future development and move toward a green growth model, one emphasising greater balance between economic growth and environmental sustainability. Lately, countries have begun to view the green growth model as a new way to generate economic growth. The challenge is to achieve sufficiently high economic growth (to avoid falling into the middle-income trap) while making improving the environmental consequences of growth.

One means to achieve greener growth is to invest more in 'green technology', which would not only promote economic growth domestically but is potentially a good source of export revenue when the technology becomes mature and saleable. Thailand is not at that stage yet, but it should be aiming in that direction. There are many areas in green technology that Thailand has natural comparative advantages, such as solar energy, bio-energy, and organic agriculture. A proactive policy to develop these technologies would in the long term put the country in the forefront of new green products.

Green growth will also make Thailand more resilient to energy shocks. At present the country depends too much on energy from fossil fuels and too little on alternative energy sources. As shown in Figure 2.6.9, alternative energy usage in Thailand is among the lowest in Asia. This is in spite of the recent progress in the promotion of bio-energy (such as compressed natural gas, biogas, bio-diesel and bio-ethanol) in the transportation sector. This dependence on fossil fuels has been a major contributor to the country's high CO^2 emissions.

Figure 2.6.9. **Use of alternative and nuclear energy in Thailand and other Asian countries, 2009**

(percentage of total energy use)



Source: World Development Indicator database, 2012.

StatLink *http://dx.doi.org/10.1787/888932774699*

Promising initiatives are being undertaken but more will need to be done

Two significant policy initiatives concerning green growth have recently been taken by Thailand. The first is the launch of the 11th National and Social Development Plan, which puts special emphasis on green growth. The plan consists of "four pillars" for promoting low-carbon growth for Thailand: *i)* adjustment of the country's economic structure for less energy- and carbon-intensive economic growth; *ii)* development of low-carbon cities; *iii)* achievement of high energy efficiency and widespread diffusion of low-carbon technologies; and *iv)* encouragement of resource-efficient and sustainable lifestyles. Since the 11th plan has just begun, it is not yet possible to evaluate its achievements.

The second initiative is a new environmental law – the 'Environment Fiscal Act' – now being drafted by the Ministry of Finance. The draft law is consistent with suggestions made in the SAEO 2011/12 to use fiscal tools to provide incentives for greener economic activities and behaviours. The draft act consists of six fiscal measures, ranging from taxes on consumption and production of goods and services that generate pollution, fees for environmental management, the trading of rights to emit pollutants and subsidies for environmentally friendly products and activities. However, the draft act will require much time for consultation.

Other measures to limit carbon emissions have been proposed and some already have been implemented. (Box 2.6.3). Of special interest are the tax and subsidy measures administered by the Board of Investment (BOI). The current approach embodied in the BOI measures is to reward firms that promise to limit pollution from their production activities, without penalising firms that are relatively heavy polluters.

Box 2.6.3. **Carbon emission reduction measures being taken in Thailand**

Tax incentives through the Board of Investment (BOI)

The BOI has granted duty-free import of machinery and an eight-year corporate income tax holiday to enterprises engaged in energy conservation, production of renewable energy and production of environmentally friendly products. The tax preferences include a 50% reduction of the corporate income tax on net profit for five years after the expiry of the tax holiday, that is during the 9^{th} to the 13^{th} year; as well as a deduction from net profit of the costs associated with facility installation and construction costs (not to exceed 25% of investment capital) in addition to the deduction for depreciation.

Investment grants through the Ministry of Energy

Investors can apply to the Ministry of Energy for investment grants for design and consultant fees and a portion of the investment cost to support three types of renewable energy projects, namely biogas projects, municipal waste projects and solar hot water projects. The maximum amount of the investment grant is around 10% to 30% of the cost for biogas, 25% to 100% for municipal waste and 30% for solar hot water, with a maximum cap of THB 50 million per project.

Energy Soft Loan through the Energy Efficiency Revolving Fund and the ESCO Fund

The Energy Efficiency Revolving Fund and the Energy Service Company (ESCO) Fund are the two featured funds under the ENCON Fund.

The Energy Efficiency Revolving Fund provides credit lines to 11 participating Thai banks at a zero interest rate. The requirements stipulated by the Revolving Fund are that the interest rate charged to borrowers be no more than 4%, with a maximum repayment period of no more than seven years and maximum loan size of THB 50 million. In cases where a project requires finance of over THB 50 million, the commercial banks will also provide their own funds to cover the remaining amount. It is important to note that the loan repayment flows back to the ENCON Fund and not to the Revolving Fund. During 2003-10, the Energy Efficiency Revolving Fund has supported over 335 energy efficiency projects and 112 renewable energy projects, with the estimated total energy saving of over USD 154 million per year and an average payback period of approximately three years (World Bank and NESDB, 2011, p.78).

Feed-in tariff

Thailand's Department of Alternative Energy Development and Efficiency (DEDE) has implemented a system of feed-in tariffs, with the objective of promoting private investment in renewable energy, to provide an incentive to small and very small power producers (10MW to 90MW and under 10MWH respectively) to enhance the commercial viability of their renewable energy projects.

Source: Anuchitworawong et al. (2012).

Without further measures, it is difficult for Thailand to be able to "clean-up" its high-polluting economy, which is partly the result of the BOI's past promotion of FDI without sufficient regard to environmental consequences. Achievement of greener growth will require recognition by government, business and the public that Thailand is still far away from becoming a sufficiently green economy and that strenuous efforts must be taken by all elements of society to remedy the situation. A comprehensive set of steps needs to be developed and implemented to clean up the effects of past pollution. To provide long-needed incentives for more environmentally friendly growth, the draft environmental fiscal act needs to be completed and enacted into law as soon as possible.

Box 2.6.4. **Environmentally related taxes: Examples from the OECD**

Green growth means the fostering of economic growth and development while ensuring that the environment and other natural resources continue to provide the benefits on which national well-being depends. However, there is no "one-size-fits-all" prescription for green growth that is suitable in all cases because the policies that need to be implemented depend on national circumstances, such as a country's stage of development, its institutions and its resource endowments. However, environmentally related taxes, which put a price on pollution or on the exploitation of natural resources, have been playing a central role in promoting green growth in many countries. Environment-related taxes provide clear and sustained incentives for businesses to invest and innovate for reduction of environmental damage, but also for households to reduce their energy consumption or to increase their recycling of materials. There are several OECD country examples illustrating the use of tax instruments that can promote green growth.

In **Turkey**, fuel taxes have significantly been increased over the last decade. The tax rate on petrol is higher than the taxes on diesel or liquefied petroleum gas (LPG). Lower tax rates on LPG have provided an incentive for consumers to shift towards LPG-fuelled vehicles. The number of LPG-fuelled cars increased from 800 000 to over 1.8 million between 2003 and 2007. Also, diesel consumption has increased while petrol consumption has remained quite flat.

In **Sweden**, the tax on NOx emissions was implemented 1992 and about 200 plants with energy output greater than 50 MWh were subject to the regulation. Currently, the NOx charge applies to plants in a range of industries producing above a specified energy output threshold. The percentage of firms with established NOx mitigation technologies has shown a significant rise and NOx emissions from regulated plants decreased by 50% between 1992 and 2007.

In **Japan**, several environment-related taxes have been introduced. Tax incentives for new low-emission vehicles or high fuel efficiency vehicles have encouraged consumers to replace old cars with new eco-friendly vehicles, such as hybrid cars and electric cars. Home insulation and industrial investments in energy efficient or renewable energy facilities have been incentivised by tax measures as well.

In **Canada**, the province of British Columbia charges a tax on various energy products, such as petrol, diesel, natural gas, heating oil, coke and aviation fuel for flights. The current tax rate is equivalent to CAD 15 (Canadian dollars) per tonne of CO2 and will be raised to CAD 30 per tonne by 2012.

Source: OECD (2010d, 2010e, 2011e, 2011f).

Viet Nam

A. Medium-term economic outlook (forecast, 2013-17 average)

GDP growth (percentage change):	5.6
Current account balance (% of GDP):	-1.5
Fiscal balance (% of GDP):	-2.5

B. Medium-term plan

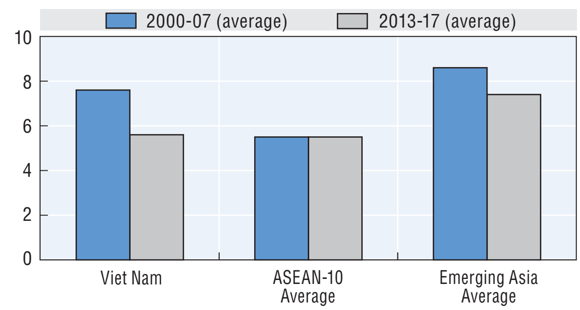
Period:	2011-15
Theme:	Strong and sustainable growth by improving the quality and competitiveness of the economy.

C. Basic data (in 2011)

Total population:	89 million*
Population of Hanoi:	6.7 million
GDP per capita at PPP:	3 359 (current USD)

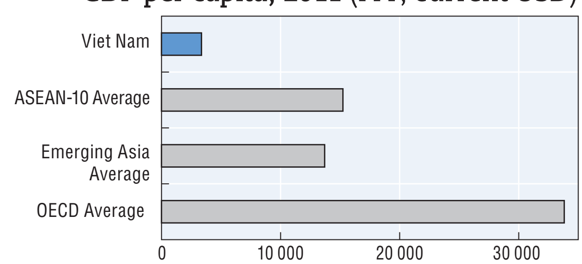
Note: *Total population data for 2011 are an estimate.
Sources: OECD Development Centre, MPF-2013, national sources and IMF.

GDP growth rates (percentage change)



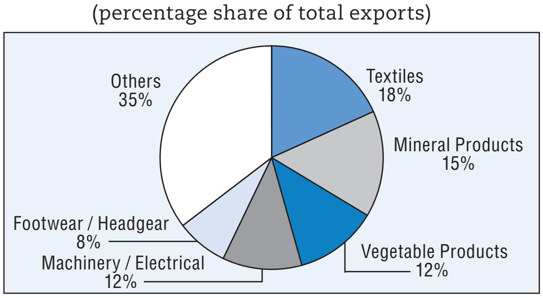
Source: OECD Development Centre, MPF-2013.

GDP per capita, 2011 (PPP, current USD)

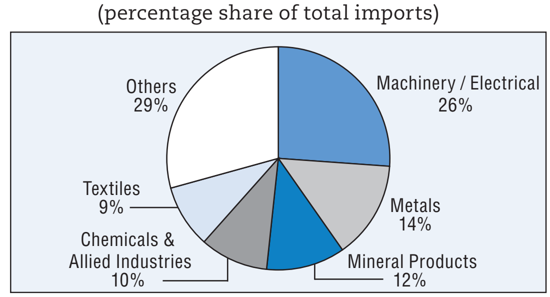


Source: IMF and national sources.

Composition of exports in 2011
(percentage share of total exports)



Composition of imports in 2011
(percentage share of total imports)



Source: Trademap.

Viet Nam will need to meet several challenges in the medium term to sustain rapid growth and realise its development potential. As in several other countries in the region, the supply of skilled labour needs to be increased and better adapted to the needs of industry through reforms to the vocational training and education systems, including further encouragement of workplace training.

Reforms to the financial system and to state-owned enterprises (SOEs) need to be broadened and accelerated. The bad loans of the commercial banking sector need to be addressed in the medium term but reforms to improve their governance and strengthen regulatory oversight are crucial to ensure that they function effectively and prudently in the future. Ownership diversification of SOEs needs to be broadened and governance and oversight improved. Reforms to allow all businesses to compete on equal terms will be especially critical to ensuring that SOEs can compete as fully market-based enterprises.

Viet Nam's medium-term policy challenges and responses

- Reform training and education to better meet demand for skilled labour
- Strengthen the banking system by establishing effective supervision
- Strengthen market-based reforms and monitoring of SOEs

POLICY FOCUS

Reform training and education to better meet demand for skilled labour

During the period 2000-11, thanks to high economic growth, Viet Nam has achieved large improvements in human capital development: life expectancy increased by 3.2 years; the average number of years of education received over a lifetime by people aged 25 and older increased by 1 year; gross national income (GNI), measured in constant (2005) USD at the purchasing power parity (PPP) exchange rate, increased 1.77 times. The overall Human Development Index (HDI) for Viet Nam published by the United Nations Development Programme (UNDP) increased by 12.3%.

The education and training systems have not adequately met needs for skilled labour

Viet Nam's human capital has developed rather well during 2001-11. The portion of the labour force in "elementary occupations" (the unskilled) dropped by 10 percentage points; while the portion of "legislators, senior officials and managers" (the occupations with the highest skills) nearly tripled, the greatest proportional increase of any of the occupational groups (Table 2.7.1). The occupation of "professionals", which also requires labour with high skills, also grew rapidly, with an average growth rate of 9.37%. Other occupations requiring a medium level of skills, notably "technicians and associate professionals", "clerks", and "plant and machine operators and assemblers" expanded considerably as well. However, it should be noted that the portion of the labour force in the high and medium-skilled groups was initially quite low, so that the groups accounted for only a small portion of the overall growth in the labour force during 2001-11.

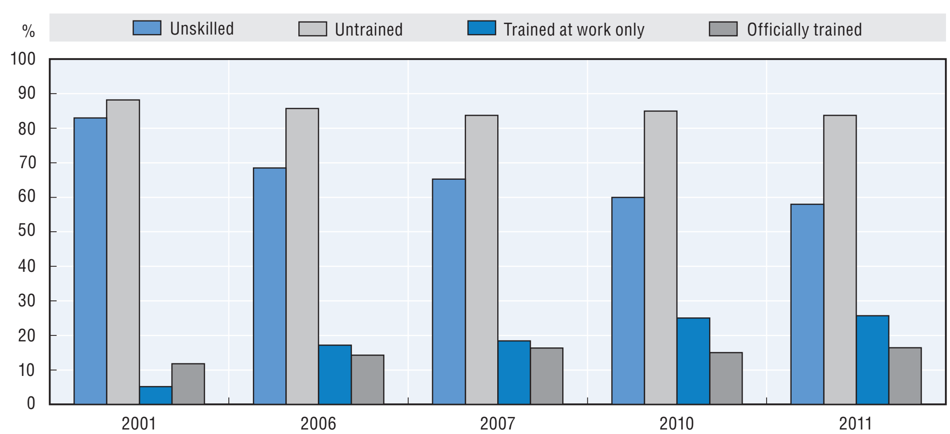
The education and training system in Viet Nam has not functioned well to meet the economy's demands for skilled labour. As shown in Figure 2.7.1, most workers in Viet Nam lack formal training at one of the official institutions. In 2001 only 11.8% of total employed labour was officially trained and 11 years later this ratio had increased by only 4.6 percentage points to 16.4%.

Table 2.7.1. **Occupational structure of the labour force in Viet Nam, 2001-11**
(percentage of total labour force)

Structure	2001	2006	2007	2010	2011	Growth 2001-11
Legislators, senior officials and managers	0.4	3.2	0.6	0.9	1.1	13.53
Professionals	2.8	3.9	4.5	5.1	5.3	9.37
Technicians and associate professionals	2.7	2.7	2.9	3.7	3.6	5.60
Clerks	0.9	1.0	1.2	1.4	1.5	7.99
Service workers and shop and market sales workers	8.4	6.4	7.3	14.6	14.9	8.66
Skilled agricultural and fishery workers	11.4	4.6	5.7	15.5	13.9	4.66
Craft and related trade workers	10.5	12.1	12.5	12.6	12.1	4.08
Plant and machine operators and assemblers	3.3	3.6	3.3	7.1	7.0	10.62
Elementary occupations	58.5	62.5	61.7	39.1	40.4	-1.12

Source: Ministry of Labour, Invalids and Social Affairs (MOLISA), Survey on labour and employment, 2001, 2005, 2006; General Statistics Office (GSO), Report on survey on labour and employment, 2010 and 2011.

Figure 2.7.1. **Structure of human capital in Viet Nam**



Notes:
"Officially trained workers" refers to those who have received training at one of the official training institutions.
"Unskilled labourers" refer to workers who have been trained neither at any official training institution nor at work.
"Trained at work only" refers to group of labor who have not been trained at any official training institution but trained at work by their employer.
"Untrained labourers" refers to both "unskilled labourers" and "trained at work only".

Source: General Statistics Office (GSO), 2008, 2009, 2010, 2011; Ministry of Labour, Invalids and Social Affairs (MOLISA), 2006, 2007.

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Overall, the education and training systems have been subject to serious weaknesses that have given rise to shortages of skills in the economy. According to employer surveys, the majority of surveyed firms have had problems in recruiting new workers. While the situation differs among groups, the problem of "applicants lacked required skills" is commonly reported for all occupations. This demonstrates that skill gaps are major challenges to firms. This problem was consistently highlighted in a series of surveys by JETRO from 2003 to 2007. In 2003, 37.2% and 53.8% of the total of firms questioned reported difficulty in recruiting "middle managers" and "engineers or technicians" respectively. These numbers increased to 63% and 70.4% respectively in 2007. In 2010 and 2011, 52.8%

and 48.7% of surveyed firms, respectively, expressed concerns about the capabilities of Vietnamese workers.[1] The CIEM-World Bank employer survey 2012 also indicates that surveyed employers appreciate their employees' soft skills, including team-work skills, communication skills and time management skills. However, soft skills have not been a focus of the training and education programmes.

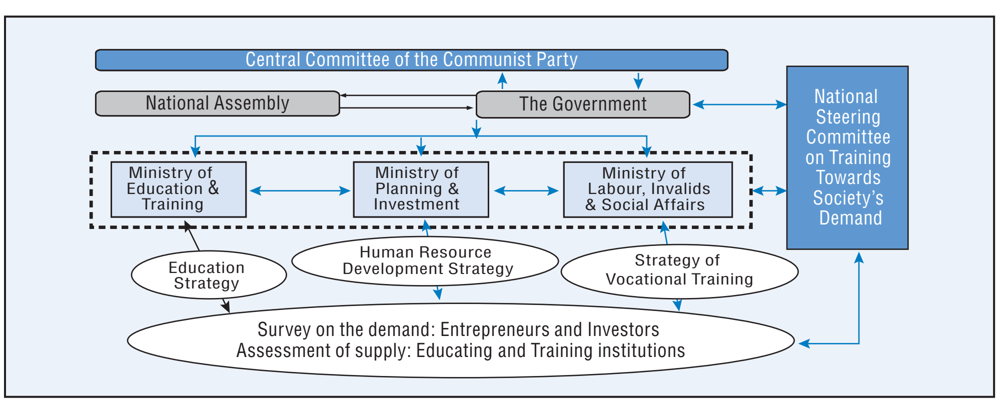
The authorities have made improvement in labour skills a major development priority

In response to the rising demand for a more highly skilled workforce, Viet Nam's political leadership at all levels is highly committed to enhancing the skills of the labour force. The Strategy for Socio-economic Development places human resource development as one of the three main breakthroughs needed for Viet Nam's economic growth.[2] It envisions an ambitious agenda for human capital development that includes strengthening foundational skills and formal pre-employment training, expanding training for vulnerable populations, and responding effectively to specific priorities for economic growth. However, clarifying the specific areas for focus to achieve a breakthrough in human capital development remains a challenge.

The top political institutions such as the Central Communist Party, the government and political leaders all provide sustained leadership (Figure 2.7.2). September 2008 marked the establishment of the "National Steering Committee on Training towards Society's Demand" (NSCTSD), which is headed by the deputy prime minister. Members of the committee are deputy ministers from various ministries and two vice presidents of the people's committees from Hanoi and Ho Chi Minh City. The mandates of the NSCTSD are to consult the prime minister in making and implementing policies for training to meet society's demand. Although broad-based consultation within the government is commonplace, industry and business have not played a significant role in identifying and implementing human capital development policies.

In the past two years, Viet Nam has promulgated a number of policies to narrow the gap between skills supply and demand. These policies are contained in three key documents: *i) the Strategy for Human Resources Development in Vietnam* issued by the 11th National Congress of the Communist Party; *ii) Strategy for Education Development in Viet Nam 2011-2020*; *iii)* and the *Master Plan for Vocational Training 2011-2020*.

Figure 2.7.2 **The education and training policy process in Viet Nam**



Source: OECD Development Centre's compilation based on national sources.

These strategies set an overall target to meet the requirements of the labour market, in both quality and quantity, to improve Viet Nam's competitiveness, increase workers' incomes and ensure sustainable poverty reduction and social welfare. The initial focus was on two priorities: improving both the soft and hard infrastructure, namely the qualifications of teachers and lecturers and the physical facilities of TVET institutions and other educational schools; and facilitating communication and interaction among all human capital development stakeholders.

Box 2.7.1. **Strengthen vocational education through workplace training: Examples from OECD countries**

Workplace training has many advantages compared to formal technical and vocational education training (TVET): It provides real on-the-job experience to enable students to acquire up-to-date hard skills related to the latest technologies as well as soft skills, such as dealing with customers and conflict management. TVET also facilitates a two-way flow of information between potential employers and employees, making later recruitment much more effective and less costly, and ensures that apprentice skills match labour market needs. Finally, TVET trainees in the workplace benefit employers by improving productivity.

Thus, although workplace training should be encouraged, it still needs to be supplemented with more formal classroom education and the quality of the training must be ensured.

Although the benefits and costs to employers resulting from workplace training may be hard to estimate, experiences with apprentices in other countries provide encouraging evidence that the economic returns can be substantial. According to a survey conducted in **Switzerland** in 2004, apprenticeship training was a good investment overall even without accounting for the recruitment benefits. The benefits to companies resulting from the productive output of apprentices (CHF 5.2 billion [Swiss francs]), calculated from the cost of employing someone else to generate the same output, outperformed the gross costs of apprenticeship training (CHF 4.7 billion), including the wages of apprentices and in-company trainers, the cost of related administrative tasks, installation and material costs, and other related costs. OECD evidence on the effectiveness of government-provided financial incentives for workplace training, such as subsidies to employers for workplace training places or training levies, is rather mixed. However, good design of government support for the apprenticeship system can strengthen workplace training. In Ireland, apprentices receive a stipend from the government during their off-the-job training phases, reducing the cost to employers of employing the apprentices. In Switzerland, apprentice wages are set relatively low but balanced by strong requirements on training companies.

Some OECD countries have established special bodies supported by the government that are involved in apprenticeship training. For example, in **Australia**, group training organisations (GTOs), which are non-profit organisations sanctioned by the government, employ apprentices and hire them out to host employers. GTOs not only select apprentices adapted to the needs of employers, they also arrange and monitor training both on- and-off-the job and take care of administrative duties. In **Switzerland**, groups of firms participating in vocational training associations share apprentices in order to reduce the financial and administrative burdens. These associations are subsidised by the government during the first three years.

Source: OECD (2010f).

The Viet Nam government is encouraging private and foreign investors to participate in the TVET sector through tax and other preferences (for example, firms that establish a vocational school or university are granted land, tax reductions and other fiscal benefits). Moreover, the government has established national targeted programmes that are granted ear-marked budgets to achieve their objectives.

The current mechanisms for communication and interaction among all human capital development stakeholders remain informal and somewhat sparse. At present, among the various stakeholders, only representatives of industry have access to policy makers through a formal mechanism. Communication among the stakeholders occurs through mostly hierarchical mechanisms. Thus, training providers communicate their concerns and input through provincial people's committees and the relevant ministries, which in turn consolidate and pass on these concerns and input to the Ministry of Planning and Investment and the Office of the government. Communication between business, industry and employees and the relevant government agencies occurs mainly through informal channels, including ad-hoc research, seminars and surveys.

Viet Nam needs to create a formal mechanism to give education and training institutions, entrepreneurs and employees a voice in making and implementing policies on human capital development. Furthermore, employers need to continue to be encouraged to provide training to their workers as well as to work with education and training institutions in establishing specific programmes to meet employer needs.

POLICY FOCUS

Strengthen the banking system by establishing effective supervision

Macroeconomic instability has led to a marked deterioration in banks' financial positions …

Macroeconomic instability resulting from the surge in inflation and asset prices has led to sharp deterioration in the financial conditions of banks and highlighted their underlying weaknesses. Following Viet Nam's accession to membership in the World Trade Organization in 2007, booming foreign capital inflows helped spur a surge in domestic credit growth, from 25.3% in 2006 to 54.0% in 2007.[3] The result was a sharp rise in inflation and boom in real estate and stock markets (Figure 2.7.4). By the end of 2010, Viet Nam faced severe macroeconomic instability, with continued high inflation, high interest rates, a large trade deficit and rising public debt. Economic growth continued to be below potential (although somewhat recovered from 2008-09). Confidence in the country's stability was severely depressed, as indicated by the depreciating exchange rate and declining foreign exchange reserves.

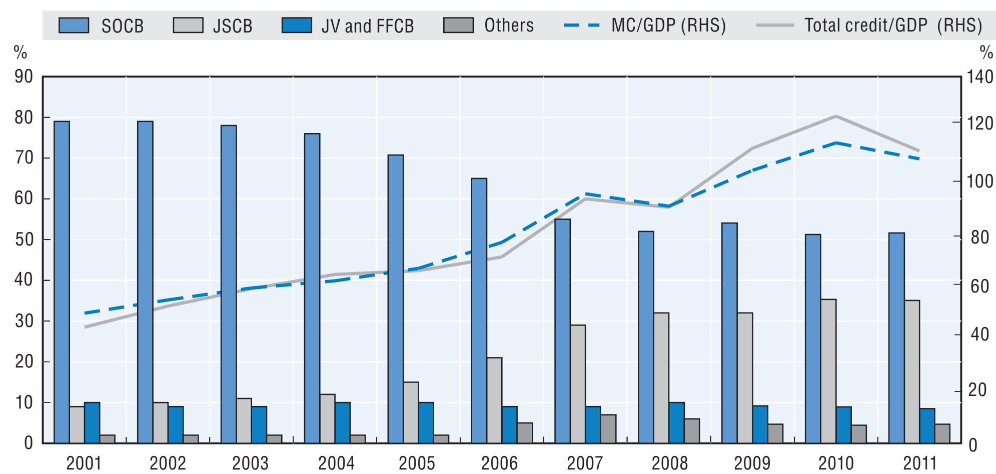
The government responded at the beginning of 2011 by tightening monetary and fiscal policy. Credit growth and money (M2) expansion were limited to no more than 20% and 16% respectively. In reality, the tightening has been even greater than the official targets imply: the growth rate of credit and M2 declined sharply from 27.65% and 25.3%, respectively, in 2010, to 10.9% and 9.27%, respectively, in 2011.

The tightening of monetary policy and resulting curtailing of bank lending on easy terms precipitated sharp reversals in the prior booms in domestic asset markets in 2011 and the first eight months of 2012. The real estate and stock markets were hit first, with property and securities prices down sharply and market activity virtually frozen. Many real estate projects were unable to be sold, leading to defaults on real estate loans and rising non-performing loans at the banks.

The collapse of the real estate market further harmed banks by lowering the value of the real estate used to collateralise most loans in Viet Nam and making it nearly impossible to sell that collateral to offset losses from loans that became non-performing. Rising non-performing loans and sharply reduced credit availability from the central bank pushed some of the banks into a severe liquidity shortage and led them to sharply raise their lending rates. The result was a vicious circle, in which rising interest rates led to declining activity and rising non-performing loans, putting further upward pressure on lending rates.

With the mobilising interest rate reaching a peak of 17.5% in May, 2011, the government came under heavy pressure to cut lending rates to help the real sector. Since January 2012, interest rates in the interbank market have steadily and sharply declined. Beginning in May 2012, signs of some relief in the bank liquidity shortage began to emerge. The shortage has largely abated over the following months.

Figure 2.7.3. **Share of credit to the economy by group of credit institutions and total credit to GDP in Viet Nam**

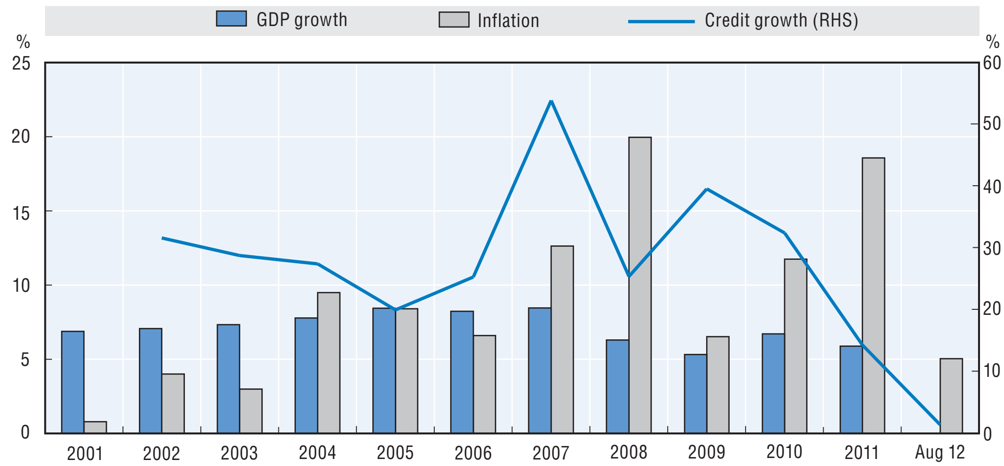


Notes: SOCB= State-owned commercial banks (5 banks)
JSCB = Joint stock commercial banks (34 banks)
JV and FFCB = Joint venture and fully foreign-owned commercial banks (4 JV banks and 5 FFOBs)
MC/GDP is mobilised capital over GDP.
Source: State Bank of Vietnam.

StatLink *http://dx.doi.org/10.1787/888932774737*

The boom and subsequent contraction in the economy and asset markets has led to a severe rise in bank non-performing loans (NPLs). By 31 March 2012, the bad debt in the commercial banking sector in Viet Nam that is officially reported by the State Bank of Vietnam (SBV) reached 8.6% of total outstanding loans. (However, in March 2012, the governor of the SBV announced in the National Assembly that bad debt in the banking system was estimated to be 10%.) The NPLs estimated by the SBV are considerably higher than the figures reported by the banks in their reports to the SBV. Notably, bank reports of June 2012 put the bad debt at 4.47% of total loans at the end of May 2012, about half the figure estimated by central bank authorities. On 12 July, SBV reported that its supervisory agency had verified the original 31 March ratio of 8.6%. The differences between the official and bank-reported bad debt figures indicate that banks are not complying with reporting rules specified by the bank's supervisory authorities.

Figure 2.7.4. **GDP, credit and inflation growth in Viet Nam**



Source: General Statistic Office (GSO) and State Bank of Vietnam.

StatLink http://dx.doi.org/10.1787/888932774756

Furthermore, bad debt seems concentrated in the largest banks, especially in the state-owned commercial banks (SOCBs). According to bank reports, the 14 biggest banks account for 69% of total bad debt in the banking system, with SOCBs accounting for 50.5%. Two SOCBs, namely Vietinbank and Vietcombank, account for 69.29% of the bad debt of the eight listed banks. The building-up of bad debt in the banking sector has widened the interest rate spread and reduced lending opportunities.

The financial performance of Viet Nam's banking sector declined sharply over the first eight months of 2012. The return on equity (ROE) of the industry decreased from 12.5% in 2011 to 4.14%. The performance of the joint stock commercial banks (JSCBs) seems to have suffered the most; the ROE of this group is lowest of three groups, at only 2.89%. Total assets of this group also declined by 1.6% even though the owner's capital and registered capital increased. These banks also are least effective in utilising mobilised capital; their loan-to-deposits rate (LDR) is only 73.66, which is far lower than those of the SOCBs and joint venture and fully foreign-owned commercial banks (JVs and FFOBs) (see Table 2.7.3). The build-up of bad debt has undermined the profitability of the banking sector, especially for the JSCBs.

… and has highlighted broader weaknesses in the banking and supervisory systems

The deterioration in financial conditions has highlighted broader weaknesses in the banking sector's structure, governance and supervisory oversight. In general, commercial banks in Viet Nam are still small. By the end of July 2012, only 13 banks had registered capital of more than VND 6 000 billion (Vietnamese dong) (around USD 287.4 million) (Table 2.7.2). These banks together accounted for 27.1% of total commercial bank assets. The registered capital and total assets of Viet Nam's biggest bank, Agribank (Bank for agriculture and rural development), were around USD 1.0 billion and USD 26.9 billion respectively. The total assets of listed commercial banks in Viet Nam range from USD 1 billion (Nam Viet Bank) to USD 21 billion (Vietinbank). The mean of registered capital of the ten biggest banks is approximately VND 16 439.6 billion or around USD 787.4 million; and the mean of total assets of these ten banks is VND 285 640 billion or around USD 13.7 billion. These numbers are small in comparison with those in other Asian countries.[4]

Table 2.7.2. **Size of the ten biggest banks in Viet Nam**
(USD million)

	Ten biggest	The biggest	The smallest of top ten
Mean of assets	13 680	26 880	64 365
Mean of registered capital	787.4	1 013	507

Source: StoxPlus

The bad debt problem of the banks has been aggravated by governance weaknesses of the JSCBs. A number of JSCBs have reportedly been required by some of their major stockholders to lend to very high-risk projects in which the stockholders have interests. These projects are of a speculative nature and almost all have failed recently owing to the tightening monetary policy and slowing of economic growth. Defaults on lending to these projects have contributed to the build up of bad debt in the JSCBs and the banks' shortage of liquidity.[5]

The vulnerability of the commercial banking sector in Viet Nam also results from low capital adequacy ratios (CAR). The State Bank of Viet Nam requires all commercial banks to maintain CAR above 9% (State Bank of Viet Nam, 2010). Almost all commercial banks met this requirement by the end of 2011. However, excluding the foreign joint venture and foreign funded banks, who maintain the highest ratios, the CAR in the SOCBs and JSCBs, on average, are 10.82% and 13.48% respectively. These ratios are far below those of leading banks in Asia-Pacific region but roughly at the same level with those in the People's Republic of China and India.[6] Furthermore, big banks in Viet Nam tend to have lower CAR than smaller banks: the CAR of the SOCBs are all lower than 12%. Overall, the Viet Nam commercial banks just meet the country's legally required minimum of CAR, but this requirement is far below the level that their peers in other countries in the Asian region maintain.

Table 2.7.3. **Viet Nam's commercial banks' financial conditions (as of 31 July 2012)**
(USD billion)

	Total assets		Owner's capital		Registered capital						
	Assets	Growth	Capital	Growth	Capital	Growth	ROA	ROE	CAR	SDMLL	LDR
SOCB	97.839	3.72	6.377	15.12	5.334	27.87	0.5	6.52	10.82	21.03	102.52
JSCB	106.602	-1.6	8.423	2.13	8.243	4.78	0.26	2.89	13.48	10.53	73.66
JV and FFOB	25.545	-2.45	4.335	4.42	3.558	0.32	0.69	3.88	29.94	-1.04	99.55
Total	**239.417**	**0.79**	**19.939**	**6.5**	**18.435**	**9.19**	**0.39**	**4.14**	**14.03**	**13.25**	**89.79**

Notes:
SDMLL = short-term deposit for medium-/long-term loans.
LDR = loan to deposit ratio.
The exchange rate used for conversion: USD/VND=20 880.
Source: State Bank of Viet Nam.

The building-up of bad debt remains a crucial problem that prevents banks from functioning as the key lender to the economy. The magnitude of bad debt is around USD 10 billion, too big for any individual institution to resolve.

Resolution of the bad debt problem and prevention of future bad debts is severely hampered by present limits on weaknesses in supervision and oversight of the banks by the SBV. SBV's reporting rules and mechanism seem not to be seriously complied with by banks. SBV has not yet been able to acquire timely necessary and true information about the banking system. As a result, SBV's responses usually take time and are costly.

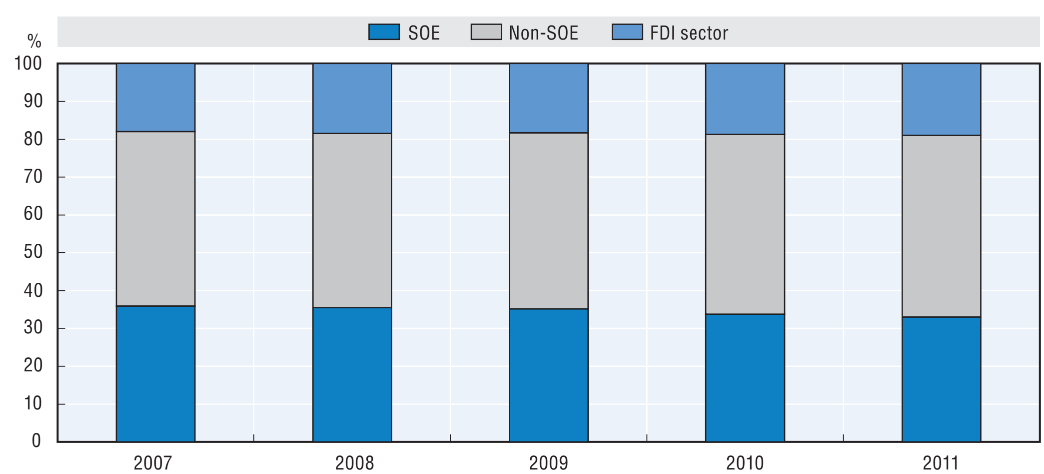
In the near term, SBV's first priority is to clean up bad debt in the system and then improve banking governance and supervision. This will require a number of related steps. Voluntary bank mergers should be encouraged and impaired banks that cannot find partners or be acquired should be taken over by the government for a limited time and then sold once they have been consolidated into viable entities. Non-performing loans that are collateralised should be sold to the Debt and Assets Trading Corporation (DATC) belonging to the Ministry of Finance; and collateral should be sold where possible to help defray the loan losses. Efforts should be made to encourage non-public investors to purchase problem loans at a discount. Public funds might also be used in some circumstances to purchase real estate facilities that were used as collateral for impaired loans; these facilities could then be put to public use.

POLICY FOCUS

Strengthen market-based reforms and monitoring of SOEs

The SOEs sector of Viet Nam has undergone a long development process and has been a vital pillar in Viet Nam's economy. Annually, the SOE sector contributes more than one-third to GDP, about 50% to exports, 28% of total domestic government revenue (excluding revenue from crude oil and the import-export tax) and 39.5% of the value of industrial production (Figure 2.7.5).[7] SOEs create about 1.2 million jobs annually. SOEs play an important role in macroeconomic policy, social security, poverty reduction as well as in providing essential products and services. SOEs control key industries of the economy, including electricity, petroleum and gas, mining and quarrying, and the water supply, and they invest in industries, sectors and areas that other types of businesses are not allowed or do not want to invest in.[8]

Figure 2.7.5. **Contribution to GDP in Viet Nam, by types of ownership**



Source: General Statistics Office (GSO).

StatLink http://dx.doi.org/10.1787/888932774775

The institutional framework for SOE reform has been established

The legal institutions and framework for the restructuring, renovation and development of SOEs as well as mechanisms for state oversight and management of SOEs have been established and gradually improved. The SOE Law enacted in 1995 and amended in 2003 significantly improved the definition of SOEs' rights, obligations, operating mechanisms, financial management and other key features. The Enterprise Law approved in 2005 (and amended in 2009) created a common legal framework for all enterprises in Viet Nam, regardless of type of ownership and economic sector.

The Enterprise Law requires all SOEs to be transformed into joint stock companies or into one-owner limited liability companies with 100% capital from the state by 1 July 2010. The legally permitted forms of SOEs have been diversified to encompass state companies (transformed to one-member limited liability company since 1 July 2010), joint stock companies, limited liability companies, economic groups and state corporations. Each SOE is now managed in compliance with the company's charter, and subsidisation of SOEs largely has been eliminated. SOEs are allowed to mobilise capital from different sources other than state capital, and have independence in allocating profits or setting up legal funds. SOEs participate in public good provision by tendering for supplying services.

Allowing private interests partial ownership in certain SOEs (equitisation) has been considered one of the most important measures in Viet Nam's SOE reforms. Small-scale or unprofitable SOEs were merged or dissolved. Large numbers of fully state-owned SOEs were transferred, sold or rented. Since 1992, nearly 4 000 SOEs have been converted to partial or complete private ownership. The number of SOEs with 100% state ownership has been significantly reduced, from more than 12 000 in 1996 to 6 000 in 2000 and about 1 309 in 2011. Among the 1 309 remaining fully state owned companies, 37% are industrial, construction or transport enterprises, 36% are operating in trading, services or tourism, and the remaining 26% are agricultural, forestry or irrigation enterprises. Through equitisation, more than VND 55 000 billion has been mobilised for the SOE Reform and Equitisation Support Fund, which mainly originated from revenue from the sale of state capital (65%) and dividends (22%).

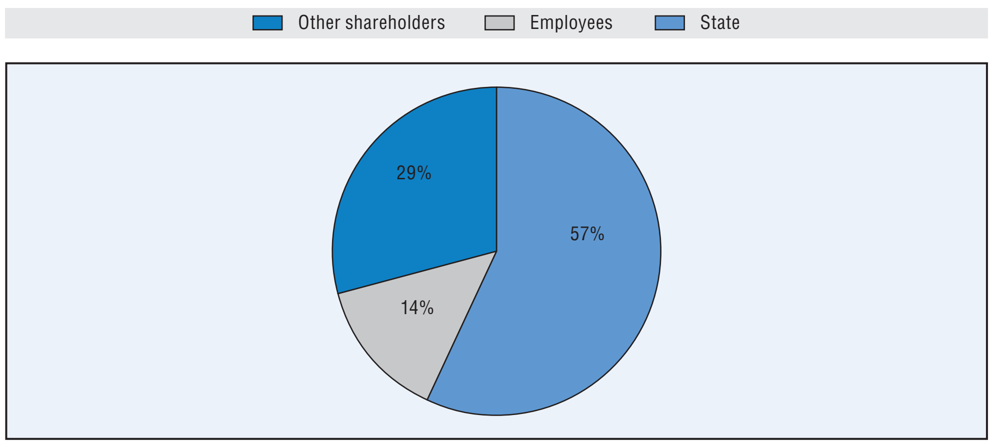
The other form of SOE reform has been to establish "State Corporation 90",[9] "State Corporation 91"[10] and economic groups which operate as parent-subsidiary companies. Currently, Viet Nam has 13 economic groups, 10 "state corporations 91", 80 "state corporations 90", and 2 commercial banks that are fully owned by the government. In addition, there have been 16 corporations and commercial banks that have completed equitisation in which the state has retained the majority share of the capital.

The establishment of the State Capital Investment Corporation (SCIC) to represent the state's ownership in equitised SOEs is an important step to improve the management of the government's ownership in SOEs while gradually eliminating government administrative intervention in SOEs' operations. Similarly, the DATC has fostered the process of restructuring, innovation and development of SOEs.

Despite important progress, SOE reform in Viet Nam is still coping with many limitations. Though the number of SOEs has been reduced and SOEs' scale of operations has been increased, many SOEs remain in industries and sectors where the state does not need to hold complete or majority ownership share, such as wholesale and retail trade, services and tourism. SOEs operating in these sectors account for 32% of total SOEs in Viet Nam.

Changes in the SOE's ownership structure have been much less than originally expected. By 2011, only about an estimated 30% of state ownership in SOEs was equitised, and the government retained an average ownership stake of 57% in these firms (Figure 2.7.6). Thus, in the 20 years since the equitisation process began, less than 15% of state ownership has been transferred from the government to employees or other shareholders.

Figure 2.7.6. **Ownership structure of equitised SOEs in Viet Nam**



Source: Vu Thanh Tu Anh (2012), Restructuring of SOEs in Viet Nam, Fulbright Economics Teaching Program, Vietnam Program, Harvard Kennedy School, 14 March 2012, Hanoi. www.imf.org/external/country/VNM/rr/2012/031412c.pdf.

StatLink http://dx.doi.org/10.1787/888932774794

SOEs need to become market-based and less dependent on government preferences

SOEs, including both individual corporations and economic groups, are still receiving relatively favourable treatment in comparison with other business segments, notably in their access to financing. Currently, SOEs obtain financing mostly through the SCIC, the Viet Nam Development Bank (VDB) and other commercial banks. In the meantime, financing from the stock market, strategic investors or investment funds is still limited. The explanation for this pattern is that SOEs have been able to borrow from commercial banks on very easy terms that require little disclosure by the borrower and which are largely unsupervised by the prudential authorities. SOEs seem to have been reluctant to raise funds through initial public offering (IPO) on the stock exchange since this requires greater transparency, such as the requirement to publish annual balance sheet information and to be accountable to shareholders. In 2009, most of the financing provided by the VDB went to SOEs as preferential loans, which account for about 75-80% of the VDB's assets. Total loans to SOEs from the VDB which were indirectly guaranteed by the government are estimated to total about VND 130-150 thousand billion (about USD 6.5 – 7.5 billion). In total, loans to SOEs that were directly or indirectly guaranteed by the government constituted about 20-25% of SOEs' debts.

The government also usually gives preferential support for SOEs by providing supplementary capital, debt rescheduling, or even debt forgiveness in critical cases. In addition, in special cases, the government has paid SOEs' loan obligations to foreign commercial banks. For instance, loans of the Construction Machinery Corporation (COMA) and the Machines and Industrial Equipment Corporation (MIE) from ANZ Bank were guaranteed by the Ministry of Finance when those projects became insolvent. By 2011, foreign loans to SOEs and credit institutions guaranteed by the government amounted to 12.8% of Viet Nam's foreign medium to long-term borrowings (slightly above the 12.5% recorded in 2010). As these figures show, SOEs inefficiencies and inability to repay their loans can create substantial burdens on the state budget.

After 20 years of SOE reform, most equitised SOEs remain under the management of local authorities or central government ministries (Table 2.7.4). The number of state corporations and economic groups that are not supervised by central or local government authorities is very limited. In the 1992-2000 period, equitised state corporations and economic groups only accounted for 5.27% of all equitised SOEs (588), and this figure only increased to 10.42% (of 3 388) in the 2001-11 period.

Table 2.7.4. **Supervision of equitised SOE in Viet Nam, by governing body**
(percentage)

	1992-2000	2001-11
Central government ministry	31.29	31.79
Local authority	63.44	57.79
State corporation/economic group	5.27	10.42
Total	**100**	**100**

Source: Ministry of Finance, Viet Nam.

As mentioned above, state corporations and economic groups have key positions in the SOE sector and the overall economy. Legally as well as in practice, state corporations and economic groups in Viet Nam are mostly free from supervision and management by outside bodies, even the State Audit. According to Decree No. 101/2009/NĐ-CP, economic groups are established by the government and only have to report to the government and the prime minister on such important issues as current business activities; investment plans and the investment structure of their core and non-core business; capital mobilisation and bank, real estate, and stock market activities; the form and level of co-operation among enterprises within each economic group and certain other matters.[11] There are cases when the management of economic groups refused to meet working groups from ministries or ignored their requests for information.

Moreover, some state corporations and economic groups have overly expanded their scope of operation to non-core business activities where they lack competitive advantages and which are mostly speculative and rent-seeking in nature, namely in banking, the stock exchange, insurance and real estate. Statistics show that the business activity of economic groups in Viet Nam is much more diversified than in other countries. On average, each economic group in Viet Nam operates in 6.4 two-digit industries, while comparable groups in Thailand, China, Indonesia and Korea operate in only 3.5, 2.3, 2.1 and 1.7 two-digit industries, respectively. Viet Nam's state corporations and economic groups also have a comparatively large number of subsidiaries – four times higher than in China and even much higher in comparison with Korean chaebol in their most prosperous period.[12]

A number of recent examples, notably with Vinashin and Vinalines, have provided further warnings about the lack of transparency and inadequate state management and supervision of SOEs, especially state corporations and economic groups. The monopoly of SOEs in some key industries (including electricity, water, gas supply, coal and cement)[13] has made these firms reluctant to innovate and to strengthen their competitiveness, resulting in low efficiency in at least some cases.

Overall, comprehensive SOE reform is not only important to SOEs themselves, but also essential to Viet Nam's further development. SOE reform needs to be pursued steadily and flexibly.

Over the medium term, state corporations and economic groups need to be a main focus of SOE reforms in Viet Nam. Many measures have already been initiated, in compliance with the mandates of the Communist Party and the government.[14] To comply with Decision No. 929 on the 2015 period, each ministry, line-ministry, province, state corporation and economic group is required to submit its own reform project to the Prime Minister for approval by the third quarter of 2012. According to current plans, nearly 900 SOEs will be restructured and equitised in the 2012-15 period (93 in 2012).

In order to achieve more efficient SOE reform, Viet Nam needs to focus on strengthening the governance of SOEs and the mechanisms for the state to exercise its ownership and oversee the SOEs performance. In particular, the state ownership function needs to be clearly separated from the governance and management of the SOEs and their business activities. To this end, the responsibilities and powers of the SOE boards of directors and those of the relevant ministries and other government authorities need to be clearly defined and differentiated. Government oversight of the SOEs needs to be strengthened through the creation of well-defined reporting systems and improved mechanisms for evaluating performance, including provision for independent audits. SOEs need to implement the same accounting standards that are required of listed companies.

The process of equitisation also needs to be continued and ownership further diversified, focusing particularly on state corporations and economic groups. SOEs need to withdraw from activities unrelated to their core competencies and where they lack competitiveness.

Equally important, reforms need to focus on levelling the playing field between SOEs and other businesses. Social, welfare and other mandates now imposed on SOEs but which are unrelated to their commercial function need to be transferred to the government as far as possible. Preferences for SOEs, such as priority in access to financing and land and to certain economic sectors, should be eliminated except where they are clearly necessary to national security or other key priorities. Accelerated development of the domestic financial system, including capital markets, and relaxation of barriers to participation of domestic and foreign strategic investors would also help greatly to allow all businesses to contribute on equal terms to the economy.

Box 2.7.2. **Equitable treatment of shareholders in state-owned enterprises: Examples from OECD countries**

In OECD countries, the state is a majority shareholder in approximately a half of SOEs that involve other shareholders. Some OECD experiences show that assuring equal treatment of shareholders is one of the most important elements to improve efficiency of SOEs. While the state, as a significant shareholder, may have considerable influence on the company's decision-making process, respecting minority shareholders is a key for introducing market pressure and monitoring the management of SOEs. Because of these roles, minority shareholders play a key role in enhancing the value of the company's shares and the future capacity of the company to raise funds from the market.

Several OECD countries provide examples of how policies that recognise, and in some cases protect, minority shareholders' rights in SOEs can be effectively recognised and protected. In **Denmark**, minority shareholders in SOEs are granted board representation, and the state encourages provisions allowing for additional minority rights in the individual SOE by-laws as well. In **Italy**, disproportional voting rights are assigned to the minority shareholders of all listed SOEs through a cumulative voting-type system, "*voto di lista*". Through this election system, only those shareholders who, alone or together with other shareholders, represent at least 1% of the shares with voting rights at ordinary shareholders' meetings are entitled to present lists of candidates for the board of directors, and all those entitled to vote can vote for only one list. In the **Slovak Republic**, the state has a contract granting minority non-state shareholders majority representation on the board of directors in SOEs which are owned more than 51% by the state. In addition, fundamental matters are required to be approved by two-thirds of the shareholders and this requirement can be extended further. In **Israel** and **Slovenia**, SOEs also provide for voting by letter and via Internet in order to promote participation of minority shareholders in shareholder meetings.

Source: OECD (2005, 2011g).

Notes

1. "Japanese-Affiliated Manufacturers in Asia and Oceania" surveys, by the Japan External Trade Organization (JETRO) for the years 2003-07 and 2010 and 2011.
2. The three breakthroughs include quality of human resources, market institutions and infrastructure.
3. The capital account in 2007 received USD 18 771 million, six times higher than those in 2006.
4. Based on data from StoxPlus (2012) the average of registered capital of listed banks in China is around USD 4.17 billion, around USD 2.2 billion in Singapore, around USD 4.1 billion in Malaysia, and around USD 3 billion in Thailand. The total assets of leading banks in China is around USD 2 456 billion, in India USD 369.5 billion, in Indonesia USD 60 billion, and in Thailand USD 66 billion.
5. The collapse of Vinashin caused Habubank to go bankrupt and to be subsequently acquired by the SHB.
6. According to the Asia Association Banker (2012), 35 leading banks in the Asia-Pacific Region maintain CAR of more than 19.2%.
7. Source: Report dated 15 February, 2011 by the National Steering Committee for Enterprise Reform and Development on "Summary of the SOE rearrangement, renovation, development in the 2001-10 period".
8. SOEs operating in manufacturing; electricity, gas and water supply; transportation and storage; information and communication; mining and quarrying.
9. SOEs that were established pursuant to Decree No. 90/TTg dated 7 March 1994 on rearranging state-owned enterprises are under direct management by Province People's committee or a ministry.
10. SOEs that were established pursuant to Decree No. 91/TTg dated 7 March 1994 on the trial establishment of economic groups are under direct management of a Ministry.
11. Item 2, Clause 41.
12. In the most flourishing period, Vinashin had more than 400 subsidiaries that produced products ranging from consumer goods to heavy industrial equipment.
13. Vietnam Petroleum Group accounts for more than 60% of the petroleum market, while the market share of Vietnam Electricity is 80%, of Vietnam National Coal-Mineral Holding Corporation is 98%, and Vietnam Cement Industry Corporation is 50%.
14. Main orientations include: *i)* SOE sector is an important instrument for state macroeconomic management; *ii)* SOE reform aims at strengthening SOE's vital role in the market economy with socialist orientation; *iii)* SOE reform should be done at both macro and micro levels, in compliance with the growth model, macroeconomic stability and the socio-economic development strategy for the 2011-20 period; and *iv)* there is no discrimination among SOEs.

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PART THREE
Thematic focus: Narrowing development gaps

CHAPTER THREE

Overview of development gaps in Southeast Asia: Gaps between ASEAN-6 and CLMV countries

Abstract

Narrowing social disparities and economic development gaps between countries are key challenges facing ASEAN as it works towards its end-goal of an ASEAN Economic Community by 2015. Member countries differ in their levels of development, political systems, investment environments and economic structures. Their domestic agendas also often take precedence over regional integration.

This chapter is designed to provide direction and focus for policy makers at the regional and country level. Accordingly, it examines the development differences and disparities in ASEAN, particularly between the prosperous, more highly developed group of countries (the ASEAN-6) and the more recent, less developed member countries of Cambodia, Lao PDR, Myanmar, and Viet Nam (CLMV). To that end it uses the Narrowing Development Gaps Indicator (NDGI), recently designed by the OECD Development Centre and the ASEAN Secretariat to measure progress, or lack thereof, in closing development gaps between countries and over time. The NDGI encompasses six policy areas – infrastructure, human resource development, information and communication technology (ICT), trade and investment (regional economic integration), tourism and poverty.

The first, introductory, section of this chapter offers an overview of the social and economic development gaps that ASEAN must narrow before it can achieve full integration. It describes how the NDGIs were built and how they are used. The second section looks at development gaps in each policy area, considers government action to date, and suggests new and additional measures that should be taken. The third section concludes.

Introduction and key findings

Though still significant, socio-economic development gaps among the ASEAN member countries have generally narrowed in the last five years, while income disparities have widened.

At the 9th ASEAN Summit Meeting, held in Bali in 2003, ASEAN leaders adopted ASEAN Concord II, a joint statement in which they set out their vision of an integrated ASEAN community. In 2007, ASEAN leaders declared that they envisioned regional economic integration as culminating in the end-goal of the ASEAN Economic Community (AEC) in 2015. The ASEAN Vision 2020[1] and ASEAN Economic Community Blueprint outline that goal in these words: "[a] stable, prosperous and highly competitive region with equitable economic development and reduced poverty and socio-economic disparities".

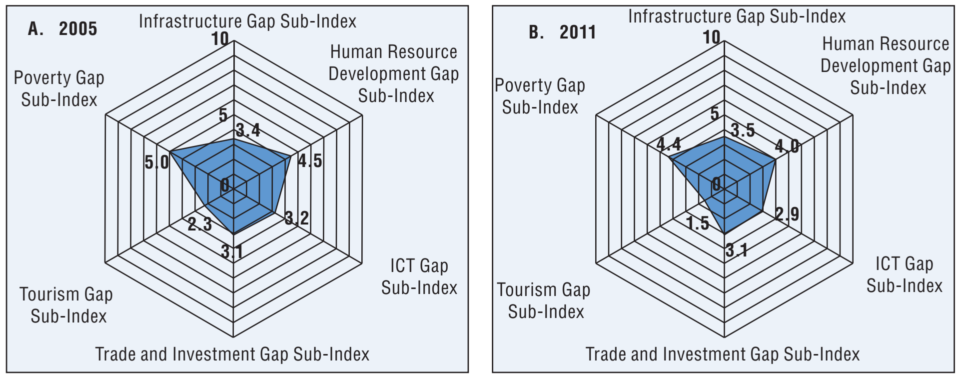
To ensure that all member countries enjoy the benefits of regional integration, states the Bali Concord II, the AEC will also address the integration of Cambodia, Lao PDR, Myanmar, and Viet Nam" (known collectively by the acronym CLMV). The Initiative for ASEAN Integration (IAI) was launched in 2000 with precisely the purpose of narrowing the development gaps among ASEAN member countries and between ASEAN and the rest of the world. It has identified the following priority areas: infrastructure, human resource development, information and communications technology (ICT), capacity building for regional economic integration, energy, investment climate, tourism, poverty reduction and improvement in the quality of life.

To monitor the progress of efforts to reduce disparities in development, the ASEAN Secretariat and the OECD Development Centre jointly developed a set of indicators – the ASEAN-OECD Narrowing Development Gaps Indicators (NDGIs) (see Box 3.1). The NDGIs, which measure gaps in six policy areas identified in the IAI's Strategic Framework and Work Plan 2 (2009-15), showed that significant discrepancies in socio-economic development persisted in 2005-11 between the more highly developed, prosperous ASEAN-6 (Brunei Darussalam, Indonesia, the Philippines, Singapore, Malaysia and Thailand) and the CLMV countries. On a more positive note, NDGIs also pointed to a narrowing of development gaps between ASEAN-6 and the CLMV economies, which suggests that ongoing regional and country efforts undertaken by policy makers in the CLMV member countries are on the right track (Figure 3.1). That said, income level disparities have widened between 2005 and 2011, the inference being that CLMV countries should further target efforts on ensuring a more equitable distribution of income among their populations.

The main findings to be drawn from the ASEAN-OECD NDGIs are:

- Disparities are at their widest in poverty and human resource development. Greater efforts are consequently required in these areas and regional support should prioritise CLMV.
- Disparities in tourism and ICT between ASEAN-6 and CLMV countries were the narrowest in 2005 and continued to be so in 2011, which suggests that efforts undertaken by ASEAN member countries to accelerate development in both fields have been successful. However, there is room for improvement in all countries: they should seek to attract more international visitors and expand access to Internet technology.

Figure 3.1. **Narrowing Development Gap Indicators (NDGIs): disparities between ASEAN-6 and CLMV**



Note: Each sub-index of the NDGI, whose value ranges from 0 to 10 base points – where 0 denotes no gap and 10 the widest gap – is built from multiple variables within six key policy areas shown above.
For more detailed information, see www.oecd.org/dev/asiapacific.

Source: ASEAN Secretariat and OECD Development Centre.

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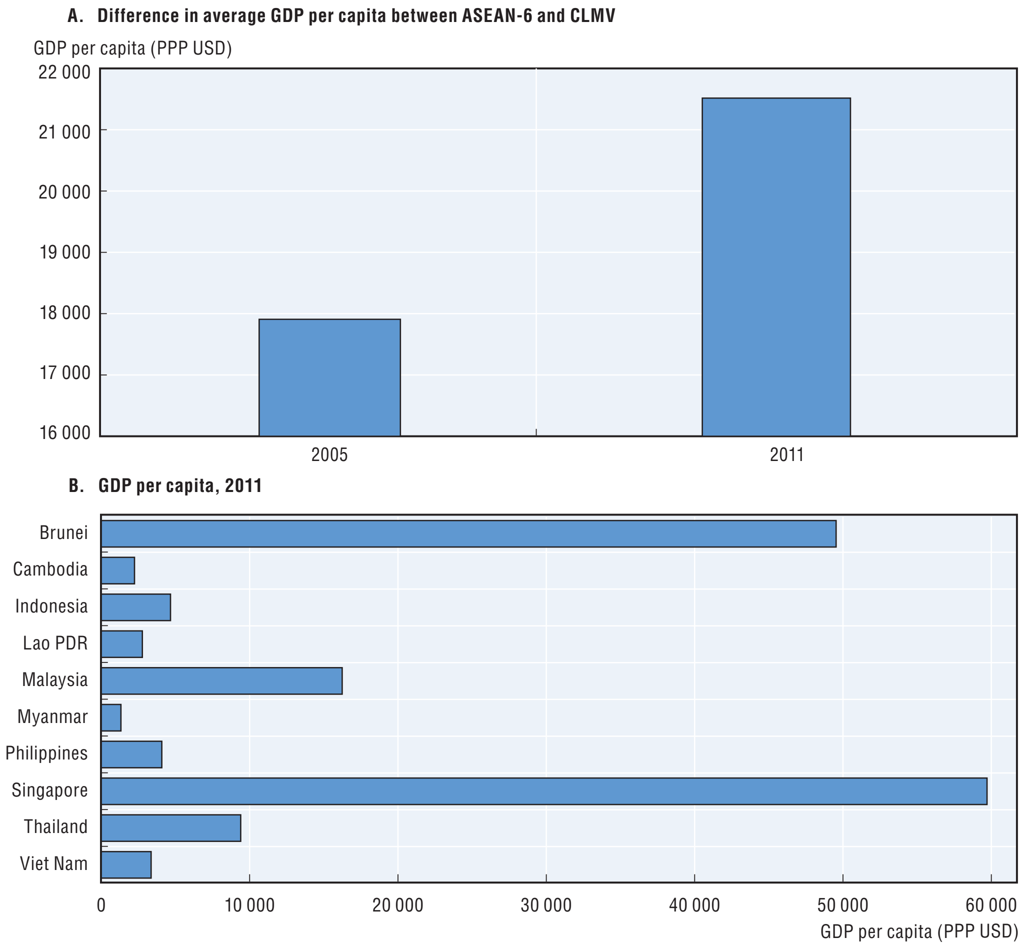
- Between 2005 and 2011, disparities in poverty, human resource development, ICT and tourism gradually narrowed. However, over the same period, the infrastructure and trade and investment gap indicators showed no improvement. Many regional projects designed to increase connectivity in transport and energy need to be strengthened. Legal and regulatory structures for investors must be made more transparent and logistical procedures more efficient.
- It is as important to address disparities in income levels as disparities in development policy. Comparison of ASEAN income levels reveal that, while the general trend has been an increase in income disparities between ASEAN-6 and CLMV, there are also wide differences within both groups.
- The region faces an issue of dual disparities – i.e. disparities between and within countries. In this respect, Viet Nam has been the most successful CLMV country in both closing the gap on the wealthier ASEAN countries and reducing domestic disparities. There is a sharp contrast between Lao PDR and Cambodia. While Cambodia has been relatively slow in catching up with ASEAN-6, it has been successful in reducing income inequality at home. Lao PDR, on the other hand, has caught up fast – but only at the cost of widening domestic income disparities.

Disparities in development and income level

Gross domestic product (GDP) per capita – one measure of income disparity among countries – rose faster between 2005 and 2011 in the ASEAN-6 countries than in CLMV. The result was a widening of the income gap between the two country groupings (Figure 3.2). Although Viet Nam's per capita GDP was just behind that of the poorest members of ASEAN-6 – the Philippines and Indonesia – Cambodia's was only USD 2 200 and Lao PDR's USD 2 800 in 2011. Myanmar lagged even further behind with an estimated GDP per capita of USD 1 300. However, even within the ASEAN-6 countries there are wide disparities. At over USD 48 000, Singapore and Brunei record the highest GDP per capita, while the rest (Indonesia, Malaysia, the Philippines and Thailand) have only half that.

Figure 3.2. **Income level disparity between ASEAN-6 and CLMV economies**



Source: International Monetary Fund, World Economic Outlook Database, October 2012.

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Income level differences are just one aspect of disparities. They need to be examined from various angles. In this respect, the NDGIs are a starting point for measuring socio-economic disparities among ASEAN member countries. They reveal that in certain policy areas (i.e. poverty, human resource development, ICT, and tourism) the gap between ASEAN-6 and CLMV has gradually narrowed since 2005, while in infrastructure and trade and investment there has been no improvement (Figure 3.1).

Box 3.1. **How the Narrowing Development Gap Indicators (NDGIs) measure development gaps in Southeast Asia**

The ASEAN-OECD NDGIs:

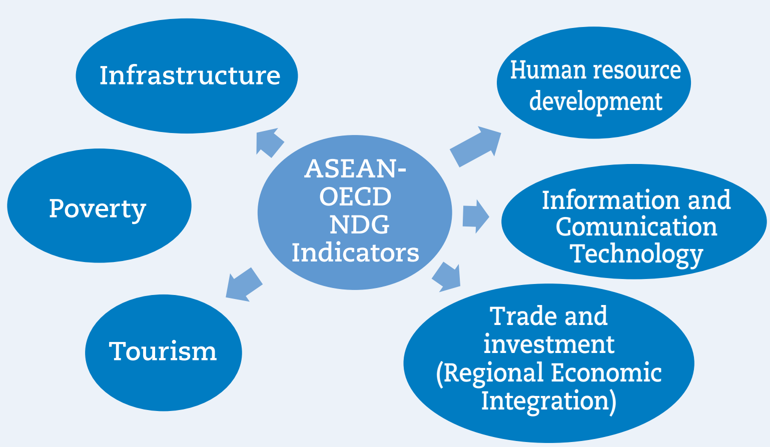
- provide comparative information on socio-economic development among Southeast Asian countries,
- act as a regional benchmarking tool to monitor the status and progress of development gaps within the region as part of the ASEAN integration process,
- facilitate policy dialogue and co-operation among ASEAN member countries.

The ASEAN Secretariat and the OECD Development Centre jointly built the NDGIs to measure the development gaps between the ASEAN-6 and CLMV countries. They are aligned with the IAI in order to promote equitable economic development between the two groups through regional co-operation.

The NDGIs are created in a three-stage process:

Each NDGI, which comprises 10 base points – where 0 denotes no gap and 10 the widest gap – is built from multiple variables within six key policy areas shown below. Variables are selected on the basis of their relevance to the stated policy area, then indexed and averaged by country grouping (i.e. ASEAN-6 or CLMV). The gap for each variable is the difference between the averaged indices in each country grouping. Thereafter, the sub-index is calculated from the average of all the gaps within each key policy area. High values close to 10 base points represent large development gaps, while values close to 0 signify small development gaps.

The NDGIs were first used to assess development gaps in policy areas in 2005, then again in 2011 to measure their evolution over time.

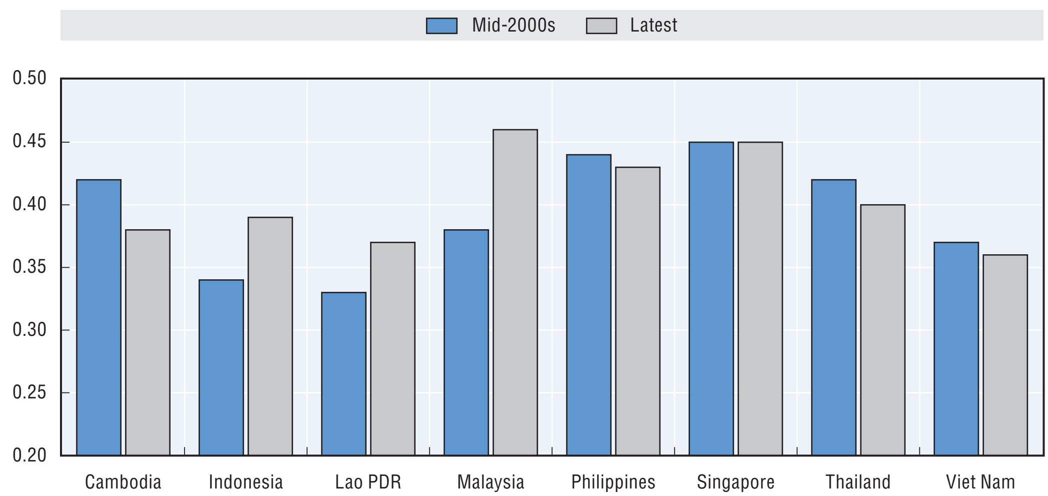


Source: the ASEAN Secretariat and OECD Development Centre.

Disparities both among and within countries need to be addressed

Examination of recent patterns in income inequalities within countries, as measured by the Gini coefficient, reveals different trends among ASEAN countries (Figure 3.3). Between 2005 and 2011, inequality eased in Cambodia and Viet Nam and grew in Lao PDR, even though it started from a very low level. As for Myanmar, lack of data makes it difficult to examine inequality trends in that country.[2] Patterns of change in income inequality also vary in ASEAN-6 economies. Indonesia and Malaysia became more unequal, while the Philippines and Thailand managed to reduce inequality to a certain extent. Income inequality in Singapore seems to have been stationary at a relatively high level since 2005.

Figure 3.3. **Gini coefficients of inequality in ASEAN-6 and CLMV**



Note: Mid-2000s: Cambodia, 2004; Indonesia, 2005; Lao PDR, 2002; Malaysia, 2004; Philippines, 2006; Singapore, 2005; Thailand, 2006; Viet Nam, 2004.
Latest: Cambodia, 2008; Indonesia, 2011; Lao PDR, 2008; Malaysia, 2009; Philippines, 2009; Singapore, 2011; Thailand, 2009; Viet Nam, 2008.

Sources: World Bank *World Development Indicators*, ADB *Asian Development Outlook 2012*. Department of Statistics Singapore.

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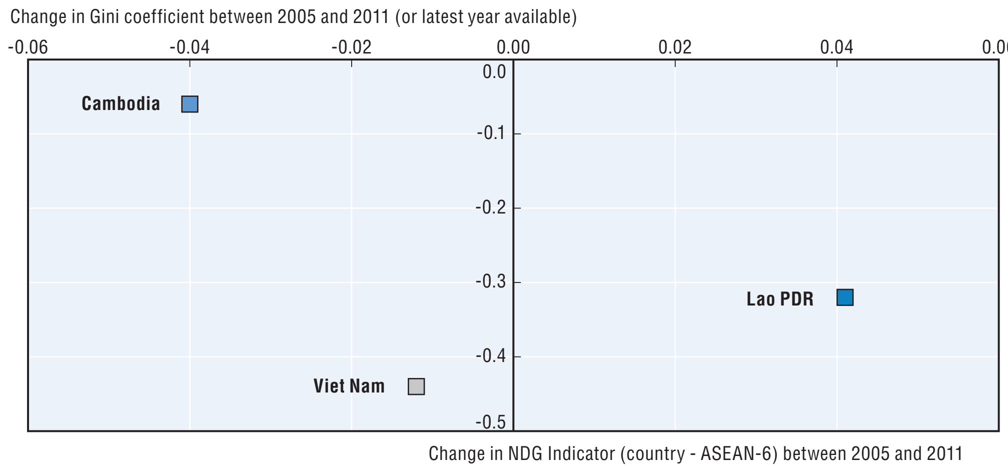
Study of the relationship between disparities among countries and within countries yields some interesting observations (Figure 3.4).

Viet Nam has been the most successful CLMV economy both in reducing income disparities at home and in closing the gap between the ASEAN-6 (see Box 3.2). Lao PDR and Cambodia show different growth and development paths. Lao PDR has successfully caught up with ASEAN-6 countries at the cost of increasing domestic inequalities, while Cambodia has been slower to make ground on ASEAN-6 but effective in reducing income disparities within the country.

Figure 3.4. **Disparities "among countries" and "within countries" in Southeast Asia**



Note: Change in Gini coefficient between: 2004 and 2008 for Cambodia; 2002 and 2008 for Lao PDR; 2004 and 2008 for Viet Nam.
Source: OECD Development Centre.

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Box 3.2. Viet Nam's growing clout among the CLMV countries

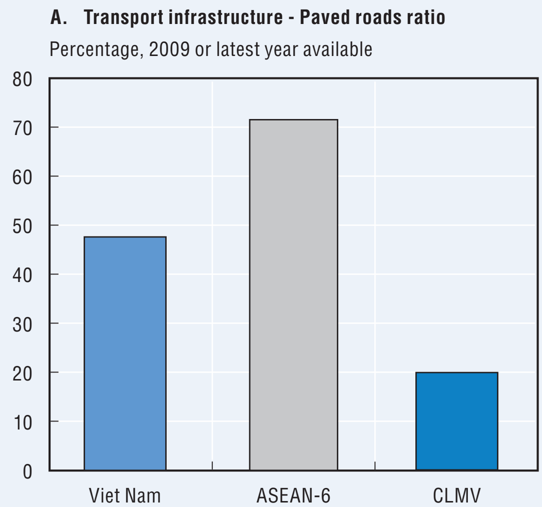
Viet Nam had transformed itself from a heavily indebted into a middle-income country by 2010. After the reunification of the North and the South of the country in 1975, it found itself in economic crisis with falling standards of living left by the ravages of war. The launch of the ruling Communist Party's *doi moi* strategy in the 1980s and entry into the World Trade Organization in 2007 helped change Viet Nam from a closed, centrally planned economy into one that was market-based. As a result, its real GDP has grown strongly by an average of 7.2% since 1988 – higher than the 3%-5% growth range of most advanced economies and the 5.6% average of the rest of the ASEAN countries.

With faster growth more resources can be channelled into improving economic conditions, infrastructure and human development. Indicators in the areas of transport and ICT infrastructure, standard of living and foreign investment show that Viet Nam is doing better than the rest of the CLMV countries (see Figure 3.5). For instance, average telephone lines per 100 persons in Viet Nam reached ASEAN-6 levels in 2008, while net foreign direct investment (FDI) into Viet Nam is higher than that of the CLMV and ASEAN-6 countries.

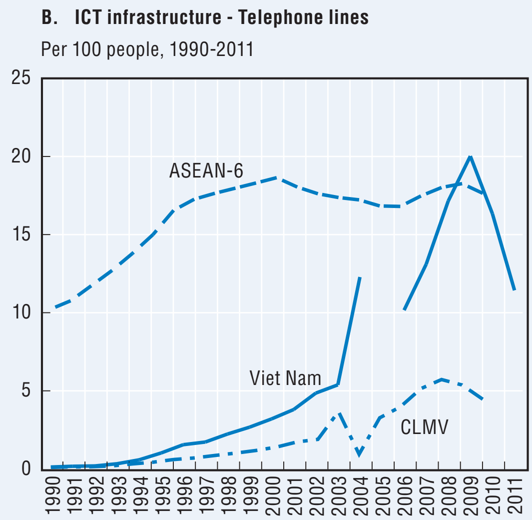
Even with its fast pace of growth, Viet Nam still faces considerable challenges relative to income inequality, corruption and bureaucracy, vulnerabilities in the financial sector, and strengthening its legal framework. (For more detailed information, see Chapters 4 and 5.

Box 3.2 (contd.)

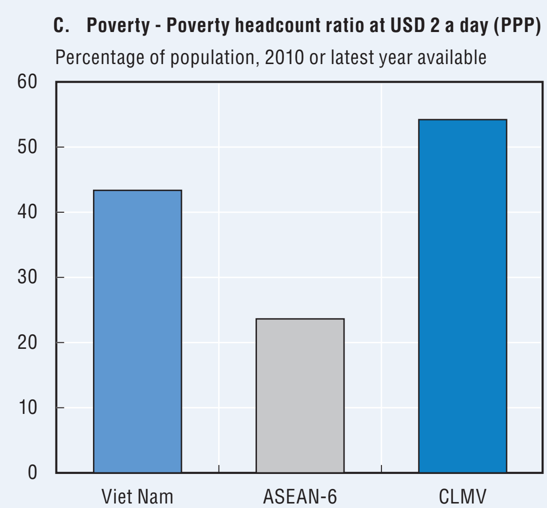
Figure 3.5. **Viet Nam's transport and ICT infrastructure, standard of living and FDI indicators**



Sources: World Bank *World Development Indicators* and UNESCAP.



Source: World Bank *World Development Indicators*.



Note: No data available for Brunei, Singapore and Myanmar.

Source: World Bank *World Development Indicators*.

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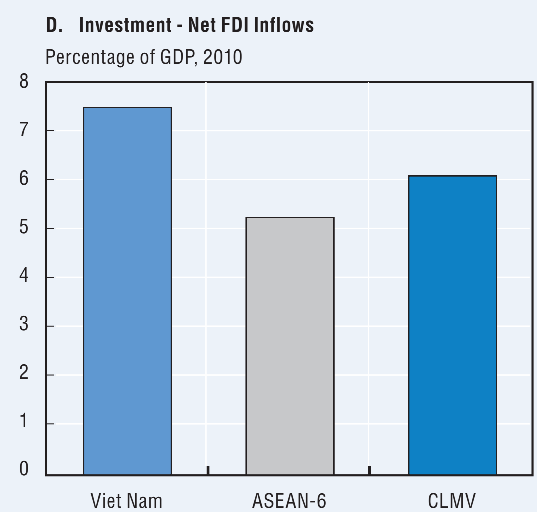


Note: No data available for Myanmar.
Source: World Bank *World Development Indicators*.

Trade and FDI are major driving forces common to Cambodia, Lao PDR and Viet Nam (CLV) and are behind their efforts to catch up with ASEAN-6 countries (see Chapter 4). There are, however, clear differences between Cambodia and Lao PDR.

Examination of patterns of trade specialisation reveals that Cambodia remains highly specialised in labour-intensive apparel export, while Lao PDR's exports have shifted towards natural resource-based products, such as hydropower and mining products (see Chapter 4). Cambodia and Lao PDR also address income inequality in different ways. The Cambodian government long ago recognised the need for equitable growth, introducing and maintaining targeted strategies – e.g. the Rectangular Strategy to promote equity and a land reform to help poor rural households. In Lao PDR, where inequality is closely related to ethnicity and geography – with plains dwellers benefiting most from market reforms, infrastructure development, and public services – the success of the anti-poverty development strategy of resettling people in commercial agricultural sites has so far been limited (see Chapter 5).

The following section of this chapter discusses in greater detail the NDGIs, their individual components, and ongoing developments at regional, subregional and individual country levels.

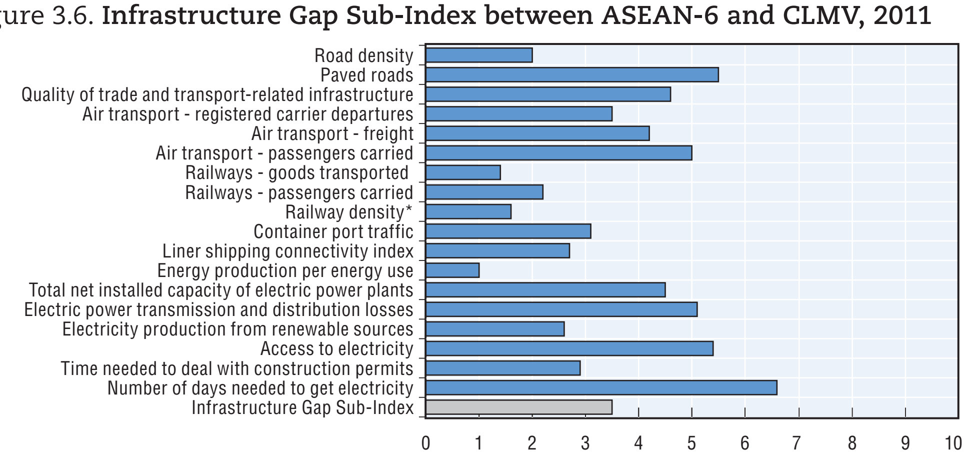
Infrastructure

Infrastructure development gap between ASEAN-6 and CLMV has not narrowed

The ASEAN Economic Community Blueprint emphasises the importance of infrastructure development as key to maintaining the competitiveness of Southeast Asia. The Blueprint considers that regional and sub-regional connectivity are a crucial engine of regional growth. In 2011, the overall score for the Infrastructure Gap Sub-Index – which comprises 18 sub-components encompassing land, air and maritime transport as well as energy – was 3.4 base points, unchanged from 2005 (Figure 3.6).

The sub-components show considerable differences between ASEAN-6 and CLMV, with land and air transport and the energy sector accounting for particularly wide gaps. The widest are the number of days required to get electricity, paved roads (as a percentage of total roads), access to electricity (as a percentage of population), which register 6.6, 5.5 and 5.4 base points respectively. These scores suggest that neither regional nor country initiatives in the CLMV countries are doing as well as hoped in these areas. They perform better, however, in areas such as the construction and use of railways and in goods transportation: the narrowest gaps between ASEAN-6 and CLMV are in energy production per energy use (kt of oil equivalent), goods transported by rail and railway density (i.e. kilometre of line per 1 000 km2 land area), which score 1.0, 1.4 and 1.6 base points, respectively.

Figure 3.6. **Infrastructure Gap Sub-Index between ASEAN-6 and CLMV, 2011**



Note: An asterisk (*) indicates a larger value for CLMV countries *vis-à-vis* ASEAN-6 and thus denotes a change in the direction of the gap between the two country groups.
Source: OECD Development Centre's calculations based on UNESCAP Asia-Pacific database, World Bank`s *World Development Indicators* (WDI), World Bank's *Doing Business* and UN Energy Statistics database.
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Slow regional progress in the transport and energy sectors is due to resource constraints and lack of consensus in implementation

The stationary overall score in the Infrastructure Gap Sub-Index can be partially attributed to the slow progress of agreed regional initiatives in infrastructure development in the land, air and maritime transport sectors.[3]

In land transport, the Asian Highway Network (AHN) programme is behind schedule. The AHN is supposed to comprise 23 routes covering 38 400 kilometres and linking ten ASEAN member countries by 2020. In 2010, however, only the inventory of all the national route sections had been completed. Highway links 227 kilometres long on the ASEAN Transit Transport Routes are still to be built, while roads need to be upgraded to Class III and above (Table 3.1). In addition, common road signage on all designated routes will need to be installed. In contrast, the Singapore-Kunming Rail Links (SKRL), built under the ASEAN Mekong Basin Development Co-operation (AMBD) framework, has shown steady progress.[4]

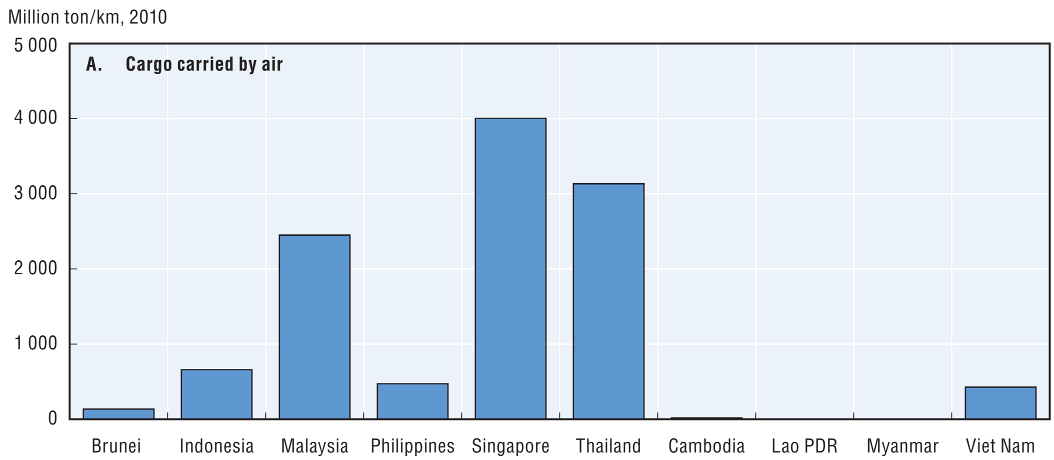
Table 3.1. **Priorities for the completion of ASEAN Highway Network (AHN), 2011-15**

Scheduled timetable	Project purpose	Country	Route Number
Completion by 2012	Upgrade roads on the Transit Transport Routes (TTR) to Class III"	Lao PDR	AH12 (293 km)
			AH 15 (98 km)
			AH131 (96 km)
			AH 132 (126 km)
		Myanmar	AH1 (781 km)
			AH 2 (593 km)
			AH3 (93 km)
			AH111 (239 km)
			AH112 (1 085 km)
		Indonesia	AH25 (141.55 km) AH150 (1 762.3 km) AH151 (611.9 km)
			AH150 (40 km)
		Malaysia	AH13 (215.5 km) AH132 (160 km)
		Viet Nam	
Starting from 2013	Build additional missing link sections on the AHN.	Myanmar	AH 112 (60 km)
			AH 123 (141 km)
Completion by 2015	Upgrade the extension of AHN to China and India, particularly sections from Hanoi via northern Lao PDR through Myanmar to the border with India.		
	Build the Mekong Bridge in Neak Loung (National Road No. 1 in Cambodia).	Cambodia	
Completion by 2020	Upgrade "Class II or III" sections with high traffic volume to "Class I"		
	Build the highway between Kanchanaburi (Thailand) and Dawei (Myanmar).	Thailand and Myanmar	
	Build the missing link in the East West Economic Corridor (EWEC).	Myanmar	

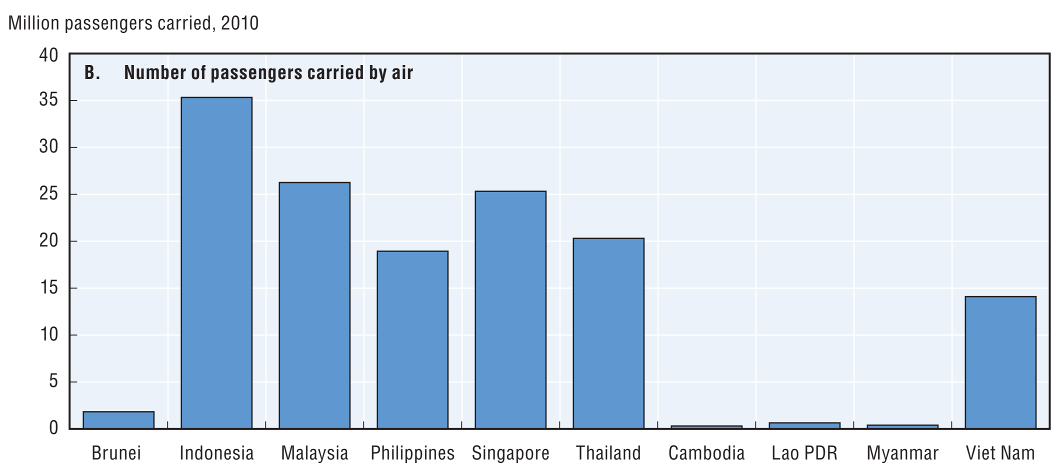
Source: Master Plan on ASEAN Connectivity, December 2010.

In cargo and passenger-carrying air transport, closing the wide gap between the ASEAN-6 and CLMV countries prompted the idea of an ASEAN Single Aviation Market (ASAM). Figure 3.7 shows that air transport and travel continue to make a much bigger contribution to the economy in ASEAN-6 economies than in CLMV countries.

Figure 3.7. **Cargo and passenger-carrying air transport in ASEAN countries**



Source: World Bank *World Development Indicators*.



Source: World Bank *World Development Indicators*.

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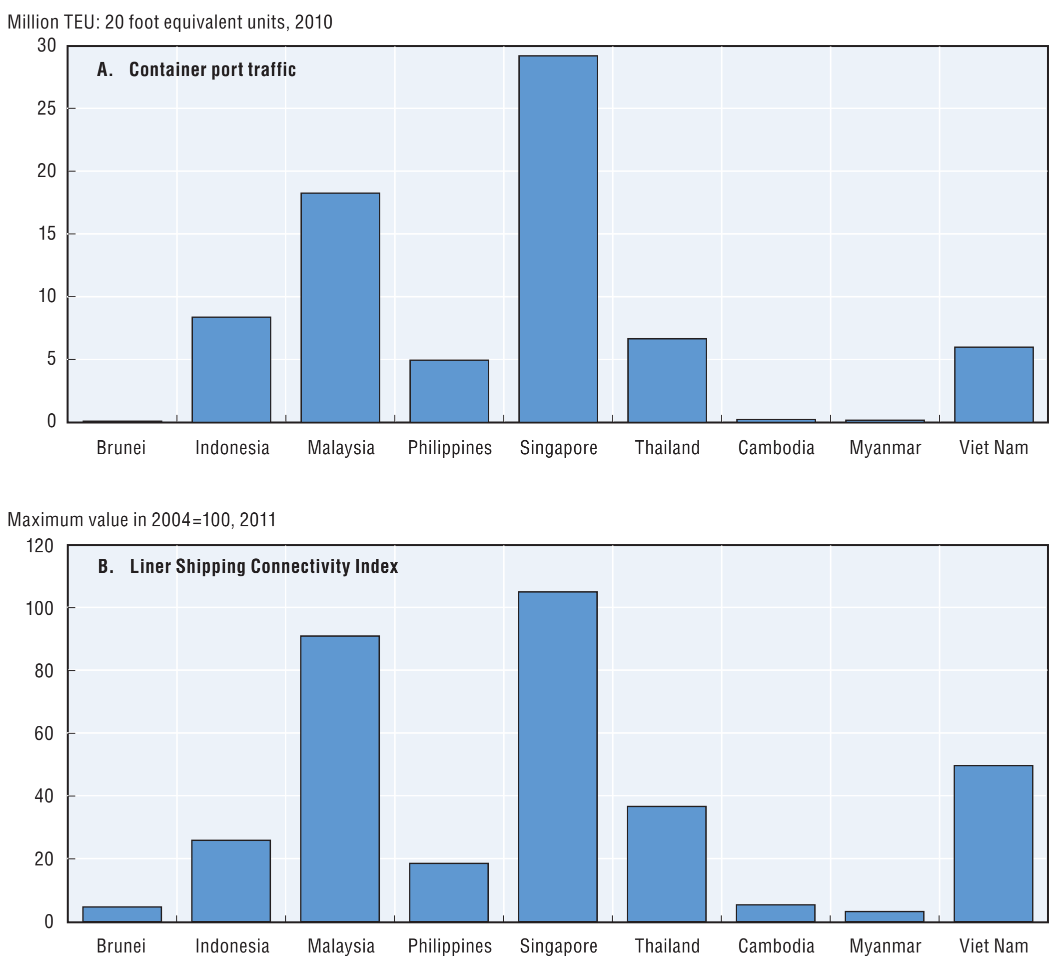
There has been some progress in the last five years, particularly with the signature of the ASEAN Multilateral Agreement on Air Services (MAAS) in May 2009 under the ASEAN Open Sky Policy and its ratification by seven ASEAN countries. MAAS and its six Implementing Protocols provide unlimited 3rd, 4th and 5th freedom traffic rights for scheduled passenger services from and to any points with international airports within and between the sub-regions and the capital cities of ASEAN member states. However, the liberalisation of air services as part of the framework for the ASAM has been slow. While several low-cost carriers (LCCs) – such as Air Asia, Jetstar, and CityLink – have entered the market, there is still a fear of LCCs and entrenched state carriers are anxious to preserve their market shares and profit margins.

In maritime transport, progress has been slow – Figure 3.8 shows that the differences at the country level are substantial. ASEAN countries face three main challenges in creating a single shipping market:

- shipping and port hard infrastructure is developed to varying degrees;
- the institutional framework needs improvement so as to reinforce efficiency gains in the shipping markets;
- key activities and resources closely associated with regional shipping need to be complemented by investment in support activities.

Figure 3.8. **ASEAN countries' maritime cargo volumes and place in shipping networks**



Notes: No data for Lao PDR.

The Liner Shipping Connectivity Index captures how well countries are connected to global shipping networks. It is computed based on five components of the maritime transport sector: number of ships, their container-carrying capacity, maximum vessel size, number of services, and number of companies that deploy container ships in a country's ports. For each component a country's value is divided by the maximum value of each component in 2004, the five components are averaged for each country, and the average is divided by the maximum average for 2004 and multiplied by 100. The index generates a value of 100 for the country with the highest average index in 2004.

Source: World Bank *World Development Indicators.*

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In energy, flagship programmes such as the ASEAN Power Grid (APG) and the Trans-ASEAN Gas Pipeline (TAGP) are spearheaded under the ASEAN Plan of Action on Energy Co-operation (APAEC) 2010-15. They, too, are progressing slowly.[5] In 2011, only six grid interconnections were in operation, with the remaining nine scheduled for commissioning by 2015 (Table 3.2). In addition, there will reportedly be four projects after 2015, while another two have been newly proposed.

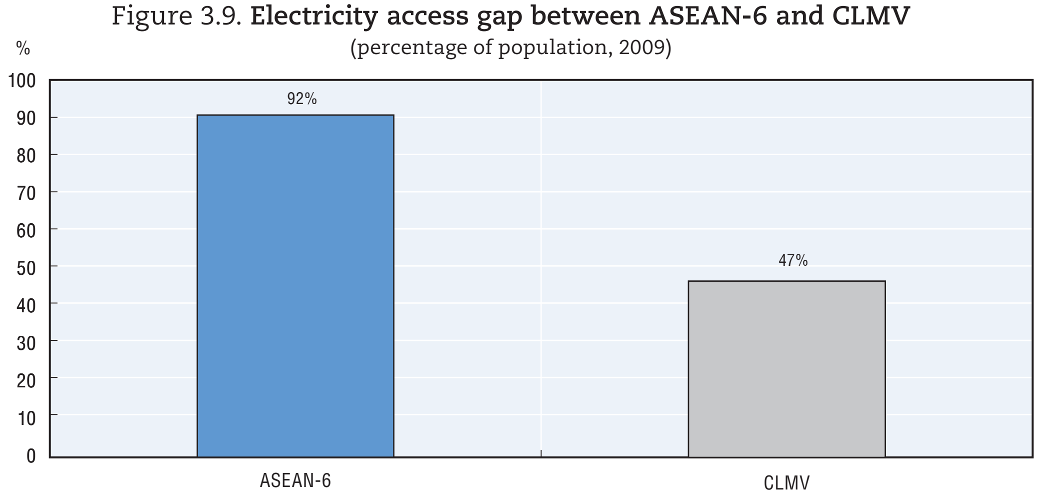
Table 3.2. **Existing linkages on the ASEAN Power Grid, end 2011**

No.	Interconnected systems	Capacity (WM)
1	Thailand-Malaysia	
	Sadao-Bukit Keteri	80
	Khlong ngae-Gurun	300
2	Thailand-Lao PDR	
	Roi Et 2 – Nam Theun 2	920
	Udon Thani 3 – Nabong	597
	Ubon Ratchathani 2 – Houay Ho	126
	Sakon Nakhon 2 – Theun Hinboun	210
3	Singapore – P. Malaysia	2x200
4	Cambodia – Viet Nam	135
5	Thailand – Cambodia (115 kV)	80

Source: Report of the 8th meeting of the ASEAN Power Grid Consultative Committee, June 2011.

Delays in implementing the APG are due mainly to ASEAN member states' difficulty in reaching consensus on a number of issues – operational reliability, safety standards, generation and transmission procedures, the investment reference model for interconnection projects, cross-border sales and power transmission. The CLMV countries also face financial constraints and may require assistance in building undersea and inland interconnections. However, once the APG project has been completed in 2020, it is expected to reduce the electricity access gap: in CLMV countries only 47.4% of the population have access to electricity from the public grid (Figure 3.9).

Figure 3.9. **Electricity access gap between ASEAN-6 and CLMV**
(percentage of population, 2009)



Source: World Bank *World Development Indicators*.
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By 2011, there had been little progress towards the TAGP, with only eight bilateral gas pipeline interconnection projects currently operating for a total length of some 3 200 kilometres.[6] Pending the resolution of commercial issues, the pipeline to ASEAN nations from East Natuna in Indonesia (the region's largest resource of natural gas) has not been built, potentially increasing the natural gas shortfall for use by ASEAN countries should no new significant discoveries be made.

Subregional co-operation and individual country policies can distract from agreed ASEAN initiatives

In addition to ASEAN-level initiatives, there are several frameworks for co-operation between Southeast Asian countries at the subregional level. Each initiative is geared towards closer economic co-operation and greater transport and energy connectivity in specific groups of countries (see Table 3.3).

At the national level, most ASEAN governments have also put in place national plans to improve both transport and energy infrastructure and facilities, albeit with different focuses and strategies.

- In the transport sector, larger countries such as Indonesia and Malaysia are focusing on improving transport connectivity within the country. Railway construction in Indonesia is concentrated principally in the province of East Kalimantan in the east of the country. The Malaysian government, for its part, intends to reduce inequalities between Peninsular Malaysia and the less developed eastern states and is building new roads, upgrading existing road links, and upgrading international and domestic airports.
- Thailand, on the other hand, has been focusing its efforts on further facilitating trade with its neighbours (Lao PDR, Malaysia, Cambodia, Myanmar and China) through inter-city road transport linkages and a pivotal maritime transport route. Heavy road congestion has also prompted the government to divert land traffic to sea-going modes of transport despite the higher cost and longer journey times.
- In the energy sector, countries such as Indonesia, Thailand and particularly the Philippines are prioritising energy diversification and improving their renewable resources programmes in order to reduce their oil dependency (Figure 3.10). Under the 2009-30 Philippines Energy Plan, one of the main objectives of the government is to double the plantation and production of renewable energy. In contrast, countries such as Brunei and Viet Nam are focused on optimising oil and natural gas production for domestic consumption and export commodities.

Indeed, with so many subregional and national initiatives, the challenge for ASEAN is that member countries disconnect from the regional effort, especially when they are at different stages of development and consequently have different priorities. Action on bilateral and subregional types of co-operative agreements may take precedence over regional agreements, especially when there is no enforcement mechanism in place at the ASEAN level. For instance, the idea for a body like ASAM had been envisioned in 2007, but took off only four years later at the ASEAN Transport Ministers Meeting in December 2011.

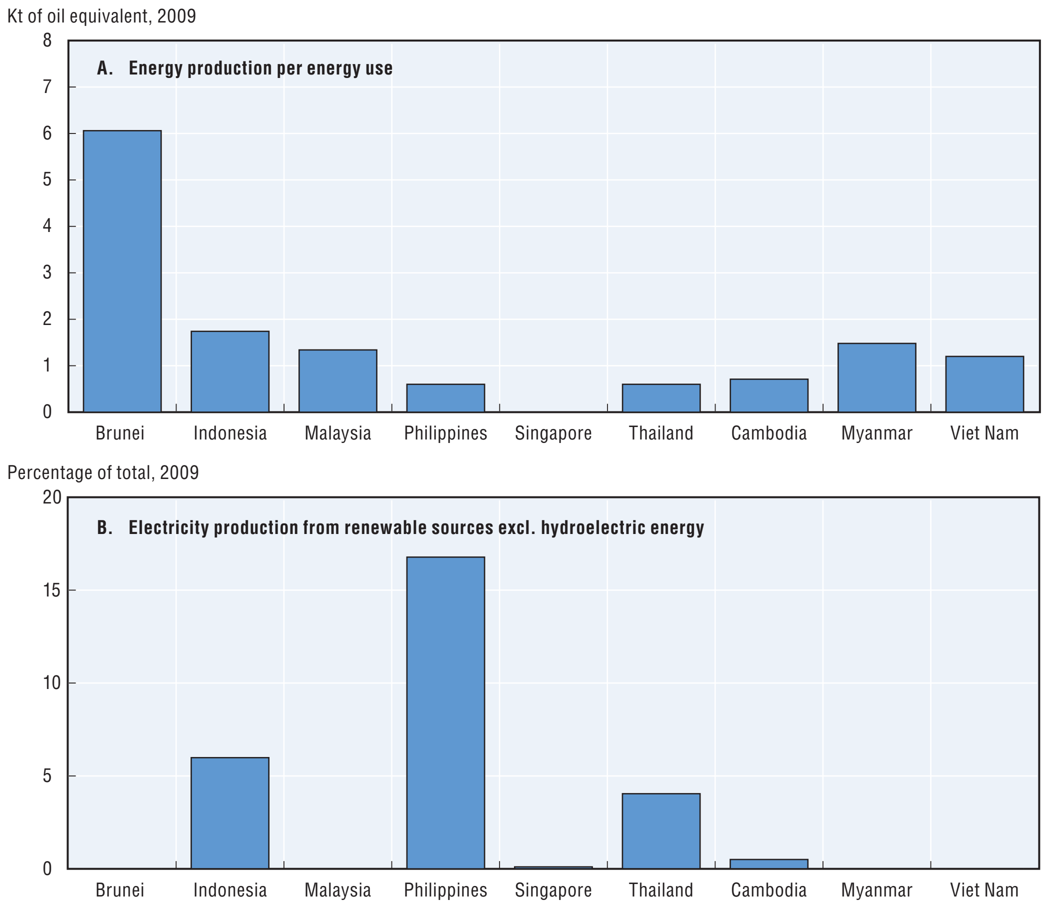
As for air services liberalisation, only airlines between Malaysia and Singapore have been fully liberalised, even though member countries signed the MAAS agreement in 2009. Some countries such as Indonesia are holding back on the implementation of ASEAN's open skies policy because of their uncompetitive national airlines, poor infrastructure facilities and low demand for air travel in their smaller cities.

Table 3.3. **Subregional initiatives in ASEAN on infrastructure development**

Subregional initiative	Countries involved	Strategy
The Brunei-Indonesia-Malaysia-Philippines East ASEAN Growth Area (BIMP-EAGA)	Brunei Darussalam; the provinces in Kalimantan, Sulawesi, Maluku, and Papua (Eastern Indonesia); the states of Sabah and Sarawak, and the federal territory of Labuan (Malaysia); and Mindanao and Palawan (Philippines)	Formally launched in 1994 as a key strategy of participating governments for addressing the social and economic development of their underdeveloped and more remote territories. At the operational level, BIMG EAGA project was funded chiefly by ADB. It has contributed to regional development and an ASEAN connectivity framework, and especially to airport and seaport infrastructure achievements. The participating governments facilitated the liberalisation of the transport sector to allow for greater mobility of people, goods and services. For example, at the 4th BIMP-EAGA Transport meeting on April 2007 – the Infrastructure and ICT Development Cluster Meeting – the EAGA working group on air linkages agreed to grant fifth freedom traffic rights (FFTR) to all passenger and cargo services in the airports of Manado and Tarakan in Indonesia, Labuan and Miri in Malaysia, and Puerto Princesa and General Santos in the Philippines.
The Greater Mekong Subregion (GMS)	Cambodia, China (specifically Yunnan Province and Guangxi Zhuang Autonomous Region), Lao PDR, Myanmar, Thailand and Viet Nam	Created in 1992 with the main objective of enhancing subregional economic co-operation across six countries with technical and financial assistance from the ADB. In the transport sector, the GMS established the East West Economic Corridor (EWEC) which facilitates trade activities. Under the framework of the Cross-Border Transport Facilitation Agreement (CBTA), some progress had been achieved by the end of 2011: • Establishment of fast-track lanes along the EWEC to allow truck drivers transporting goods and holding CBTA documents to cross borders with minimum inspection by customs officers. • Establishment and piloting of the GMS Road Transport Permit System. It enables more efficient custom formalities than those that haulage companies usually have to undergo at border crossings. • Introduction of the Customs Transit and Temporary Admission System (CTS) on charges on transit traffic and the pricing of customs documents. In the energy sector, some real progress in GMS projects has come with the construction of interconnected electricity links in the subregion. Up to 2011, seven existing interconnections had been built and were fully operational, covering China, Thailand, Viet Nam, Myanmar, Cambodia and Lao PDR. The total length was 1 168 kilometres and total capacity 2 750 MV. The upcoming GMS Roadmap on Energy Co-operation (2009-2015) embraces a wider scope of energy co-operation in the subregion, but no significant progress had been achieved by the end of 2011.
The Indonesia-Malaysia-Thailand Growth Triangle (IMT-GT)	14 provinces in southern Thailand, 8 states in Peninsular Malaysia and 10 provinces in the island of Sumatra in Indonesia	The IMT-GT was formed in 1993 to better connect the subregion through the construction of highways, ports and railways access. Towards the end of 2011, two flagship infrastructure projects were completed: 1. The upgrade of Melaka Berendam Airport in Malaysia to an international airport serving as a new gateway into the IMT-GT subregion. 2. The construction of the Inland Port of Thungsong Nakhon Si Thammarat in Thailand.
CLMV Sub-Regional Co-operation on Air Transport	Cambodia, Lao PDR, Myanmar and Viet Nam	Initiated in 1998 and designed to facilitate air transport connectivity between the countries in the subregion. This co-operation framework has contributed to the ASEAN open skies policy for liberalising air transport within the CLMV subregion replacing all existing bilateral air services agreements signed between member countries of the CLMV subregion.

Source: OECD Development Centre's compilation based on national sources.

Figure 3.10. **Energy production in ASEAN countries**



Note: No data available for Lao PDR.
Source: World Bank *World Development Indicators*.
StatLink http://dx.doi.org/10.1787/888932774984

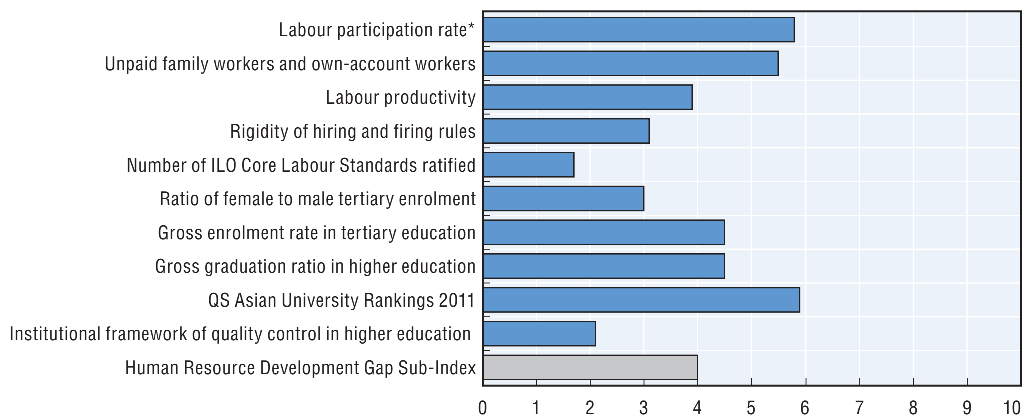
Human resource development

Human resource development gaps between ASEAN-6 and CLMV are wide and persistent

The Human Resource Development Gap Sub-Index reported a score of 4.0 base points between ASEAN-6 and CLMV countries in 2011 (Figure 3.11). Although it was an improvement on 2005's 4.5 base points, it is the second widest of all the NDGI sub-indices and higher than the overall 3.2 NDGI for all six IAI policy areas – all of which suggests that CLMV countries still have a fair amount of catching up to do. Gaps are at their widest in the employment and education subcomponents, namely the labour participation rate, the proportion of unpaid family workers and own-account workers and Asian university rankings. Most resources should be directed towards these areas in order to reduce the human resource gap.

In contrast, the gap between the number of International Labour Organization (ILO) core labour standards ratified by both country groupings is just 1.7 base points – the narrowest of all the human development subcomponents. It indicates that the CLMV countries have made considerable progress in ensuring basic labour rights, protecting the workforce against discrimination and forced and compulsory labour, abolishing child labour and allowing freedom of association and collective bargaining.

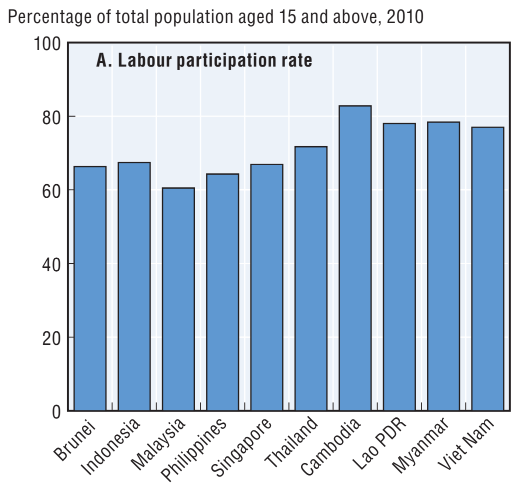
Figure 3.11. **Human Resource Development Gap Sub-Index between ASEAN-6 and CLMV, 2011**



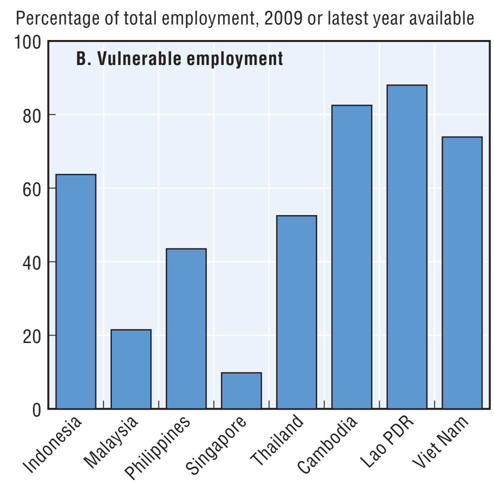
Note: An asterisk (*) indicates a larger value for CLMV countries *vis-à-vis* ASEAN-6 and thus denotes a change in the direction of the gap between the two country groups.
Source: OECD Development Centre's calculations based on World Bank's *World Development Indicators* (WDI), World Bank's *Doing Business* database, national sources, ADB *Key Indicators 2011*, ILO *Key Indicators of the Labour Market* (KILM), UNESCO UIS database and QS University Ranking.
StatLink http://dx.doi.org/10.1787/888932775003

Gaps between ASEAN-6 and CLMV countries in the employment and educational components are marked by different trends. More than 77% of the population aged 15 and older are economically active in CLMV economies, compared to an average of 66% in ASEAN-6 countries, which suggests that the young in these countries begin work earlier to supplement family income (Figure 3.12, A). The share of unpaid family workers and own-account workers, who come under the heading of “vulnerable workers”, is higher in the CLMV countries – 81% compared to an average of 38% in ASEAN-6 (Figure 3.12, B). Labour productivity in Indonesia, Malaysia, the Philippines and Thailand averaged USD 15 000 (GDP per person employed) – substantially more than the USD 5 000 in Cambodia, Myanmar and Viet Nam (Figure 3.12, C). Nevertheless, caution should be exercised in assessing employment issues in ASEAN countries, since the macro-level data do not reflect the extensive informal sector which characterises developing ASEAN countries. As for hiring and firing rules, Indonesia had the most rigid employment structure, scoring higher than Cambodia, Lao PDR and Viet Nam (Figure 3.12, D).

Figure 3.12. **The employment component of the human resource development gap in ASEAN countries**

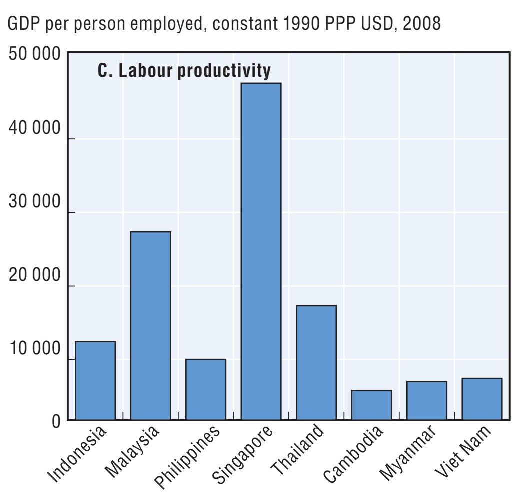


Source: World Bank *World Development Indicators*.



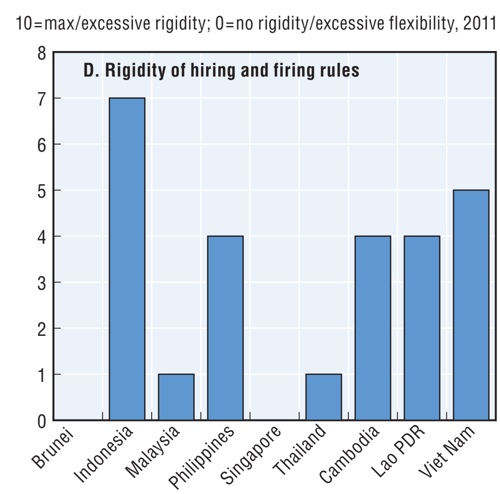
Note: No data available for Brunei and Myanmar. Vulnerable employment refers to unpaid family workers and own-account workers.

Source: World Bank *World Development Indicators*.



Note: No data available for Brunei and Lao PDR.

Source: ILO *Key Indicators of the Labour Market* (KILM).



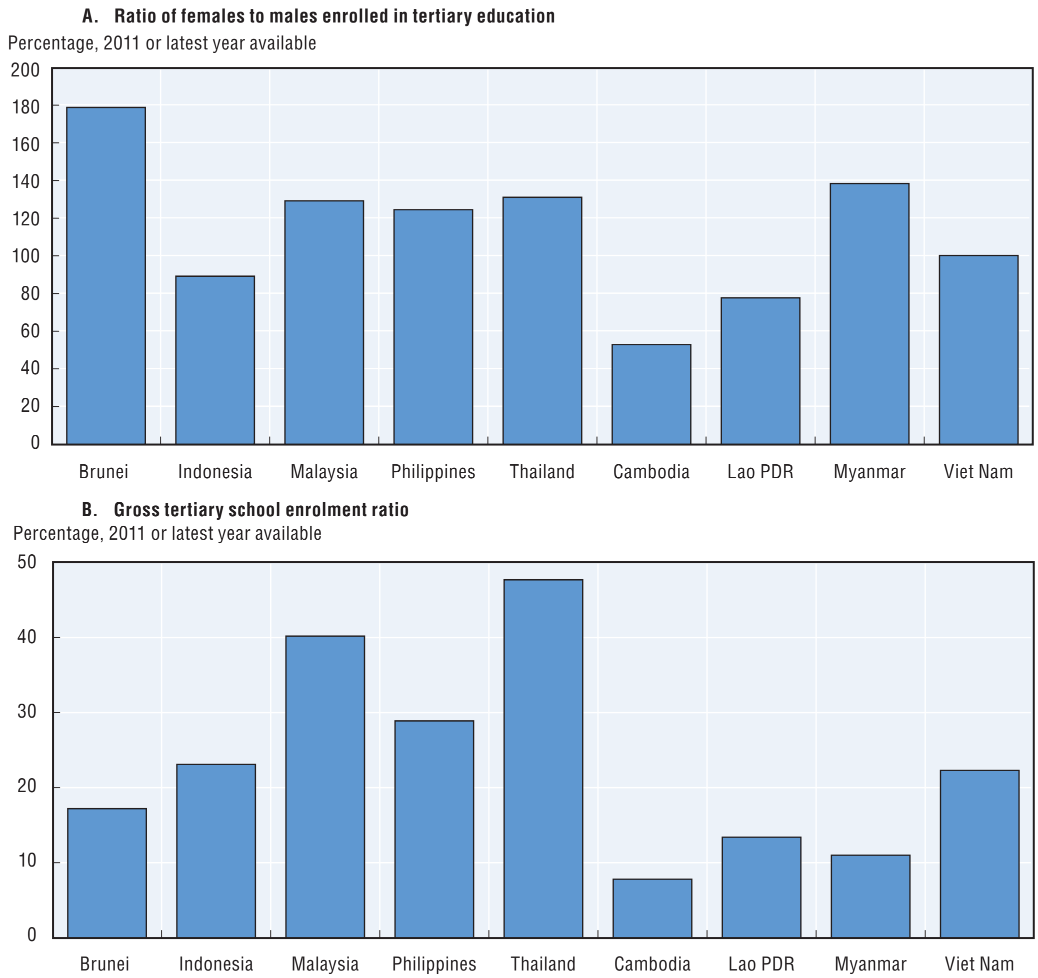
Note: No data available for Myanmar.

Source: World Bank's *Doing Business* database.

StatLink http://dx.doi.org/10.1787/888932775022

With regards to tertiary education in ASEAN, the ratio of male to female students is higher in all CLMV countries except Myanmar. This trend is just the opposite for the more developed ASEAN economies, where – with the exception of Indonesia – female students typically outnumber male students (Figure 3.13, A). In general, there is also a higher percentage of tertiary school enrolment in the more developed ASEAN countries than in the CLMV countries: an average of 31% against 14% (Figure 3.13, B).

Figure 3.13. **Tertiary education attendance in ASEAN countries**



Note: No data available for Singapore.

Source: World Bank *World Development Indicators*.

StatLink http://dx.doi.org/10.1787/888932775041

In the labour sector, the significant human resource development gap between ASEAN-6 and CLMV economies is attributable primarily to a workforce that is inadequate for the growing needs of ASEAN economies and to the lack of legal and institutional frameworks. At the regional level, ASEAN has put in place guidelines and co-operation programmes to encourage the sharing of labour market practices and to support the strengthening of institutional capacities.

The guidelines are geared towards creating jobs, developing the quality of the workforce, and providing social security to workers (see Box 3.3 for more information on the ASEAN Labour Ministers' [ALM] Work Programme). However, because different social and cultural characteristics and labour requirements make ASEAN employment markets so diverse, ASEAN cannot force countries to meet targets and timelines. Its role is restricted to facilitating: it can do no more than offer a common platform where policy makers gather information and share best practices which they then implement in their national labour policies.

Box 3.3. **ASEAN facilitates a better quality of life through productive employment and social protection**

At the regional level, ASEAN's overall labour policy objective is to build towards a better quality of life, productive employment and adequate social protection by enhancing workforce competitiveness, creating a harmonious and progressive workplace, and promoting decent work for all.

Since 2000, ASEAN's work on labour and human resources has been guided by the ASEAN Labour Ministers (ALM) Work Programme. The programme provides a framework that prepares the region's labour force for the challenges of globalisation and trade liberalisation. The ALM Work Programme initially set out five broad priorities: employment generation, labour market monitoring, labour mobility, social protection, and tripartite co-operation. In May 2006, the ministers issued a joint statement that added a sixth priority area – occupational safety and health (OSH) – to the programme.

The ALM Work Programme (2010-2015) serves as a guideline for co-operation in labour policy co-operation towards the realisation of the ASEAN Community by 2015. Taking into account the unique circumstances of each member state, the programme comprises four strategic priorities:

- legal foundation
- institutional capacities
- social partnership
- labour markets and workforce development.

The ALM Work Programme sets forth collective or individual strategies for member states to develop policies and mechanisms that ensure the labour co-operation activities undertaken over the next five years are effective and responsive to the various ASEAN challenges.

ASEAN also made a ground-breaking move to address the issue of migrant workers on 13 January 2007, when member country leaders signed the ASEAN Declaration on the Protection and Promotion of the Rights of Migrant Workers. The declaration mandates ASEAN countries to promote fair and appropriate employment protection and wages for migrant workers and proper access to decent working and living conditions. ASEAN foreign ministers called for a committee to facilitate and enforce the implementation of the declaration. The ASEAN Committee to Implement the Declaration on the Protection and Promotion of the Rights of Migrant Workers (ACMW) came into formal existence at its first meeting in September 2008. The ACMW started a first round of discussions in April 2009 in Bangkok and is currently drafting the ASEAN instrument for protecting and promoting migrant workers and ASEAN website).

Source: OECD Development Centre's compilation base on national sources.

ASEAN marked by low labour productivity, skills mismatches and large informal sector

Although ASEAN countries have reached different levels of social and economic development, they face – to varying degrees – similar labour market issues.

First, much of their workforce is to be found in the agricultural sector, which generally accounts for a country's low productivity. The majority of the labour force in Myanmar and Lao PDR work in agriculture, with Lao PDR reporting that less than 1% of workers move out of agriculture in any given year.

Second, the informal sector in many of the ASEAN countries is large and in some it even outweighs the formal sector. In Cambodia, for example, around 85% of the population works in the informal economy – mostly in agriculture, forestry, fishing and in small and micro enterprises. The figure is 68% in Indonesia, between 40% and 80% in the Philippines, 82% in Viet Nam, and 50% in Thailand.

Third, there is a mismatch between job seekers' expectations and opportunities and employers' skills requirements. In Brunei, for example, the result has been that migrant workers take private sector jobs. In some countries, the skills mismatch may stem from too many students with higher (tertiary) education degrees and too few obtaining the technical and vocational qualifications which meet countries' skills needs. In the Philippines, there are shortages in medical and health-care services and in the business process outsourcing industry, but an oversupply of the arts graduates. The same problem occurs in Cambodia, where the country generates far more university graduates – mostly in a handful of subjects (typically, social sciences and business-related studies) – than it does mechanics, electrical technicians, or hospitality and building-trade professionals for whom there is the greatest call.

Fourth, some labour markets have inflexible institutional and weak regulatory structures which can prove difficult to change. For instance, the rigidity of labour regulations in Indonesia inhibits job creation and fails to provide protection for the most vulnerable workers.

What is more, some countries – such as the Philippines and Viet Nam – face the challenge of regulating and protecting the many emigrants from their populations who work and live abroad and whose remittances are vital to the domestic economy. There are around 10 million Filipinos overseas, while more than 70 000 Vietnamese quit the country for jobs abroad every year.

To deal with these issues, individual ASEAN governments have come up with a wide variety of programmes and reforms to reduce skill mismatches, raise the quality of the workforce and improve social protection for their workers (Table 3.4).

Table 3.4. **National initiatives to improve labour markets in ASEAN countries**

Country	Organisation/Initiative	Strategy
Brunei Darussalam	The 21st Century National Education System	Enhance vocational education to orientate Bruneians towards more manual, semi-skilled, and skilled jobs (Cheong and Lawrey, 2009).
Cambodia	Ministry of Labour and Vocational Training (MLVT)	Mandated to manage the social security system for those who fall under the provisions of Labour Law. It has so far put in place labour risk insurance for about 400 000 workers and employees in all types of business establishments and will expand the coverage of this scheme to the whole country.
	National Training Board (NTB)	Formed to oversee the co-ordination and development of technical and vocational education and training (TVET) and aims to adjust TVET to the needs of the labour market (ILO, 2012).
	Co-operation with external parties	To assist Cambodians seeking overseas employment, the MLVT forged with its Korean counterpart an Employment Permit System to recruit and send Cambodian workers to Korea and to manage them there. Moreover, the ministry is working with international organisations such as the ILO and the International Organisation on Migration (IOM) to improve the system of managing the placement of Cambodians abroad.
Indonesia	Ministry of National Education (MoNE)	Issued three significant labour laws between 2003 and 2007: the Industrial Disputes Settlement Law 4/2004, the Social Security Law 41/2004 and the Migrant Worker Law 39/2004. To address the skills mismatch issue, the MoNE launched its controversial "70:30" policy that aims to have 70% of all senior secondary students enrolled in public and private vocational (SMK) schools by 2015 (World Bank, 2010).
Lao PDR	The National Economic and Social Development Plan (2006-2010)	Aims to enhance employment creation, improve social security, expand social protection, and promote safety and health, including HIV/AIDS workplace policy and safe labour migration.
Malaysia	Tenth Malaysian Plan, 2011-2015	Aims to enhance the quality of the workforce in the following ways: • Enhance both the quality and quantity of technical and vocational education and training by establishing 10 skills training institutes and upgrading 16 existing institutes to produce the skills enhancement that meet industry requirements. • The National Dual Training System (NDTS) and apprenticeship scheme were intensified through greater collaboration with industry sectors. • The National Skills Development Act was enacted in 2006 to enforce accreditation procedures. • Lifelong learning programmes were enhanced through the expansion of distance learning, e-learning, retraining and skills-upgrading offered by various institutions. • Enhance Bumiputra representation in highly paid jobs through supply-side and market-friendly demand-side measures and the requirement that employers disclose the gender and ethnic make-up of their workforce. • Improve the unskilled foreign labour policy through a new multi-tiered levy system to encourage employers of unskilled workers to move towards a highly skilled workforce. The skills and capabilities of the existing workforce will be upgraded through the expansion of upskilling and retraining activities, such as the Skills Development Fund, the Human Resource Development Fund (HRDF), or the Industrial Skills Enhancement Programme (INSEP). With regards to attracting skilled foreign talent, the objective is to simplify procedures and provide better incentives by aligning with the more liberal work permit requirements of other high-income countries.

Table 3.4. (contd.)

Country	Organisation/Initiative	Strategy
Philippines	Department of Labour and Employment (DOLE) / Philippine Labour and Employment Plan (2011-16)	• Facilitate employment through the expansion of the PhilJobNet system to cover job and applicant matching, house databases such as the Integrated Human Resources Data Warehouse, the National Skills Registry System and job vacancy management. • Advocate the institutionalisation of Public Employment Services Offices (PESOs). • Expand the number of walk-in examinations (WES) for maritime professionals to address the growing needs for licensures among maritime professionals and other engineering and health-related professions. • Conduct labour market signalling activities on a regular basis to flag the unemployed and employers with critical information that will lead to better management of skills availability in the labour market. • Publish industry career guides containing critical indicators on the growth potential of key industries in the medium term and their skills requirements.
Singapore	Ministry of Manpower	Aims to upgrade the skills of its workers, moderate the supply of foreign workers and provide support for low-wage workers: • The Workforce Skills Qualifications system trains, develops, assesses and recognises individuals for competencies that companies are looking for. • Enhance lifelong learning through the Continuing Education and Training (CET) centre. • In the period between 2008 and 2010, the Skills Programme for Upgrading and Resilience (SPUR) was introduced to help companies and workers manage the economic downturn and invest in skills ahead of recovery. • A high-level National Productivity and Continuing Education Council (NPCEC) was set up to strengthen efforts to boost skills and enterprise productivity. • Revised the qualifying salary threshold for work permits to better manage the inflow of foreign workers. Foreign worker levies were also increased in phases between January 2012 to July 2013 while the proportion of foreign workers that companies could hire was lowered from July 2012 onwards. • Support for low-wage workers through the Workfare Bonus Scheme (WBS), Workfare Income Supplement (WIS) and Workfare Training Support (WTS) schemes.[7]
Thailand	National Economic and Social Development Board	Aims to: • Accelerate the development of labour skills in accordance with labour market demand. • Revise employment-related definitions and classifications.
Viet Nam	Ministry of Labour, Invalids and Social Affairs (MOLISA) / The Viet Nam Employment Strategy for 2011-20	• Provide compulsory social insurance for employees, mainly in the public sector and foreign-owned enterprises, under the Social Insurance Law of 2007. • The Unemployment Insurance Scheme of 2009 entitles workers who have lost their jobs in enterprises registered with ten or more workers to receive a payment of 60% of the average pay of the last six months of employment. • The Law on Vocational Training (2006) aims to strengthen vocational training policies by: widening the vocational training network and improving the vocational training quality; investing in certain skill-focused vocational training; publicising vocational training activities; and supporting those who the policy is aimed at in getting jobs.

Source: OECD Development Centre's compilation based on national sources.

ASEAN approach to improving higher education more hands-on than in the labour sector

In education, the human resource development gap between ASEAN-6 and CLMV economies is driven primarily by the access and quality of higher education. At the regional level, ASEAN has mapped out a Five-Year Work Plan on Education (2011-2015) which focuses on the two issues. It intends to work through the regularly held ASEAN Education Ministers' Meetings (ASED) with the aim of enhancing regional co-operation in education.

Various projects and activities are carried out by the ASEAN Senior Officials on Education (SOM-ED), which reports to the ASED. One key initiative on co-operation in higher education carried out by SOM-ED is the ASEAN University Network (AUN), a programme that promotes student mobility in ASEAN (see Box 3.4 for further information on AUN).

In addition, ASEAN education ministers have agreed to integrate their respective programmes and activities in a complementary manner with the Southeast Asian Ministers of Education Organisation's (SEAMEO) and, correspondingly, the SEAMEO Regional Centre for Higher Education and Development (SEAMEO RIHED). Both bodies share many characteristics for facilitating student mobility in the region[8] – namely, the sharing of experience in issues of higher education, quality assurance and credit transfer (see Box 3.4 for more information on SEAMEO RIHED).

Other regional education co-operation agreements include the ASEAN+3 Plan of Action on Education 2010-2017 and the East Asia Summit Education Co-operation Action Plan 2011-2015. They have similar plans for closer linkages between universities and encouraging credit transfers in ASEAN+3 countries.

Box 3.4. **ASEAN efforts to improve higher education at the regional level**

ASEAN has centred its commitment to better regional higher education on improving quality assurance mechanisms and streamlining university curricula and grading systems. AUN and SEAMEO RIHED are the two bodies with regional reach that are key to the higher education effort.

ASEAN University Network (AUN)

The key objectives of AUN, which includes 26 universities from the ten ASEAN countries, are:

- to strengthen the existing network of co-operation among universities in ASEAN,
- to promote collaborative study, research and educational programmes in the priority areas identified by ASEAN,
- to promote co-operation and mutual support among scholars, academics and researchers in ASEAN member states,
- to serve as the policy-oriented body in higher education in the ASEAN region.

To raise standards, AUN began operating a regional quality-assurance system to assess undergraduate programmes at its member universities in 2007. It hopes to open the process to other universities in 2012 and extend it to postgraduate programmes in 2013. The focus areas of AUN in 2010-11 were quality assurance, student mobility,[9] academic exchange, intellectual property and an improved AUN database:

Quality assurance. In order to further promote the development of quality assurance (QA) system among AUN member universities, the following activities were planned: review of AUN-QA documentation hosted by the National University of Singapore in September 2010; AUN Actual Quality Assessments at programme level; benchmarking by peer assessment: AUN-QA Peer Assessment at programme level; and Actual Quality Assessment at the institutional level.

Student mobility and academic exchange. To facilitate student mobility among AUN Member Universities, AUN took the following action: provided an up-to-date inventory of the courses and programmes available to exchange students; introduced an ASEAN Credit Transfer System that will be applied to the AUN Student Exchange Programme; together with AUN member universities it introduced an initiative to grant five full scholarships per year to help university students from one AUN member university to study in another one. In order to foster research collaboration, AUN has acted to encourage ASEAN scholars to share expertise and technology, while the AUN secretariat further planned joint academic conferences and workshop on topics of particular interest and exchanges of PhD students across universities.

Box 3.4. (contd.)

Intellectual property (IP). To boost co-operation in the AUN Intellectual Property Network (AUNIP) and achieve ASEAN's goal of using IP to promote the creative economy, the AUN Secretariat collaborates with the EU-supported ECAP III Programme (2010-2014) to implement a number of workshops: AUNIP Annual Academic Conference hosted by Nanyang Technological University on 16-17 November 2010 in Singapore; Workshop on Developing IP Policies and Support Services at Nanyang Technological University on 18-19 November 2010 in Singapore; and ASEAN IP Curriculum and Teaching Materials for universities to promote IP awareness and appreciation.

AUN database. The AUN Secretariat has planned to update the AUN database with the following features: improved AUN website; up-to-date AUN directory and archives, which include basic information on AUN member universities and a list of contacts; UN ICT Network in preparation for the inception of the ASEAN-ROK e-learning Network; and an ICT knowledge-based centre.

Southeast Asian Ministers of Education Organisation Regional Centre for Higher Education and Development (SEAMEO RIHED)

SEAMEO RIHED, which is based in Thailand, promotes regional co-operation and development in higher education by assisting member countries in fostering efficiency and effectiveness through policy-oriented research and professional training courses, workshops, seminars, conferences and educational trips. SEAMEO RIHED takes action to strengthen the capacity of university board members and administrators in the areas of university governance, quality enhancement, strategic planning and knowledge, as well as the harmonisation of higher education across the region.

Under the M-I-T (Malaysia-Indonesia-Thailand) Student Mobility Programme, SEAMEO RIHED convened two meetings in 2009 among the three participating countries where five disciplines for student exchange were selected, namely, agriculture, language and culture, hospitality and tourism, international business and food and science technology. Other details agreed upon were the language to be used in the programme, the number of participating universities and the number of students targeted.

Under Quality Assurance in Higher Education, SEAMEO RIHED initiated discussions to collaborate with the ASEAN Quality Assurance Network in developing the ASEAN quality assurance and qualification framework. It also held talks with the ASEAN University Network, and the ASEAN Quality Assurance Network to promote cross-organisational collaboration on the same topic in Southeast Asia. It subsequently organised a workshop on 16-18 November 2009 in Myanmar for 25 university administrators in the Greater Mekong Subregion to further develop the quality assurance system of their respective institutions and encourage greater use of resource personnel from SEAMEO Member Countries to assist with the development of quality assurance systems.

In 2009, SEAMEO RIHED began developing a Southeast Asian credit transfer system template based on the existing model, University Mobility in Asia and the Pacific (UMAP). The idea was that it should serve as the main mechanism for promoting and facilitating mobility programmes in participating countries. The centre also hosted a policy forum on 28-30 June 2010 that generated recommendations on the key principles of a credit transfer system.

As a platform for sharing experience on higher education issues, SEAMEO RIHED, in co-operation with the Indonesian Ministry of National Education, convened the 4th Meeting of Directors General, Secretaries General and Commissioners of Higher Education in Southeast Asia. The meeting, held in Jakarta on 11 March 2010, focused on future regional collaboration in the areas of student mobility, executive development, e-learning, mobile learning and research.

Source: OECD Development Centre's compilation based on national sources.

ASEAN'S higher education challenges range from improving access to improving institutions

In addition to the country level objectives of improving the quality of access to higher education, countries such as Cambodia, the Philippines, Singapore and Thailand also list more equitable access to education as a priority. Cambodia and Viet Nam, for their part, seek to build capacity in areas such as staff training, institutional management and to foster the greater operational autonomy of higher education institutions (Table 3.5).

Table 3.5. **National initiatives to improve higher education in ASEAN**

Country	Organisation/Initiative	Strategy
Brunei Darussalam	The 21st Century National Education System (SPN 21) Strategic Plan (2007-2011) of the Ministry of Education	Plans to increase tertiary enrolment rate to 30% by 2011.
Cambodia	Ministry of Education, Youth and Sport (MoEYS) The Master Plan for Research and Development in the Education Sector (2011-2015)	• Issued a regulation on the conditions and detailed criteria for establishing higher education institutions (HEIs) in the country in 1997. • Phased expansion of higher education institutions and prioritised professional programmes in areas like education, health care, arts and humanities, agriculture, engineering, technology, science and mathematics in 2011. • Created standards to review current higher education institution management structures in accordance with the Educational Law and drew up capacity development plan for administrative staff and lecturers by 2011. • Expanded the scholarship programme in higher education to 15% of the number of students who graduate from upper secondary education from 2011 onwards. • Improved higher education facilities, e.g. infrastructure and dormitories, from 2012. • Drew up plans to improve the quality of teaching, learning and research in higher education by updating teaching methodologies, developing curricula and equipping higher education institutions with better facilities. These measures will build on a curriculum development framework and a qualification framework for higher education to be created by 2012. • Will set forth the principles for the governance and financial management of higher education institutions by 2012. • Will improve the HEI staff profile annually by bringing in staff who return from study overseas and will report on the number of credible MA/MSc and PhD degrees • Will ensure that researchers are engaged in a wide range of research topics and will improve the capacity of researchers and HEIs.
Indonesia	Ministry of National Education / Higher Education Long-term Strategy (HELTS) 2011-20	• Integrated internal and external quality assurance in higher education institutions and will develop a HEI database • Ensures the transparency and accountability of autonomous HEIs in Indonesia through the "Law of Education Legal Entity".
Lao PDR	Ministry of Education / Master Plan for the development of Higher Education	Main objectives are to widen equitable access; enhance the quality and relevance of higher education; and improve the governance and management of the sector.
Malaysia	National Higher Education Strategic Plan (NHESP)	• Aim is to make Malaysia a "hub of higher education excellence" in the region by 2020 by developing human capital with "first-class mentality". • Set up the Malaysian Qualifications Agency in 2007 to implement the Malaysian Qualifications Framework (MQF) as the basis for quality assurance of higher education and as the reference point for the criteria and standards of national qualifications.

Table 3.5. (contd.)

Country	Organisation/Initiative	Strategy
Malaysia (cont.)	Ministry of Higher Education (MOHE)	• Established the Rating System for Malaysian Higher Education Institutions ("Sistem Penarafan Institusi Pengajian Tinggi Malaysia" [SETARA]) in 2007. • Introduced the Accelerated Programme for Excellence (APEX) the Science University of Malaysia ("Universiti Sains Malaysia" [USM)] as the first APEX University.[10] • Introduced the Generic Students' Attributes Self-Assessment Test in 2010 – also known as the Malaysia Soft Skill Scale or My3S – to evaluate graduate competency in soft skills. • In 2010, MyBrain15 programme was initiated to encourage more students to pursue their studies to PhD level.
Myanmar	Myanmar's Vision of Education	Aims to create an education system that can generate a learning society capable of facing the challenges of the knowledge-based society.
	30 Year Long Term Education Development Plan 2001/02-2030/31	Focuses on key areas of higher education, such as: the development of human resources, use of ICT, expansion of research, development of a lifelong learning society, promotion of the quality of education, and the preservation of national identity and values.
Philippines	Philippine Development Plan 2011-2016 / The Commission on Higher Education (CHED) / The Technical Education and Skills Development Authority (TESDA)	• Provide scholarships and student financial assistance programmes such as the Private Education Student Financial Assistance Programme (PESFA), the ADB-assisted Technical Education and Skills Development Programme (TESDP), the President Gloria Scholarship (PGS) Programme and the Ladderised Education Programme (LEP). • Streamlined the guidelines of its student financial assistance programmes (StuFAPs). • The Medium-Term Development plan focuses on - Enhancing private-sector resources. - Improving the efficiency of the publicly funded forms of student financial assistance. - Rationalising the number, size and roles of HEIs. - Enhancing the cross-level mobility of students between higher education and middle-level skills development. It uses the Philippine National Qualification Framework (PNQF), the Ladderised Education Programme, the Expanded Tertiary Education, Equivalency and Accreditation Programme (ETEEAP), and other modalities.
Singapore	Ministry of Education	Its aim is to expand publicly funded university education: • Nanyang Technological University (NTU): Singapore has committed to providing subsidised university education to 30% of every Primary 1 cohort by 2015. The target of 25% was achieved in 2008, ahead of its original target date of 2010. • Established a new a new publicly funded university, which took in its first batch of students in 2011. • Study the feasibility of establishing a liberal arts college. • Provide funding for part-time degree programmes offered by the National University of Singapore (NUS), NTU, and the Singapore Institute of Management (SIM) University. • Set up the Private Education Division in 2008 to oversee regulation of the private education sector, which includes private education organisations offering external degree programmes as local agents.
Thailand	Ministry of Education	Seeks to develop quality assurance in higher education. • Under the Thai Qualifications Framework for Higher Education, 44 quality assurance indicators were developed and the Commission on Higher Education Quality Assurance Database System (CHE QA Online) was set up in 2009. • Launched a three-year National Research Universities' project to enhance the research capacity of universities. • Launched the Malaysian, Indonesian and Thailand Student Exchange Programme (MIT) in 2010 to harmonise higher education in the three respective countries through student exchanges.

Table 3.5. (contd.)

Country	Organisation/Initiative	Strategy
Viet Nam	Ministry of Education and Training / Master Plan on the Development of Viet Nam's Human Resources (2011-20)	• Established the Department of Testing and Educational Quality Evaluation in 2004 to support quality assurance in universities and colleges. • Requested that from 2007 identified target enrolment rate should be based on the quality of teachers and specialised equipment and laboratories available for each student. • Strict, standardised university entrance exams have been introduced for all universities and colleges. • Implemented 23 advanced training curricula in 17 universities in key selected areas of industry-related science and technology. • Signed agreements to certify equivalent qualifications between over 30 Vietnamese universities and 10 countries around the world. • Gave priority to the construction of universities and colleges in Viet Nam's northern mountainous areas, the Central Highlands and the Mekong River delta regions. • Aims to open four prominent universities reaching international standards by 2020 and to attract a number of universities of high international standard to the country.

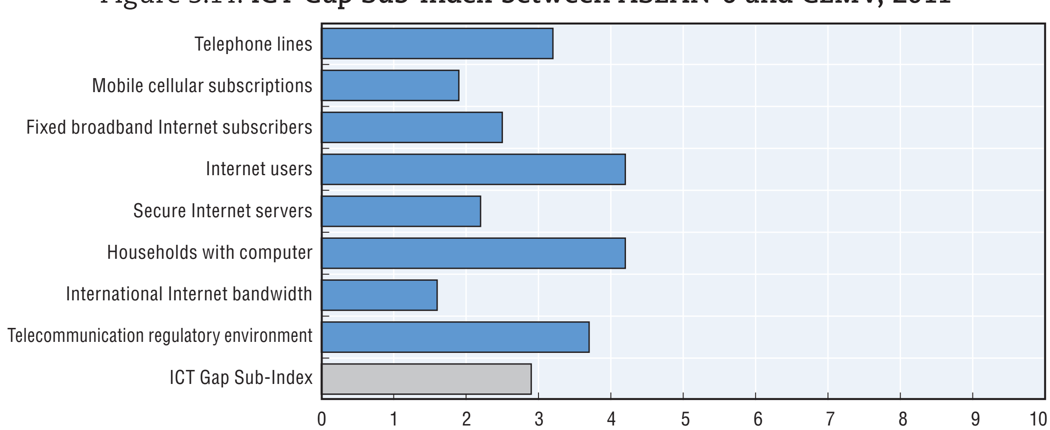
Source: OECD Development Centre's compilation based on national sources.

Information and communication technology (ICT)

ICT development gap between ASEAN-6 and CLMV narrower than other sub-indices

Recent major improvements in ICT infrastructure have enabled better information and communication among people and businesses across Southeast Asia, a trend corroborated by the ICT Gap Sub-Index. The gap narrowed from 3.2 in 2005 to 2.9 in 2011, a fall that takes it below the six policy areas' overall NDGI of 3.2. With regard to individual sub-components, the widest gaps between ASEAN-6 and CLMV economies can be observed in the number of Internet users (per 100 people) and the percentage of households with computers. This indicates that ASEAN countries, and especially the CLMV economies and in rural areas, continue to face challenges of extended coverage and access to fixed and wireless telephone and Internet connections. The gap in the telecommunications' regulatory environment is also wide. Accordingly, more can also be done to strengthen public agencies and regulatory bodies by formulating and enforcing laws and regulation that foster competition in the ICT sector (Figure 3.14).

Figure 3.14. **ICT Gap Sub-Index between ASEAN-6 and CLMV, 2011**



Source: OECD Development Centre's calculations based on World Bank`s *World Development Indicators* (WDI), International Telecommunication Union`s *Measuring the Information Society 2011*, and national sources.

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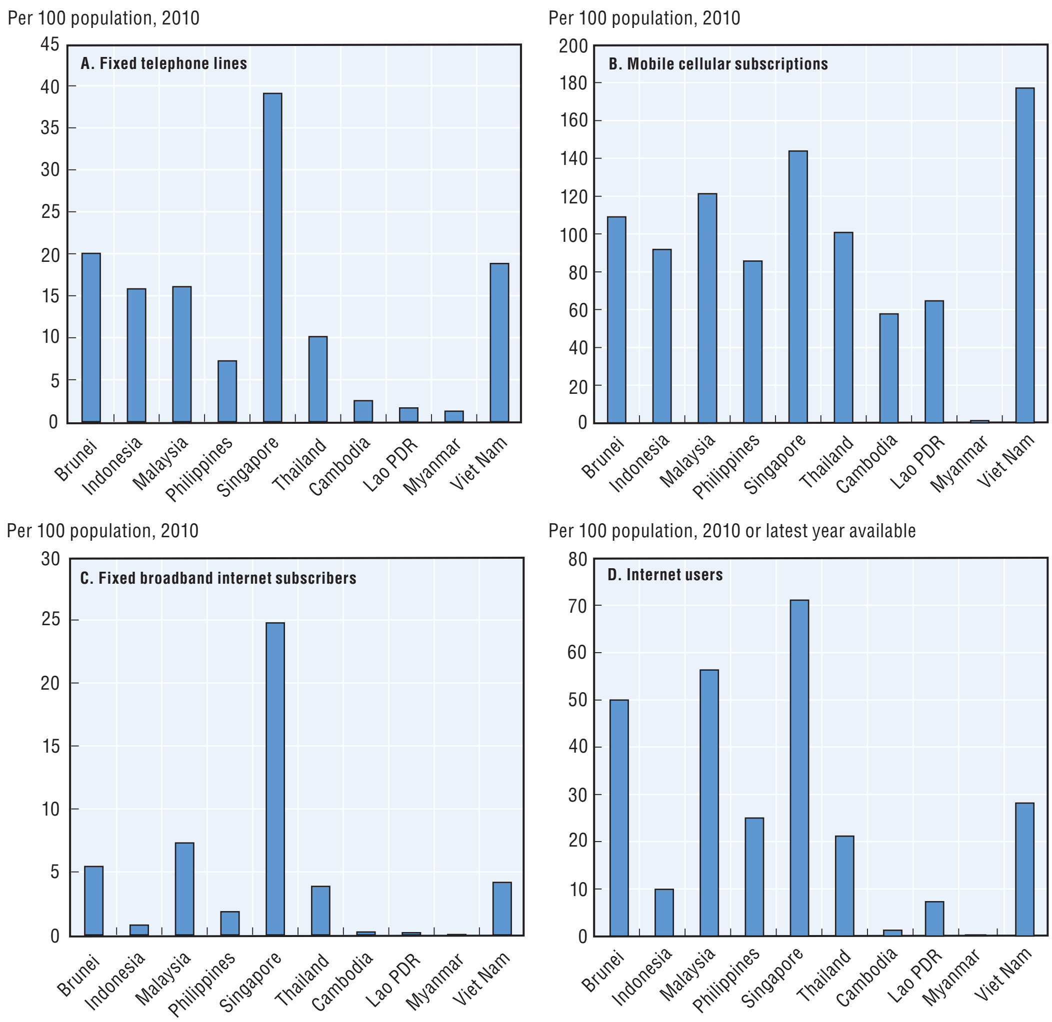
Country figures show pronounced gaps not just between ASEAN-6 and CLMV, but within each group. Singapore (and, to a certain extent, Brunei) act as outliers for all indicators within ASEAN-6, while Viet Nam scores above CLM-average on most indicators. For instance, 71 people in every 100 used the Internet in Singapore in 2010, compared to just 21 in Thailand. Among the CLMV countries, the figures were 28 per 100 in Viet Nam, and just 0.2 out of 100 in Myanmar (Figure 3.15, D). Approximately 0.2% of the population had subscribed to fixed broadband Internet in Lao PDR in 2010, against 25% in Singapore (Figure 3.15, C). Differences in the number of mobile cellular subscriptions are also large. Viet Nam is the highest with around 177 mobile phone subscriptions per 100 people in 2010, whereas in Myanmar approximately only 1 in every 100 people had subscribed to mobile phone services (Figure 3.15, B). In total, mobile penetration has reached the 100% mark in five ASEAN countries so far.

Figure 3.15. **ICT access in ASEAN countries**



Source: World Bank *World Development Indicators*.

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ASEAN-6 national policies to expand ICT by targeting investment in infrastructure and human capital

ASEAN countries have accelerated their efforts to narrow the digital divide through national and regional policy initiatives to improve ICT access and connectivity to an overall population of over 500 million. The ASEAN ICT Masterplan 2015 is the integrated ICT policy framework for furthering region-wide affordable, cost-effective ICT as a driver for economic transformation. The master plan builds on investment in infrastructure, human capital development and innovation.

Infrastructure development takes the form of an ASEAN Broadband Corridor, which prioritises the ASEAN Internet Exchange Network, a framework for network and cyber security, and the enhanced mobilisation of the private sector through public-private partnerships (PPPs). In addition, the harmonisation of ICT regulation and the sharing of best practices and business data among ASEAN member countries for a business-friendly environment are considered ways of transforming the economy across sectors. Furthering the engagement and empowerment of users through affordable and equitable ICT access (e.g. by lowering intra-ASEAN roaming charges) is another central policy pillar.

Table 3.6. **National initiatives to improve ICT development in ASEAN**

Country	Organisation/Initiative	Strategy
Brunei Darussalam	ICT Competency Programme	Offers subsidised training courses (up to 50% of the total cost) to individuals and employees in small and medium sized enterprises (SMEs) in non-ICT sectors.
	Grant from AITI (Authority for Infocommunications Technology Industry of Brunei Darussalam)	The grant can be used for different activities, ranging from product enhancement to marketing and packaging, and is awarded to stimulate local private sector innovative activity in ICT.
Indonesia	The Sub-district Internet Provision Center (PLIK) and the Mobile Sub-district Internet Provision Center (MPLIK) programmes by the Ministry of Communication and Information Technology	Aims to provide Internet access for all 6 468 sub-national districts by the end of 2012, with the help of private sector contributions from cellular and Internet service providers operating in Indonesia.
Malaysia	National Broadband Initiative by the Malaysian Communications and Multimedia Commission	Increase Internet access connectivity through high-speed broadband programme, public internet centres ("Pusat Internet Rakyat"), community broadband centres, e-kiosks in remote and rural areas, and the "1-Million Netbook Initiative" for poor students nationwide.
Singapore	Infocomm Development Authority of Singapore	Develop the Next Generation National Infocomm Infrastructure, leveraging both wired and wireless technologies: • **Wired network infrastructure.** The Next Generation Nationwide Broadband Network is an all-fibre data transmission network that enables high-speed broadband access of up to 1Gbps and is expected to extend network coverage to approximately 95% by mid-2012. • **Wireless network access.** Wireless@SG programme will expand wireless broadband access with speeds of up to 1Mbps in public areas. • **ICT in education.** A policy initiative that includes the Future Schools@Singapore programme and aims to develop 15 prototype schools which incorporate IT into all aspects of the learning environment by 2015.
Viet Nam	Masterplan for the Development of Information Technology Human Resources to 2015 and Orientation towards 2020	Aims to widen the human resource base for ICT through IT training courses (e.g. courses on ICT-related business English), conducted in co-operation with 33 different universities and technical institutes across the country.

Source: OECD Development Centre's compilation based on national sources.

ICT innovation will also be nurtured by rewarding business innovators and introducing new intellectual-property-rights-driven regimes and digital content exchange mechanisms across the region. Another central element comes in the shape of investment in human capital development through an ASEAN ICT scholarship scheme and different ICT certification programmes – e.g. by increasing ICT roll-out in schools and through enhanced collaboration between the relevant ministries across member countries. So far, telecommunications and ICT ministers from member countries have approved 21 initiatives to be implemented in 2012.

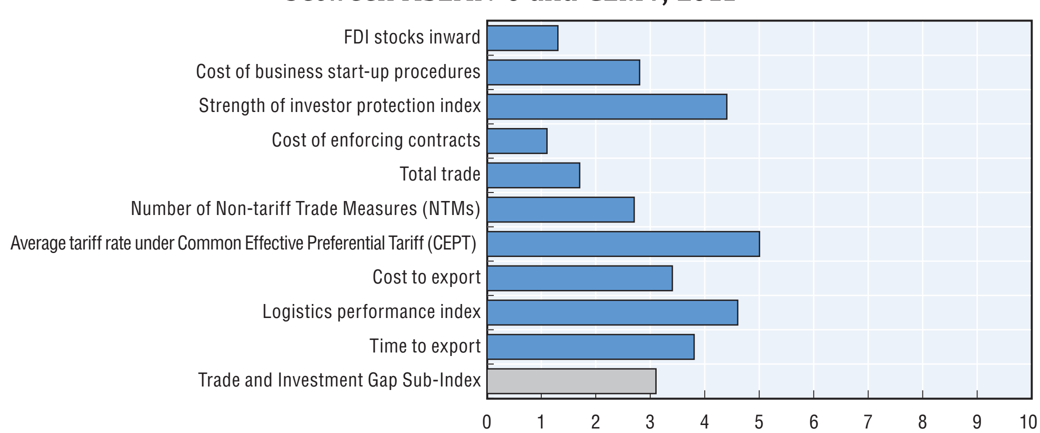
On the national level, individual ASEAN member countries are implementing different types of ICT strategies based on individual country needs assessments in different resource and technology capabilities. High and upper-middle-income ASEAN countries are investing heavily in advanced ICT infrastructure to further transform their economies into global knowledge hubs. On the other hand, lower middle-income and low-income countries in ASEAN are focusing on the need to expand their domestic mobile cellular and broadband coverage in urban and rural areas through investment in infrastructure and human capacity building programmes (see Table 3.6).

Trade and investment (regional economic integration)

Trade and investment development gaps in ASEAN have not improved over time

The Trade and Investment Gap Sub-Index showed a gap of 3.1 base points between ASEAN-6 and CLMV countries – unchanged from its previous score in 2005. The score suggests that both trade and investment initiatives at regional and individual country levels are not making the required progress in narrowing the development gaps. Measurements using ten trade- and investment-related sub-components reveal that trade component gaps contributed more to the overall economic integration gap than investment components, as Figure 3.16 illustrates. Among the investment sub-components, investor protection shows the widest gap at 4.4 base points, which points to the difficulty of creating an environment where investors, foreign and domestic, can feel secure. On the trade side, the widest gaps are in the average tariff rate under the Common Effective Preferential Tariff (CEPT) scheme – 5.0 points – and the logistics performance index, at 4.6 base points.

Figure 3.16. **Trade and Investment Gap Sub-Index between ASEAN-6 and CLMV, 2011**



Sources: OECD Development Centre's calculations based on UNCTAD, World Bank`s *World Development Indicators* (WDI), World Bank's *Doing Business* database, World Bank`s *Investing Across Borders*, *ADB Key Indicators* 2011 ADB Regional Integration database, IMF DOT database, ASEAN Secretariat.

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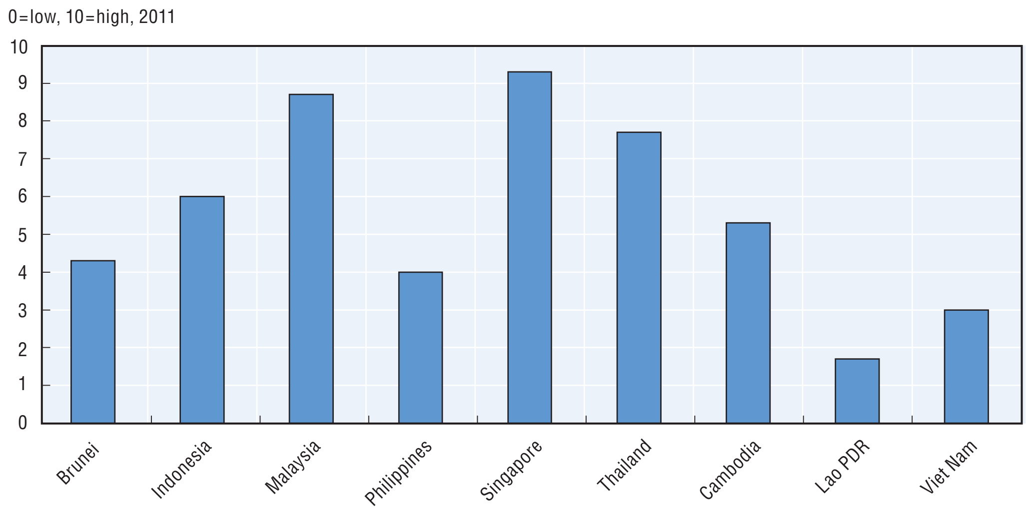
Wide differences can also be observed between countries. In investment, the gap between ASEAN-6 and CLMV countries in the cost of business start-up procedures is caused primarily by the high cost in Cambodia. ASEAN-6 economies in general also enjoyed higher investor protection – e.g. strong minority shareholder protection against directors' misuse of corporate assets for personal gain, investors' freedom to choose capable management for the firms they invest in and the ability of the state to settle disputes between shareholder and company (Figure 3.17).

Figure 3.17. **Strength of investor protection in ASEAN countries**



Notes:

No data available for Myanmar.

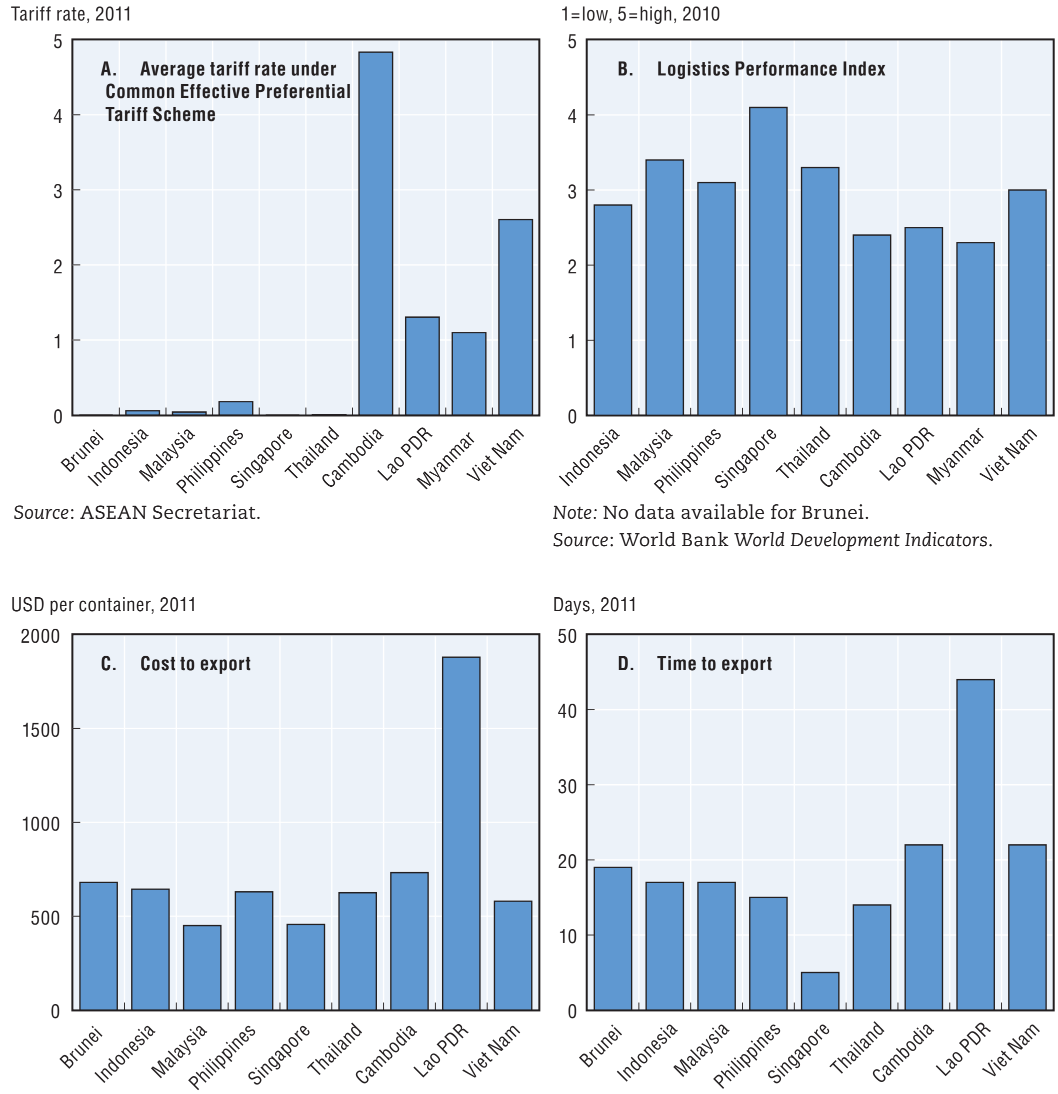
The strength of investor protection index is the average of the extent of disclosure index, the extent of director liability index and the ease of shareholder suits index.

Source: World Bank's *Doing Business* database.

StatLink *http://dx.doi.org/10.1787/888932775117*

CLMV countries should make greater effort in the area of trade, especially with regard to tariff reduction and logistics efficiency. In general, the less developed, less open CLMV economies have higher tariff rates and poorer logistics performances than ASEAN-6 countries (Figure 3.18, A and B), where the removal of tariff and non-tariff barriers involves less paperwork. Furthermore, CLMV reforms in logistics services – such as border clearance processes, competence and quality of transport-related infrastructure and logistics services – are slower than in ASEAN-6 countries. For instance, Lao PDR's delivery cost and timeliness indicators (as measured by cost and time to export) revealed that it was the Southeast Asian country from export procedures that cost the most (USD 1 880 per container compared to the ASEAN-6 average of USD 581) and took the longest time (44 days against an average of 15 days) (Figure 3.18, C and D).

Figure 3.18. **ASEAN countries' trade performances**



Source: ASEAN Secretariat.

Note: No data available for Brunei.

Source: World Bank *World Development Indicators*.

Notes: No data available for Myanmar.

Cost to export measures the fees levied on a 20-foot container in USD.

Source: World Bank *World Development Indicators*.

StatLink http://dx.doi.org/10.1787/888932775136

Note: No data available for Myanmar.

Source: World Bank *World Development Indicators*.

National economic growth plans slow regional and subregional schemes to attract FDI

Foreign direct investment (FDI) is extensively reported to have tremendous benefits in developing economies. It is argued that foreign capital inflows enable less developed host countries to benefit from the transfer of technology from more developed economies and that the spillover effects boost job creation and human capital development in the domestic labour market.

Mindful of this, ASEAN has several regional agreements in place that seek to improve co-operation in attracting and facilitating investment and to sell the region to foreign investors. The ASEAN Agreement for the Promotion and Protection of Investment (commonly known as the ASEAN Investment Guarantee Agreement [IGA]) was signed in 1987 and followed by the ASEAN Investment Area (AIA) in 1998. There were further institutional developments in February 2009 when the ten ASEAN member countries signed the ASEAN Comprehensive Investment Agreement (ACIA). It replaced the IGA and AIA and reinforced ASEAN's commitment to establishing a stable environment for inward investment. At the core of the agreement is the objective of further liberalising, protecting, facilitating and promoting FDI in sectors such as manufacturing, agriculture, mining, forestry and fishery, and services.

Some ASEAN member countries also signed subregional investment programmes to attract greater investment. For example, in 1991, Indonesia and Singapore entered into an investment agreement (the "Batamindo and Bintan Project") to develop the Batamindo and Bintan industrial estates in the Riau islands. Both countries have since agreed to include Malaysia as a partner to enhance triangular growth opportunities. The project is still in progress. In addition, Viet Nam and Lao PDR have also come together to facilitate land concessions and plantations in both countries.

However, ASEAN's attempts to encourage region-wide investment co-operation seem to be moving slowly. For example, the ratification of the ACIA, although agreed upon in 2009, took three years to complete and only came into force in April 2012. Such a slow pace suggests that national sensitivities and priorities hinder countries' commitments to implementation timelines.

At the country level, the investment policy of individual ASEAN member countries may differ from one another, depending on the individual country's priorities for economic development (Table 3.7). For instance, Brunei focuses on several key industry clusters that have the potential to bring value added activities to the country and create spin-off opportunities, while modernisation of the Brunei International Airport, scheduled for completion in 2014, is expected to contribute to the tourism sector and to trade and investments in general.

Table 3.7. **National initiatives to promote trade and investment in ASEAN**

Country	Sectoral focus/Key measures
Brunei Darussalam	Key export-oriented sectors identified by the Brunei Economic Development Board (BEDB) are: • pharmaceutical, food and food ingredients, petrochemicals, integrated petrochemical refinery and renewable energy within the manufacturing sector; • ICT, logistics and oil field support services within the services sector. A project to modernise Brunei International Airport is underway.
Cambodia	• 21 special economic zones (SEZs) have been approved across the country. • SEZs provide domestic/foreign investors with an attractive investment environment. • 8 of these SEZs are in operation and it is expected that further SEZs will be developed.
Indonesia	• One-stop-shop system (PTSP) is implemented by Presidential Decree. • PTSP allows investors to process business licences faster. Infrastructure, food and agriculture, and energy are identified as key opportunities for investment (e.g. construction of railways from Soekarno-Hatta Airport to Manggarai Station, DKI Jakarta, will be conducted through a public-private partnership(PPP) scheme.
Lao PDR	The new Investment Promotion Law was promulgated in July 2009: • comprises both domestic and foreign investment promotion laws; • creates "level-playing-field" for both domestic and foreign investors. The National Committee for Special Economic Zone Development was established immediately the new law was promulgated.
Malaysia	Direct and indirect tax incentives: • are provided in the Promotion of Investments Act 1986, Income Tax Act 1967, Customs Act 1967, Sales Tax Act 1972, Excise Act 1976, and Free Zones Act 1990; • cover manufacturing, agriculture, biotechnology, tourism, shipping & transportation, ICT and approved services sectors, R&D, training and environmental protection activities; • include, for instance, the Pioneer Status and the Investment Tax Allowance, which grant companies a five-year partial tax exemption or allowance of capital expenditure.
Myanmar	Foreign investors are: • allowed to Invest in agriculture, livestock and fishery, forestry, mining, industry; construction, transportation and communication, and trade sectors; • also allowed 100% equity ownership in accordance with the Foreign Investment Law; • granted a minimum of 3-year corporate income tax exemption. The Myanmar SEZ Law and the Dawei SEZ Law were promulgated in 2011. Although the government has made progress toward political reform, which may attract foreign investment, implementation of new foreign investment law has been delayed.
Philippines	The Investment Priorities Plan (IPP) 2012 identifies as preferred activities: • Agriculture/agribusiness and fishery, creative industry/knowledge-based services (business process outsourcing and IT), shipbuilding, mass housing, iron and steel, energy, infrastructure, R&D, green projects, motor vehicles, strategic projects, hospital/medical services, and disaster prevention, mitigation and recovery projects. A network of Investment Promotion Agencies (IPAs) is created in order to contribute to diversifying location offerings and maximising advantages inherent to a given location across the country.
Singapore	Economic Development Board (EDB) provides incentives and development schemes through: • the "from host to home" strategy, • Research Incentive Scheme for Companies (RISC), • initiatives in New Technology (INTECH), • attracting foreign companies from various fields, such as biomedical science, energy and chemicals, ICT, logistics, precision engineering, and transport engineering.
Thailand	The Board of Investment has given priority to • Agricultural activities and agricultural products, projects related to technological and human resource development, public utilities, infrastructure and basic services, environmental protection and conservation, and targeted industries. No equity restriction on foreign investors in manufacturing projects. The country is divided into three economic zones to create more effective incentive schemes.
Viet Nam	Discussions related to the promotion of foreign investment are currently taking place. • The Law on Corporate Income Tax could be revised in order to allow expanded projects to enjoy incentives, since the law has stipulated that only new investment projects may enjoy corporate income tax incentives. • A special decree on electronic gaming services was proposed in order to encourage further foreign investment and the development of the tourism sector.

Source: OECD Development Centre's compilation based on national sources.

Regional trade liberalisation is slow, but brisk at the country level

One ASEAN goal is to increase the region's competitive advantage as a production base geared towards the world market. To that end, it has adopted a two-pronged approach towards trade integration with its ASEAN and global trade partners.

At the regional level, trade liberalisation – or the elimination of tariff and non-tariff barriers – is key to the formation of a single market and production base. Accordingly, in 2003, ASEAN members issued the Declaration of ASEAN Concord II (also known as the Bali Concord II), following it up it the next year with a framework of agreement on priority sectors in order to complete the ASEAN trade sector institutional setting. Priority sectors include agro-based products, air travel, automotive products, the e-ASEAN initiative, electronics, fishery, health care, rubber-based products, textile, tourism and wood-based products.

Trade liberalisation under the ASEAN Free Trade Area (AFTA) has met with some success. One area is lower tariffs. ASEAN's Common Effective Preferential Tariff Inclusion List (CEPT IL) requires tariffs of 0% and 5%. According to the ASEAN Secretariat, 98.58% of all products in ASEAN were on the CEPT inclusion list by 2007, and tariffs of between 0% and 5% applied to 93.67% of them. Tariffs on 98.67% of the products on the inclusion list of ASEAN-6 countries have been brought down to within the 0-5% range. To date, products in the IL with tariffs of below 5% are those which have been removed from the Sensitive Lists (SL), Highly Sensitive Lists (HSL) and General Exception Lists (GEL). The CLMV countries are also contributing to this progress: they have added 97.32% of their products to the CEPT IL and brought tariffs on 86.21% of them into the 0%-to-5% band.

To improve global trade opportunities, ASEAN has also implemented free trade areas (FTAs) with some of its key trading partners, such as Australia, New Zealand and China. In addition, a number of ASEAN countries are developing subregional trade agreements with one another and/or with the wider community. Several agreements, some supported by the ADB, are shown in Table 3.8.

Table 3.8. **Sub-regional trade co-operation forums and agreements in ASEAN**

Agreement/forum	Countries	Year	Purpose
Trans-Pacific Partnership (TPP)	Brunei, Singapore, New Zealand, Chile are founding members. Australia, Malaysia, Peru, United States and Viet Nam joined in 2010.	2005	The prime purpose of this agreement is a tariff reduction up to 90% by 1 January 2006 and zero by 2015. The agreement also covers the free exchange of goods, services, litigation, intellectual property, etc.
The Brunei-Indonesia-Malaysia-Philippines East ASEAN Growth Area (BIMP-EAGA)	Brunei, Indonesia, Malaysia and the Philippines	1994	Create a regional free trade agreement across the Asia and Pacific region
Greater Mekong Subregion (GMS)	Cambodia, PRC, Lao PDR, Myanmar, Thailand and Viet Nam.	1992	Help the implementation of high priority subregional projects in transport, energy, telecommunications, environment, human resource development, tourism, trade, private sector investment, and agriculture
IMT-GT	Indonesia, Malaysia and Thailand	1993	Accelerate private sector-led economic growth and help facilitate the development of the subregion as a whole. To increase intra-IMT-GT and inter-IMT-GT trade and investment.

Source: OECD Development Centre's compilation based on national sources.

On the country level, individual ASEAN member countries continue to develop FTAs with other countries, either bilaterally or through ASEAN. Besides strengthening bilateral ties and improving market access to goods and services, countries like Myanmar are using the international trade platform to help it to move from a planned economy (where foreign trade was previously a state monopoly) to a market economy with greater participation by the private sector in domestic and foreign trade.

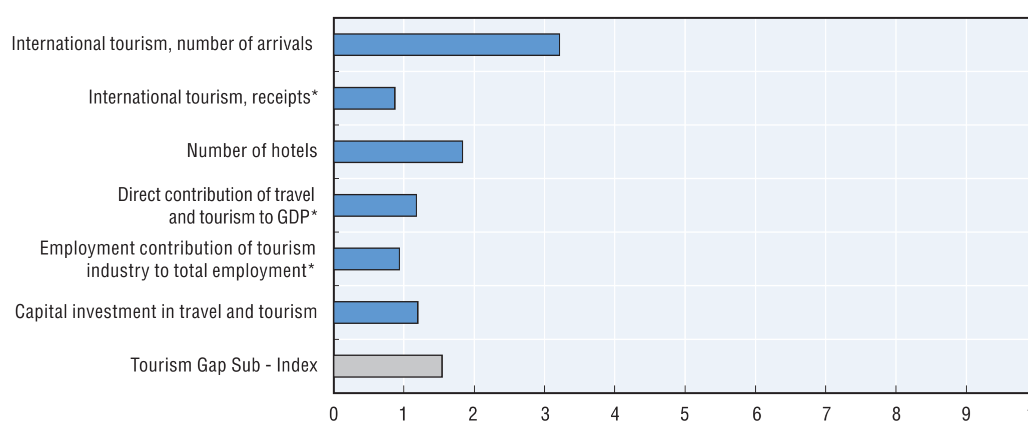
However, the multitude of subregional and bilateral trade co-operation FTAs could present a challenge to ASEAN-wide trade co-operation and integration if national priorities took precedence over regional initiatives. On the other, export competitiveness and trade integration could be hindered by impediments like inadequate trade facilitation measures or poor transport infrastructure – all features of the less developed ASEAN economies.

Tourism

Tourism indicators show relatively narrow gaps

The narrowing development gaps (NDG) sub-index for tourism showed that the gap between ASEAN-6 and CLMV countries narrowed from 2.3 base points in 2005 to 1.5 in 2011. Its score is the lowest of all six policy areas and half that of the NDGI's overall 3.2 base points. Individual components of the sub-index, such as international tourism receipts (as a percentage of GDP), direct contribution of travel and tourism to GDP, and the employment contribution of the tourism industry to total employment reflect the importance of the sector and its spillover effects on employment and consumption – especially in the CLMV countries (see Figure 3.19). On the other hand, there is room for improvement: CLMV countries should attract more visitors, as the ASEAN-6 group manages to do.

Figure 3.19. **Tourism Gap Sub-Index between ASEAN-6 and CLMV, 2011**



Note: An asterisk (*) indicates a larger value for CLMV countries *vis-à-vis* ASEAN-6 and thus denotes a change in the direction of the gap between the two country groups.

Source: OECD Development Centre's calculations based on UN World Tourism Database, World Bank (WDI), World Travel & Tourism Council (WTTC) and national sources.

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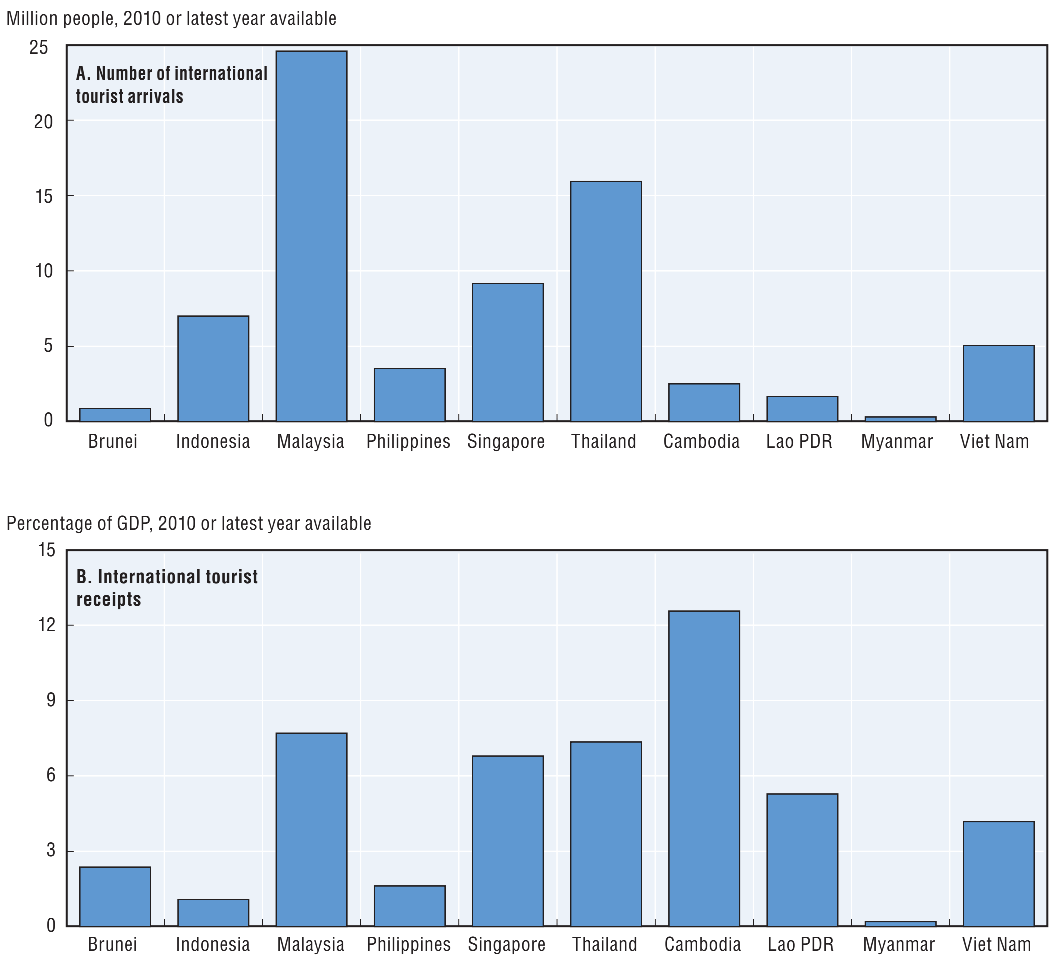
Certain components of the Tourism Gap Sub-Index point to clear differences between individual ASEAN countries. Malaysia, Thailand and Singapore, for example, which are global hubs and gateways for international trade, commerce and business activity, show large tourist inflows (Figure 3.20, A). Other countries, such as Cambodia, Lao PDR and Myanmar, which have only recently opened up to foreign tourists, have smaller inflows. The balance between ASEAN-6 and CLMV economies is reversed slightly with regards to dependency on revenues from tourism (Figure 3.20, B). Tourist receipts account for around 13% of Cambodia's GDP, the largest percentage among all the ASEAN countries. Lao PDR and Viet Nam are also more dependent on tourism than the more developed ASEAN economies such as Brunei, Indonesia and the Philippines.

Figure 3.20. **Visitor inflows and tourism income in ASEAN countries**



Sources: UN World Tourism Database and World Bank`s *World Development Indicators*.

StatLink http://dx.doi.org/10.1787/888932775174

ASEAN countries adopt different tourism strategies with common features like ecotourism and niche markets

Many ASEAN countries are increasingly aware that the contribution of tourism to the economy could offer a higher quality of life for their populations and economic opportunities for all stakeholders. In a bid to narrow the tourism gap in ASEAN and achieve the overall goals of the ASEAN Economic Community by 2015, the ASEAN Tourism Integration Working Group developed the ASEAN Tourism Strategic Plan 2011-2015. The plan intends to establish Southeast Asia as a leading global tourist destination by 2015, characterised, in the words of the ASEAN Secretariat, by "an increasing number of visitors to the region with authentic and diverse products, enhanced connectivity, a safe and secure environment, [and] increased quality of services". At the same time, the region will prioritise sustainable, inclusive socio-economic development through tourism. The ASEAN Secretariat projects that the number of international visitors to the region will total 86 million by the end of 2015 – a 64% increase from 2005.

Based on three strategic thrusts, the plan aims to leverage geographical differences and regional complementarities in tourism, so strengthening the economic base of individual member countries. The three thrusts are:

- accelerate the development of regional products and creative marketing initiatives;
- improve tourism-related human resources, services and facilities;
- improve intra-ASEAN connectivity and cross-border travel through co-operation and a harmonised regulatory environment.

Besides efforts to attract short-haul international tourists from China, Japan and Korea and long-haul visitors from Europe, the Middle East, and the Americas, the policy framework seeks to further facilitate intra-ASEAN tourist flows through closer co-operation between the individual ASEAN National Tourism Organisations (NTOs) and regional and subregional country groups (e.g. GMS, IMT-GT, BIMP-EAGA, and the Emerald Triangle).

However, it is acknowledged that there is a lack of intra-ASEAN collaboration in the tourism sector when it comes to using common procedures and enforcement mechanisms. In addition, the co-ordination of international tourist flows across borders remains another sensitive issue, preventing the region from realising its full potential as a tourist hub.

Individual countries seem to be more interested in adopting strategies to foster the development of their own tourism sectors and increase the number of international visitors to their own shores. Notwithstanding the differences in geography and social characteristics, many tourism plans share common features, such as efforts to design and implement inclusive, long-term strategies. Not only are such strategies neutral in their socio-economic and environmental impact, they also produce positive spillover effects on other sectors of the domestic economy and societies as a whole. Another common feature of tourism strategies is the trend towards specialised niche markets such as business, cultural, or medical tourism (e.g. Indonesia, Malaysia, Singapore) and strengthening "place-making" (i.e. marketing and branding) to attract foreign tourists (see Table 3.9).

While Southeast Asian countries recognise the important part that tourism plays in their economic development, they must overcome challenges such as the lack of different types of tourist infrastructure (transport, accommodation, energy facilities, etc.) and the shortage of human resources for supporting the tourist trade.

Table 3.9. **National initiatives to narrow the tourism gap in ASEAN**

Country	Organisation/Initiative	Strategy
Brunei Darussalam	Brunei Tourism (Ministry of Industry and Primary Resources)	Aim to upgrade the country's Tourism Satellite (TSA), focusing on the collection and presentation of data and the greater involvement of relevant agencies.
Cambodia	Royal Government of Cambodia	Focus on the further development of aviation infrastructure, e.g. improve airport and flight safety standards.
Indonesia	Ministry of Tourism and Creative Economy	Promote the "Wonderful Indonesia" brand with a focus on cultural tourism and selected domestic products such as batik and handicraft. Promote event locations for a selected range of tourism-related products – e.g. the International Handicraft Trade Fair (INACRAFT) in Jakarta.
Lao PDR	Lao National Tourism Administration	Identified several public-private partnership and private investment opportunities in publicly funded tourism projects such as hotel and resorts, restaurants and eco-lodges, with a focus on the natural beauty and rich cultural history of Lao PDR.
Malaysia	Ministry of Tourism Malaysia / The Tourism Transformation Plan 2020	Focus on health tourism as medical procedures cost much less in Malaysia than in Europe, the Middle East, Australia, Sri Lanka, China and India. The government expects the revenue from the Malaysian medical tourism industry will grow at a compound annual growth rate of 21% during the period 2011-14.
Myanmar	Ministry of Hotels and Tourism	Position Myanmar to world travellers as a unique cultural, historical, nature-based tourist destination in Asia.
Philippines	Department of Tourism	Encourage investment in holiday homes and eco-zones, historic and cultural heritage projects, as well as ecotourism, agritourism, and health and wellness projects. Specifically with regard to health and wellness, the Philippines offers a great many amenities, such as spas and alternative medicine (acupuncture, herbal medicines, naturopathic medicine and other healing practices).
Singapore	Singapore Tourism Board (STB)	Strengthen the promotion of Singapore as a gateway to the cultures of Asia and develop more cultural products and services that appeal to targeted tourist segments. Specifically, the STB plans to make the Civic District one of Asia's premier cultural destinations . It contains the country's highest concentration of museums, theatres, historical sites and public spaces.
Thailand	Tourism Authority of Thailand / marketing campaign "Miracle Year of Amazing Thailand" for 2012	Focus on attracting Asian tourists with the aim of compensating for possible downturns in European and North American arrivals due to the uncertain economic environment. Develop niche markets such as spas and the health business.
Viet Nam	Vietnam National Administration of Tourism	Focus on upgrading domestic airports to service international flights (for example, Cat Bi in Hai Phong and Da Lat in Lam Dong). Build new airports in the Quang Ninh Province, in the southern region of Dong Nai, and in the northern city of Haiphong.

Source: OECD Development Centre's compilation based on national sources.

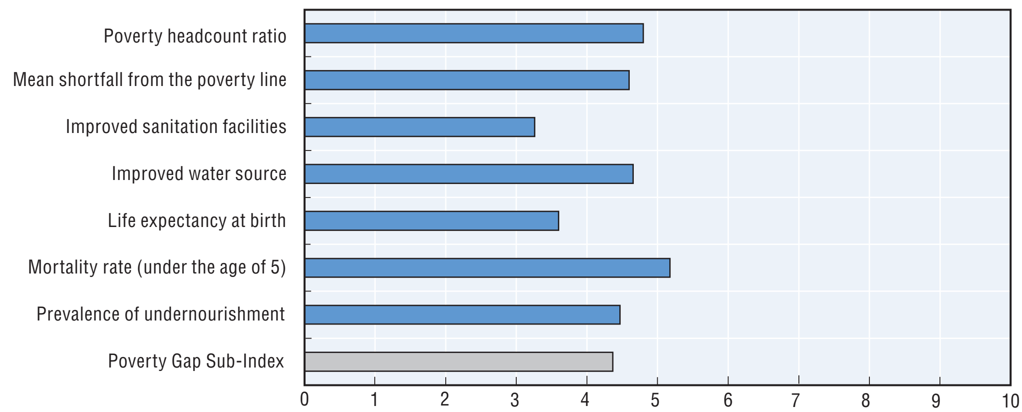
Poverty

Poverty gaps are wide and persistent across ASEAN

The final policy area examined relates to poverty gaps in ASEAN. ASEAN's endeavours to reduce poverty disparities in the region are aligned with the Millennium Development Goals (MDGs). They were formalised by the Joint Declaration on the Attainment of the MDGs in ASEAN and signed in Cha-am Hua Hin, Thailand, on 1 March 2009.

Of all the sub-indices, the NDG poverty sub-index showed the widest gap in 2011 – at 4.4 index base points. The score was actually down from 5.0 base points in 2005, which suggests that regional and country-level initiatives to reduce poverty are making progress. Nevertheless that progress is slow. Figure 3.21 shows that the Poverty Gap Sub-Index's components fall within the same broad range, indicating that resources leveraged to reduce the poverty gap between CLMV and ASEAN+6 countries should be used in such a way that they do so across all components.

Figure 3.21. **Poverty Gap Sub-Index between ASEAN-6 and CLMV, 2011**



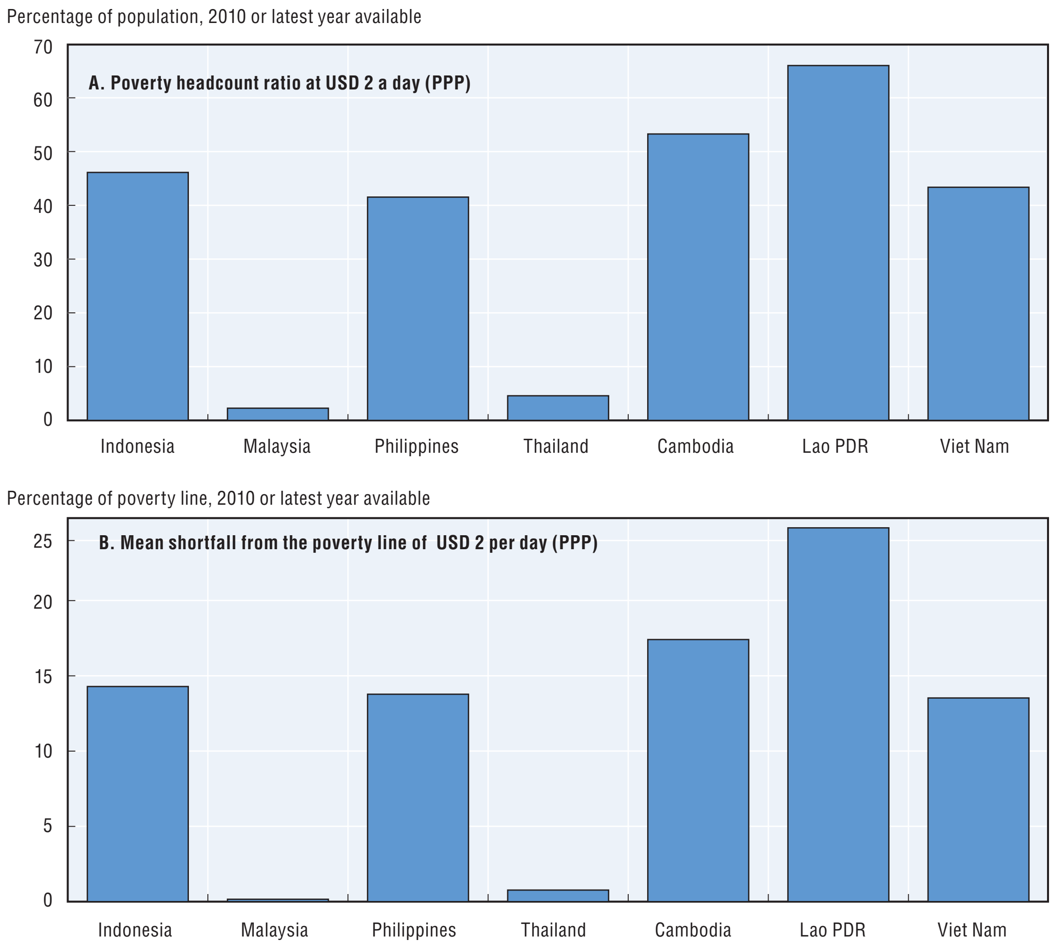
Source: OECD Development Centre's calculations based on World Bank`s *World Development Indicators* (WDI).
StatLink *http://dx.doi.org/10.1787/888932775193*

On a country level, there are significant differences among the ASEAN countries. For instance, while the ASEAN-6 countries fared better than their CLMV counterparts in reducing poverty in general, Figure 3.22 A shows that both Indonesia, with 46%, and the Philippines, at 42%, have high incidences of poverty, measured by the poverty headcount ratio of people living on less than USD 2 per day. The two countries' high poverty levels could stem from the enormous disparities generated by their uneven economic development and inadequate policy intervention. Poverty in the Philippines, for example, is attributed chiefly to causes such as weak employment generation, poor job quality, the failure to fully develop the agricultural sector, and recurrent shocks to the economy from natural disasters and internal armed conflict – all of which have direct effects on the well-being of the population. Similarly, the depth of poverty, reflected by the mean shortfall from the poverty line, is also relatively high in the Philippines and Indonesia (Figure 3.22, B). It is Lao PDR, however, where poverty was the most widespread and deepest in 2011, with a 65% poverty headcount ratio and 25% mean shortfall from the poverty line.

As for the provision of sanitation and water facilities among Southeast Asian countries, those with relatively high incomes such as Singapore, Malaysia and Thailand were able to provide their populations with almost 100% access in 2010. Access was much lower in Cambodia and Lao PDR, however.

As governments in countries with faster economic growth have been able to raise more tax revenue for expanding their public health provision, higher shares of household income are levied to pay for services from both public and private health providers. Improving the population's access to public health also depends on how governments address the health issue in their public policies. A more integrated approach beyond the public health provision relating to the provision of public infrastructure (such as roads, electricity and telecommunication) to the population should suffice. The willingness of Southeast Asian governments to raise resources from tax revenues is also worth scrutiny, given that they devote only a small average share of their tax revenues to public health.

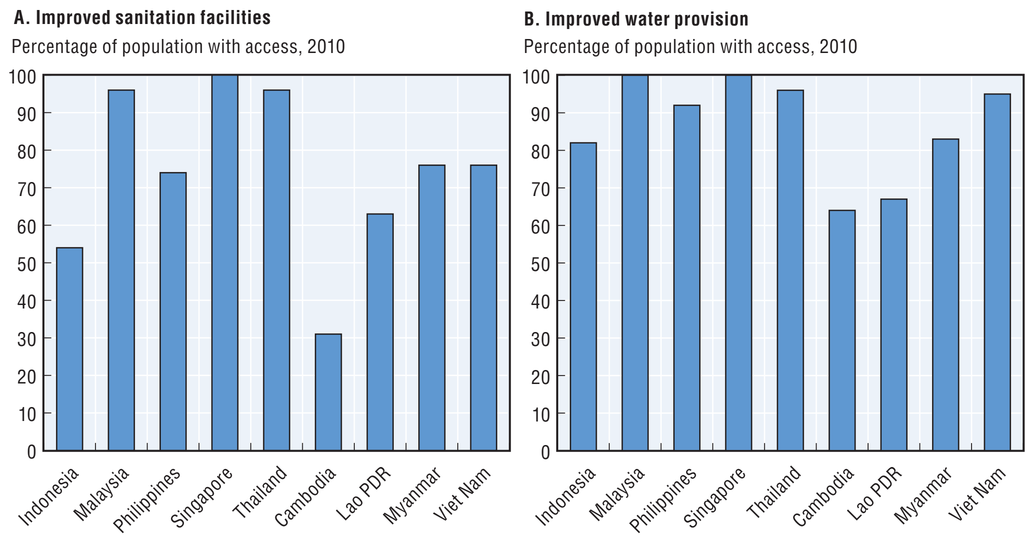
Figure 3.22. **Incidence and depth of poverty in ASEAN countries**



Note: No data available for Brunei, Singapore and Myanmar.
Source: World Bank *World Development Indicators*.
StatLink http://dx.doi.org/10.1787/888932775212

The effects of access to public health sanitation facilities on Southeast Asian populations are seen in life expectancy at birth and mortality rates among the under-fives. In 2011, the ASEAN-6 countries – generally able to provide better facilities – showed higher life expectancies at birth and lower child mortality rates then CLMV.

Figure 3.23. **Public access to sanitation and water in ASEAN countries**



Note: No data available for Brunei.
Source: World Bank *World Development Indicators*.
StatLink http://dx.doi.org/10.1787/888932775231

Countries increasingly use targeted approaches to alleviate domestic and regional poverty

At the regional level, ASEAN facilitates the exchange of views and the sharing of best experiences on poverty reduction programmes at the ASEAN Ministers Meeting on Rural Development and Poverty Eradication (AMRDPE), which is held once every two years. AMRDPE also highlights the importance of common monitoring mechanisms, fostering co-operation among the region's microfinance institutions, and identifying and extending the technical assistance required by poverty reduction programmes.

However, because AMRDPE acts only as a broker, the co-operation programmes created under its aegis are confined to seminars or workshops, personal exchanges and collaborative studies of poverty issues by ASEAN member and non-member countries. Programmes conducted between 2004 and 2010 include:

- the ASEAN Rural Youth Volunteers Movement brings together young professional volunteers to support development efforts in rural communities. It first deployed in Tasikmalaya on the island of Java, Indonesia, in 2009.
- ASEAN+3 Village Leaders Exchange Programmes, organised by Malaysia and China, aims to give village leaders in Southeast Asia a voice so that they may share their experiences and transfer their knowledge of development and poverty issues.
- ASEAN Social Safety Net.
- Collaborative ventures by microlending institutions.
- Thailand's Baan Mankong Programme, a scheme that empowers slum-dwellers to develop long-term housing solutions for "cities without slums".

The 7th AMRDPE, held on 2 November 2011 in Brunei, adopted a new 2011-15 action plan entitled "A Co-ordinated Strategy of Intervention Towards Zero Poverty". It has six priorities:

- sustainable rural development and rural economic growth,
- food security and food sovereignty amid climate change,
- social protection and safety nets,
- the development of infrastructure and human resources in rural areas,
- constituency building for rural development and poverty eradication,
- monitoring and evaluating poverty reduction in the region.

In addition, the strategy stressed partnership with non-governmental organisations as a more inclusive means of achieving the six priority goals. Accordingly, ministers endorsed the establishment of the ASEAN Governmental Organisations-Non Governmental Organisations Forum on Rural Development and Poverty Eradication. It was due to convene for the first time in 2012 to share experiences and exchange views.

Drawing on the knowledge gained from regional interactions, ASEAN member governments are doing much more to implement domestic poverty alleviation policies. Besides upgrading human resources in the labour market, raising education levels, and improving infrastructure as parts of a long-term solution to higher overall growth and a narrower poverty gap, they are also taking more closely targeted, shorter-term measures. These are designed to increase the well-being (i.e. improve employment and incomes) of people identified as poor (see Table 3.10). Indonesia, the Philippines and Thailand, for instance, have implemented conditional cash transfer programmes which offer regular cash payments to poor households so that they can enrol their children in school and access health-care services.

Table 3.10. **National initiatives to narrow the poverty gap in ASEAN**

Country	Organisation/Initiative	Strategy
Cambodia	Kingdom of Cambodia	Focuses on the construction of basic infrastructure especially in rural areas.
Indonesia	Jaring Pengaman Sosial	A masterplan for poverty reduction that covers health, education, employment creation, food security and community empowerment through a social safety net programme. The programme was subsequently modified and, in line with its objectives and targeted beneficiaries, its assistance allowance was divided into three main clusters: 1. "Social assistance", designed chiefly to help households meet their basic needs. 2. "Community empowerment", where the government allocates funds to poor communities to enable them to build the economic infrastructures so important to local incomes. 3. "Micro enterprise empowerment", in which small local enterprises are encouraged to develop their businesses through soft loan credits without needing to provide collateral.
	Poverty Reduction Committee (Badan Penanggulangan Kemiskinan) under the National Development Co-ordination Board	The Indonesian government drafts Poverty Reduction Strategy Papers to detail the action plan for each period. In National Medium Plan 2009-2014, the government targets poverty reduction of 8%.
Lao PDR	Poverty Reduction Fund (PRF)	Focuses on poverty eradication through community development activities and basic infrastructure construction in rural areas. The Poverty Reduction Fund (PRF), which was established in 2002, provides basic services to the poorest communities in remote areas and builds local capacity and institutions. The PRF has enabled the provision of public infrastructure and services, such as better access roads, primary education, clean water, and health care, to 650 000 beneficiaries, especially women and ethnic groups in remote parts of the country.

Table 3.10. (contd.)

Country	Organisation/Initiative	Strategy
Malaysia	10th Malaysian National Development Plan for 2011-2015	The plan has two main objectives: 1. Afford all Malaysians equal opportunities for participating in the economy according to their requirements and needs. This involves stepping up capacity and capability building, enhancing access to employment opportunities, and adopting a more targeted approach in encouraging innovation-driven entrepreneurship. 2. Provide a social safety net for disadvantaged groups. Equal access to health, education and basic infrastructure is emphasised, while mechanisms for targeted income support will be enhanced as general subsidies are phased out. Specifically, the government aims at elevating the livelihoods of the bottom 40% of households and improving the participation of the ethnic Malay Bumiputera community in the economy.
Myanmar	Ministry of National Planning and Economic Development	Improve the agricultural sector, as it is the country's primary food supply and most of its citizens work in the sector.
Philippines	Kapit–Bisig Laban sa Kahirapan – i.e. the Comprehensive and Integrated Delivery of Social Services Project (KALAHI-CIDSS)	The KALAHI is still the current administration's overarching framework and strategy for reducing poverty, improving governance, and empowering communities. The strategies derived from the social reform and anti-poverty agendas. The core KALAHI strategies include: • accelerated asset reform to encourage a redistribution of physical and/or financial assets to the poorest people; • improved access to human development services; • the provision of employment and livelihood opportunities; • security from violence and social protection, including safety nets for vulnerable groups; • enhancing the abilities and capacities of the poor and marginalised groups, especially in policy and decision making.
Thailand	Royal Thai Government	The strategy to reduce poverty is divided into two areas: microfinance and social assistance programmes. • To provide microcredit to low-income households at a low cost, the government set up several programmes assisted by Special Financial Institutions (SFIs) and Non Banking Financial Institutions (NBFIs) through numerous subsidised credits that also targeted micro entrepreneurs in rural areas. • Social assistance covers the village and urban community funds, sufficiency economy[11] practices for community development, community welfare funds, One-Product One-Community Enterprise Programme, a non-institutional debt programme for the poor (non-institutional debts converted into institutional loans), universal health care, and old-age allowance. • The government also introduced the Conditional Cash Transfer (CCT) which has been applied in countries including Brazil, Turkey and Mexico. This programme requires the family recipients of allowances to comply with conditions such as child school attendance, immunisation, the improvement of youth skills and any other social variables determined by the government. In practice, the effectiveness of the programme depends on the quality of school, good local governance, and proper targeting of the poor.
Viet Nam	Social protection system	The Vietnamese government uses its social protection system and its five main components: 1. labour market policy which targets 30 000 jobs per year; 2. social insurance, which addresses 11% of the population and 18% of the labour force; 3. health insurance that covers 57% of population; 4. social assistance for 1.2 % of population; 5. the Area-Based and National Targeted Programme.

Source: OECD Development Centre's compilation based on national sources.

Conclusion

ASEAN's overall goal is the realisation of the ASEAN Economic Community by 2015. However, the ASEAN member countries differ from one another in many ways, which poses a challenge to any implementation of ASEAN Economic Community Blueprint by the stated timeline. Member countries differ on their levels of development, political systems, investment environments, and economic structures. Cambodia, Lao PDR, Myanmar and Viet Nam (CLMV), for example, which were the last four countries to join ASEAN, are at an earlier stage of economic development than the other six member countries (the ASEAN-6). As a result, narrowing the development gaps between the CLMV countries and the ASEAN-6, primarily through the IAI programme, is a daunting challenge in the drive towards ASEAN integration.

The ASEAN-OECD Narrowing Development Gaps Indicator provides a first-hand overview of both the size and trends of the socio-economic development gaps separating the ASEAN-6 and the CLMV countries. In particular, it shows that while many of the reported development gaps have narrowed over time, some – poverty and human resource development, for example – are still relatively wide and require critical attention from national policy makers. At the regional and subregional levels, ASEAN has busily undertaken numerous initiatives to foster regional co-operation and share experience in each key policy area. However, greater efforts are needed in the push for greater social and economic integration, particularly in infrastructure and trade and investment.

The slow pace of infrastructure development, for example, may be attributed chiefly to resource constraints and a lack of consensus in implementation. As for regional attempts to attract investment and liberalise trade, progress has been slow because countries continue to prioritise and pursue their own agendas rather than the common goal. ASEAN needs to step up and strengthen monitoring and enforcement mechanisms to ensure that progress stays on track.

At the country level, policy areas such as human resource development and poverty alleviation lag behind. Disparities in these areas are harder to fix and policies tend to be longer-term in nature.

In human resource development, the common issues that almost all ASEAN needs to address are low labour productivity; skills mismatches; large informal sectors; and unequal, inequitable access to higher education and its uneven quality. Low labour productivity stems partly from the fact that in some countries, chiefly CLMV, a large proportion of the workforce is still employed in the agricultural sector where productivity is low. As disparities in poverty also remain wide, more vigorous policies are needed to speed up poverty alleviation. Chapters 4 and 5 discuss in greater detail such policies, particularly as they relate to CLMV countries.

A final point is that measures taken at regional, subregional, and country levels are not always consistent with one another. The result is slow progress at the ASEAN level, especially as national strategies and interests take precedence. To harmonise policies and initiatives at all three levels and speed up the narrowing of social and economic gaps, a better understanding of country sensitivities and differences is critical.

Notes

1. The Second ASEAN Informal Summit, held in Kuala Lumpur on 15 December 1997, adopted the ASEAN Vision 2020 which sets out a broad vision for ASEAN in the year 2020, www.asean.org/asean/asean-summit/item/asean-vision-2020. The ASEAN leaders adopted the ASEAN Economic Blueprint at the 13th ASEAN Summit on 20 November 2007 in Singapore to serve as a coherent master plan guiding the establishment of the ASEAN Economic Community 2015, www.asean.org/communities/asean-economic-community.
2. Nevertheless, based on the findings of UNDP`s Integrated Household Living Conditions Survey of Myanmar (IHLCA, 2009-10), relative inequality appears to have fallen since 2005 as the consumption share of the bottom quintile rose slightly from 11% to 12%. However, this result has to be handled with care since it may stem from a sampling error.
3. At the ASEAN level, the Master Plan on ASEAN Connectivity (MPAC) has underlined three priority areas in land, maritime, and air infrastructure development. Under this master plan, private enterprises – such as freight forwarders, ship owners, port authorities and national airlines – have chiefly joined in programmes and activities, e.g. the Brunei Action Plan (BAP) 2011-15 or the ASEAN Strategic Transport Plan (ASTP) which expired in 2010. The BAP is used to provide a reference for guiding ASEAN transport co-operation and integration over the next five years. Covering four main sectors (land, air, maritime transport and transport facilitation), it identifies strategic actions that should, over the period 2011-15, help make the ASEAN Economic Community (AEC) a reality by 2020.
4. SKRL has two main lines: the Eastern Line through Thailand, Cambodia and Viet Nam, with a spur line between Lao PDR and Viet Nam; the Western Line through Thailand and Myanmar.
5. The APG and TAGP are flagship programmes mandated in 1997 by ASEAN heads of state and government. Under ASEAN Vision 2020, they are designed to ensure regional energy security while promoting the efficient use and sharing of resources.
6. The eight bilateral gas pipeline interconnection projects are: *i)* Malaysia-Singapore in 1991; *ii)* Yadana in Myanmar to Ratchaburi in Thailand in 1999; *iii)* Yetagun in Myanmar to Ratchaburi in Thailand in 2000; *iv)* West Natuna in Indonesia to Singapore in 2001; *v)* West Natuna in Indonesia to Duyong, Malaysia, in 2001; *vi)* South Sumatra in Indonesia to Singapore in 2003; *vii)* Malaysia-Thailand-Joint Development Area, Malaysia via Songkla in 2004; *viii)* Malaysia-Singapore in 2006.
7. The WBS is a one-off scheme that provides a cash bonus to older, low-wage workers as part of the government budget surplus sharing exercise in 2006. This was replaced by the WIS scheme, a long-term programme that helps older low-wage workers supplement their incomes and build up their retirement savings as well as encouraging them to stay employed. Set up in 2007, it is funded through tax revenues. The WTS scheme was introduced to complement the WIS as it encourages older low-wage workers to upgrade their skills through training so that they can improve their employability, upgrade to better jobs, and earn more. WTS comprises three components: the Employer Grant, which enhances course fee-funding support and absentee payroll funding for employers; the Training Commitment Award that encourages workers to opt for continuous skills upgrading; Workfare-Skill Up, is a structured training programme with customised classes to give low-wage workers a stronger foundation in basic literacy so that they can continue with workplace skills training and enhance their ability to take on better jobs.
8. SEAMEO was established on 30 November 1965 as a chartered international organisation whose purpose was to promote co-operation in education, science and culture in the Southeast Asian region.
9. The idea of a Higher Education Area in ASEAN encompassing 6 500 higher education institutions and 12 million students in ten nations by 2015 is part of the Education for All (EFA) movement by UNESCO, a global commitment to providing quality basic education for all children, youth and adults.
10. An APEX university is granted autonomy in governance, human resources (selection of staff, faculty members and top management), finance and student admissions.
11. For an understanding of Thailand's "sufficiency economy", go to www.waset.org/journals/ijhss/v4/v4-2-19.pdf.

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CHAPTER FOUR

Integrating CLMV countries through trade and investment

Abstract

This chapter examines the experience of the so-called CLMV countries – Cambodia, Lao PDR, Myanmar and Viet Nam – in opening up their once centrally planned economies to trade, foreign direct investment (FDI) and the global market. The result has been fast growth and macroeconomic stability for Viet Nam, Cambodia and Lao PDR. They even bounced back from the global crisis of 2008-09 because their export growth in apparel, tourism, agricultural products and hydropower is sound and their trade and investment linkages with their big regional neighbours have strengthened their economies. Today, however, they must explore the agenda for future, better growth and engage in a second generation of microeconomic reforms to support human and social development. Myanmar is at a different stage altogether – it is only now following up tentative political freedoms with economic liberalisation.

The first section of this chapter sets the scene, tracing the history of CLV's gradualist approach to economic transition over the past 20 years. The following two sections explore the trade-FDI nexus, i.e. the relationship between economic liberalisation and strong trade and FDI growth (which accounts for higher shares of gross domestic product (GDP) than in ASEAN-6) and also look at how CLV have eased into the global market, joining the World Trade Organization (WTO) and signing trade agreements. The next section considers major changes in the product composition and market distribution of CLMV's exports and how their big neighbours have been engines of growth.

The chapter then looks to the future arguing that CLV countries now need to usher in further reform by improving infrastructure and skilled labour through educational reform, and sharing the benefits of growth across society.

The chapter concludes by arguing that CLV must address poverty and income disparities, while Myanmar still has its economic transition ahead of it.

Introduction: CLMV economies on the move

Cambodia, Lao PDR, Myanmar and Viet Nam (CLMV) are the newest members of the Association of Southeast Asian Nations (ASEAN). Viet Nam acceded in 1995, Lao PDR and Myanmar in 1997, and Cambodia in 1999. The CLMV countries have a total population of 158 million, equivalent to more than one-quarter of the ASEAN total. Their market size is still small – only one-tenth of ASEAN-6 economies with Cambodia, Lao PDR and Myanmar being United Nations-designated least-developed countries (LDCs). Yet they have emerged as dynamic open economies after two decades of transition and integration. Building on trade- and FDI-led industrialisation, they are now forging a new frontier in Southeast Asia's economic development

With the imminent collapse of the former Soviet Union and the withdrawal of Vietnamese troops from Cambodia in 1989, Cambodia, Lao PDR, and Viet Nam (CLV) embarked on a transition from centrally planned to market economies. Viet Nam, which had initiated its *doi moi* ("renovation") policy in 1986,[1] began to implement it seriously. Lao PDR made a similar move under the banner of the "New Economic Mechanism" (NEM). As for Cambodia, it started its market-oriented reforms in 1993 only after gaining international recognition and normalising its relations with multilateral financial institutions.

Economic reform in Cambodia, Lao PDR, and Viet Nam focused initially on measures to guarantee the freedom of choice of all economic agents and introduce price incentives and market competition. Most domestic trade barriers were removed almost immediately and private companies were allowed to trade both domestically and internationally. The governments also relaxed price controls except for those on some strategic products and public utilities. State-owned enterprises (SOEs) were granted greater autonomy in production, but there was little ownership reform or privatisation. Controls on foreign investment were relaxed gradually and investors enjoyed greater room for manoeuvre.[2] The unification of multiple exchange rates also took place with official rates being sharply devalued.[3] At the same time, governments began to attract foreign investors into special economic, or free trade, zones in metropolitan and major port areas and, more recently, into zones along the economic corridors introduced under the Greater Mekong Subregion (GMS) Programme. The initial success of these open-economy reforms, accompanied by macroeconomic stabilisation efforts, was evident in CLV, which registered strong economic growth between 1990 and 1996.

It was then, ahead of the outbreak of the Asian financial crisis (AFC) in July 1997, that reform in all three countries was stalled by serious macroeconomic imbalances caused by several inter-related factors – overvalued exchange rates, rising budget deficits, unprofitable SOEs and dwindling FDI inflows. The unfolding of the AFC was followed by steep devaluations of local currencies and a rise in inflation rates. The macroeconomic situation became worse in Cambodia, Lao PDR and Viet Nam, as growth and exchange rates collapsed in several neighbouring countries in 1997-98. Lao PDR experienced a particularly serious bout of hyperinflation in 1998-99 and all three CLV countries lost their domestic reform momentum before regaining macroeconomic stability in 2000.

The year 2000 ushered in CLV's second phase of economic transition as the countries began to deepen domestic reform so as to promote private-sector development in earnest. Viet Nam, for example, put in place a legal and institutional framework to level the playing field between, on one hand, SOEs and private enterprises and, on the other, between domestic and foreign firms. Cambodia took steps to improve transparency and rationalise incentives for foreign investors, while strengthening its national export strategy with technical assistance from the international community. In fact, the second phase of economic reform in the CLV countries coincided with their further integration into the global market as they joined the WTO and ASEAN members signed regional trade agreements with their chief trading partners. Overall, CLV enjoyed robust economic growth and relative price stability until the global financial downturn struck in September 2008.

As discussed in Chapter 1, the CLV countries have weathered the crisis relatively well, albeit to different degrees. Cambodia, for instance, had enjoyed strong growth, driven by factors including fast-paced textile and apparel exports, buoyant international tourism, a construction boom and robust agricultural growth. Yet the downturn took its growth to the brink of collapse in 2009, as garment exports and tourism revenues dwindled and investment in the real estate sector dried up. In 2010, however, the economy bounced back in a stronger-than-expected V-shaped recovery thanks to resurgent apparel and textile exports, agricultural products and increased revenue from tourism. It continued to perform well in 2011. The current account deficit, on the other hand, widened to 9.5% of GDP in 2011 owing to higher petroleum import bills and increased imports related to large hydropower projects. The deficit is still fully financed by private capital inflows and official development assistance (ODA). And, as Cambodia's high level of dollarisation limits the use of monetary policy as an effective counter-cyclical instrument, fiscal policy is the main tool left for safeguarding macroeconomic stability. The trouble is that Cambodia's fiscal space has shrunk considerably as a result of the fiscal stimulus package introduced in 2009 and its narrow tax base (IMF, 2012a).

In short, the CLV countries adopted a gradualist approach to economic transition and joining the global and regional markets and, for most of the time, they ran twin current account and fiscal balance deficits. Sizable trade deficits are, in fact, likely to persist, as strong domestic consumption and large ongoing infrastructure projects push their import bills up. To sustain their reform and catching-up processes, CLV need to maintain strong export growth and attract FDI inflows.

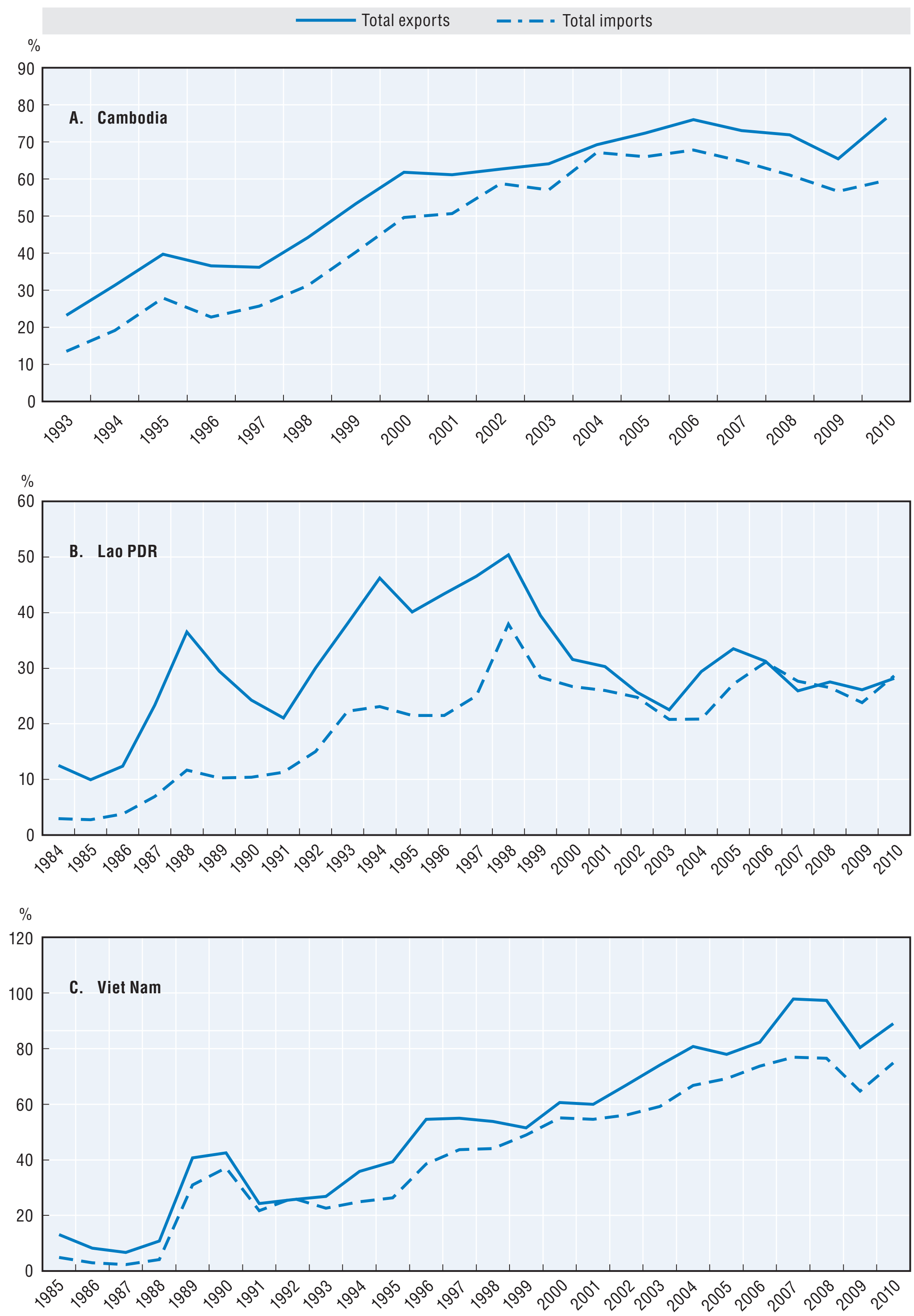
The emergence of a trade-FDI nexus

Liberalisation and the trade-FDI nexus will drive further integration

Early studies emphasise the positive effects of trade and FDI on growth as a major driving force behind East Asia's development performance since the mid-1980s. The liberalisation of trade and investment policy regimes undertaken unilaterally by reforming economies in the region has improved the business environment, favouring the expansion of both trade and FDI flow. At the same time, the strong trade and FDI performance has encouraged governments to sustain their outward-oriented development strategies and integrate their economies more closely into the global market. This positive relationship between economic liberalisation initiatives and strong trade and FDI growth – often referred to as the trade-FDI nexus – has worked well in East Asia.

Figure 4.1. **Trade/GDP ratios in Cambodia, Lao PDR and Viet Nam**

(percentage of GDP)



Source: Author's own calculations based on World Bank's *World Development Indicators* 2012.

StatLink *http://dx.doi.org/10.1787/888932775250*

Looking back, the accession of Cambodia in 2004 and Viet Nam in 2007 to the WTO played a critical role in sustaining both countries' economic transition. It took Cambodia 10 years and Viet Nam 12 to bring their accession negotiations to successful conclusions. Meanwhile, both countries have overhauled their foreign trade and exchange regimes and established more business-friendly legal and institutional frameworks for foreign investors.

The economic transition of Cambodia, Lao PDR and Viet Nam and their integration into world and regional markets also coincide with Asia's rising regionalism.[4] Until the 1990s, there was virtually no regional trade agreement, with the notable exception of the ASEAN Free Trade Area (AFTA) which was launched in 1992.[5] Since the early 2000s, the ASEAN countries have signed a series of free trade agreements (FTAs) and Comprehensive Economic Partnership Agreements (CEPAs) with their major trading partners: Australia-New Zealand, China, India, Japan and Korea (see Annex, Table 4.A1). Meanwhile, ASEAN has also decided to transform itself from an FTA into an integrated single market and production base by 2015, as envisaged by the blueprint for the ASEAN Economic Community (AEC). See OECD (2010), Chapter 3 for further discussions. The AEC allows free movements of goods, services, investment and skilled labour across its member states as well as a freer flow of capital.

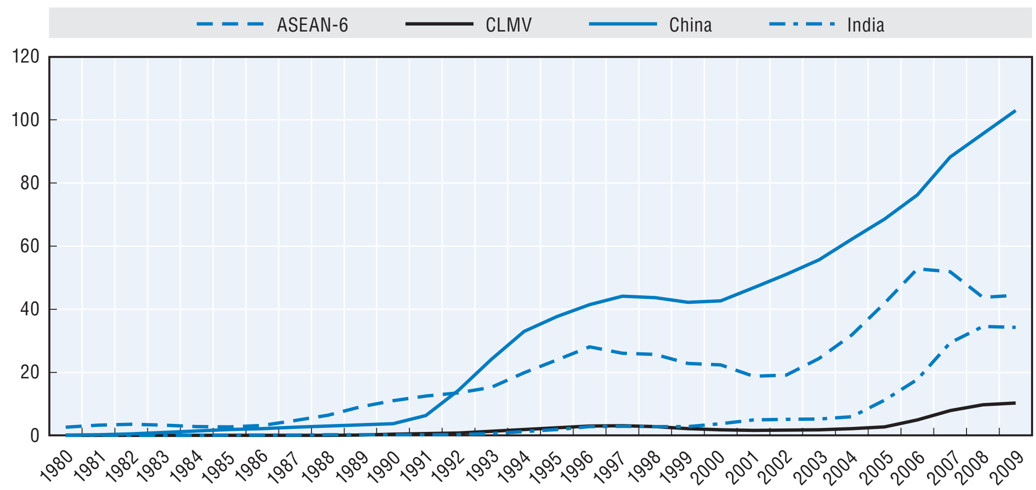
As a consequence of these unilateral and regional initiatives, the CLV countries have significantly increased their openness to foreign trade (Figure 4.1). Cambodia's and Viet Nam's trade/GDP ratios on both the export and import sides have increased in a quite linear manner, and trade deficits have persisted (with some fluctuations) throughout almost the entire periods shown in the figures – 1993-2010 for Cambodia and 1985-2009 for Viet Nam. In Lao PDR, however, the strong rise in the imports/GDP ratio during the early years of reform became unsustainable in 1997-98 and was followed by sharp downward adjustments in domestic demand. The exports/GDP ratio followed a similar trend, but rose from less than 5% of GDP in 1986 to almost 30% in 2010.

Mutual attraction between different CLV sectors and FDI

Meanwhile, the CLV countries have significantly altered their attitudes and policies towards FDI. They fully recognise that it can play an important role in establishing new export bases in host countries, restructuring at home, and bringing national economies into global supply chains. CLV have indeed opened up their economies, albeit gradually, to foreign multinational enterprises. Figure 4.2 traces annual FDI inflows into China, India, ASEAN-6 and CLMV, using three-year moving averages. It shows that the CLMV countries have recently emerged as attractive locations for FDI. At the same time, China, India and ASEAN-6 have become key players in outward direct investment (Figure 4.3).

Figure 4.2. **Annual FDI inflows into ASEAN-6, CLMV, China and India**

(USD billion, 3 year moving average)



Source: Calculated from UNCTAD, FDI database online.

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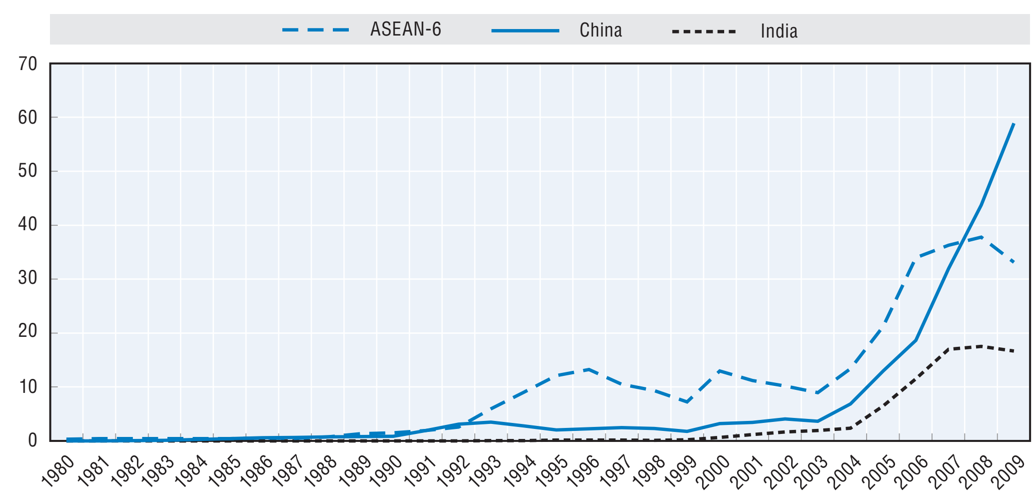
Figure 4.3. **Annual FDI outflows from ASEAN-6, China and India**

(USD billion, 3 year moving average)



Source: Calculated from UNCTAD, FDI database online.

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Table 4.1 shows that a relatively high degree of openness to inward FDI has been one of the defining characteristics of the CLMV economies since the mid-1990s. In 2008-10, FDI inflows even increased in the CLMV countries as a percentage of GDP and more than doubled in Lao PDR and Viet Nam. This strong FDI growth is in sharp contrast with the ASEAN-6 countries where FDI/GDP ratios actually declined. Hattari (2009) reports that, though still small in magnitude, bilateral FDI flows between developing ASEAN countries have become an important source of FDI to several of them, including Cambodia and Lao PDR. A recent report by ASEAN (2011) also highlights the significance of intra-ASEAN FDI flows for these countries, as well as Indonesia and Thailand (Table 4.2). At the same time, sectoral FDI data suggest that there are major differences in investment motives for foreign investors. In Viet Nam, for instance, FDI flows have been dominant in (export-oriented) manufacturing industries and in the real estate and service sectors. In Cambodia, they are important in banking, insurance and other services, manufacturing (apparel) and agriculture, whereas in Lao PDR they are directed to service-related sectors. Myanmar presents an extreme case: its mining sector accounted for more than three-quarters of total FDI inflows (Table 4.3).

Table 4.1. **Average inward FDI flows into ASEAN countries, 1989-2010**
(percentage of GDP)

	Avg. 1989-91	Avg. 1994-96	Avg. 1999-2001	Avg. 2004-06	Avg. 2008-10
Brunei Darussalam	0.2	8.4	11.6	3.7	3.0
Cambodia	0.0	5.2	4.8	5.1	6.4
Indonesia	0.8	1.9	-1.9	1.7	1.5
Lao PDR	0.6	6.2	2.4	2.5	5.1
Malaysia	5.9	6.4	3.1	3.5	2.6
Myanmar	3.3	4.3	3.3	2.5	3.5
Philippines	1.3	2.1	1.6	1.7	1.0
Singapore	12.0	12.1	18.5	17.6	10.4
Thailand	2.5	1.2	4.0	4.3	2.3
Viet Nam	2.6	9.3	4.4	3.8	9.0
Total ASEAN	**3.2**	**3.9**	**4.2**	**4.7**	**3.3**
China	0.9	5.1	3.5	3.0	2.1
India	0.1	0.5	0.8	1.3	2.5

Source: Calculated from FDI, UNCTAD Statistical Database (UNCTADSTAT), United Nations Conference on Trade and Development (UNCTAD), Geneva, http://unctadstat.unctad.org/ReportFolders/reportFolders.aspx.

Table 4.2. **Net flows of inward direct investment to ASEAN countries**
(USD million)

	Cumulative 2001-05			% share in each country's total inflow in 2001-05		Cumulative 2006-10			% share in each country's total inflow in 2006-10	
	Intra-ASEAN	Extra-ASEAN	Total inflow	Intra-ASEAN	Extra-ASEAN	Intra-ASEAN	Extra-ASEAN	Total inflow	Intra-ASEAN	Extra-ASEAN
Brunei Darussalam	108	5 077	5 185	2	98	166	1 767	1 932	9	91
Cambodia	227	663	890	26	74	1 191	2 296	3 487	34	66
Indonesia	2 546	4 255	6 801	37	63	13 144	26 197	39 341	33	67
Lao PDR	24	90	114	21	79	351	1 039	1 390	25	75
Malaysia	2 032	12 886	14 918	14	86	6 143	26 252	32 395	19	81
Myanmar	163	998	1 161	14	86	508	3 024	3 532	14	86
Philippines	545	4 225	4 770	11	89	90	10 967	11 057	1	99
Singapore	3 532	66 381	69 913	5	95	8 361	117 409	125 770	7	93
Thailand	5 969	21 572	27 541	22	78	9 384	31 241	40 625	23	77
Viet Nam	949	6 632	7 581	13	87	5 163	29 155	34 318	15	85
Total ASEAN	**16 095**	**122 779**	**138 874**	**12**	**88**	**44 501**	**249 346**	**293 848**	**15**	**85**
ASEAN-6	14 732	114 396	129 128	11	89	37 288	213 832	251 121	15	85
CLMV	1 363	8 383	9 746	14	86	7 213	35 514	42 727	17	83

Note: Figures for 2010 are preliminary.
Source: ASEAN Secretariat (2011), ASEAN Investment Report 2011: Sustaining FDI Flows in a Post-Crisis World, ASEAN, Jakarta; and ASEAN FDI database online.

Table 4.3. **Net flows of inward direct investment to CLMV countries, by sector**

	Cambodia			
	Cumulative 2001-05 (USD mn)	% Share	Cumulative 2006-10 (USD mn)	% Share
Agriculture, fishery & forestry	59	7	566	16
Mining & quarrying	n.a.	n.a.	120	3
Manufacturing	376	42	660	19
Construction	n.a.	n.a.	n.a.	n.a.
Trade & commerce	n.a.	n.a.	n.a.	n.a.
Financial intermediation & services	54	6	1 059	30
Real estate	n.a.	n.a.	n.a.	n.a.
Services	109	12	636	18
Others	291	33	446	13
Total	890	100	3 487	100
	Lao PDR			
	Cumulative 2001-05 (USD mn)	% Share	Cumulative 2006-10 (USD mn)	% Share
Agriculture, fishery & forestry	9	8	103	7
Mining & quarrying	28	25	70	5
Manufacturing	41	36	230	17
Construction	4	4	2	0
Trade & commerce	4	4	12	1
Financial intermediation & services	0	0	80	6
Real estate	1	1	n.a.	n.a.
Services	27	24	444	32
Others	1	1	455	33
Total	113	100	1 391	100
	Myanmar			
	Cumulative 2000-04 (USD mn)	% Share	Cumulative 2005-09 (USD mn)	% Share
Agriculture, fishery & forestry	14	1	1	0
Mining & quarrying	884	78	2 249	77
Manufacturing	86	8	36	1
Construction	0	0	n.a.	n.a.
Trade & commerce	48	4	7	0
Financial intermediation & services	2	0	n.a.	n.a.
Real estate	48	4	n.a.	n.a.
Services	40	4	n.a.	n.a.
Others	11	1	640	22
Total	1 133	100	2 933	100
	Viet Nam			
	Cumulative 2001-05 (USD mn)	% Share	Cumulative 2006-10 (USD mn)	% Share
Agriculture, fishery & forestry	361	5	608	2
Mining & quarrying	1 881	25	412	1
Manufacturing	3 427	45	14 772	43
Construction	145	2	2 998	9
Trade & commerce	127	2	590	2
Financial intermediation & services	113	1	217	1
Real estate	65	1	8 201	24
Services	1 333	18	5 501	16
Others	131	2	1 019	3
Total	7 581	100	34 318	100

Note: Figures for 2010 are preliminary. The abbreviation n.a. stands for "not available".
Source: ASEAN Secretariat (2011), ASEAN Investment Report 2011: Sustaining FDI Flows in a Post-Crisis World, ASEAN, Jakarta.

The detailed FDI data for Lao PDR reported by Goto (2011) reveal that Thailand, China and Viet Nam play a dominant role in its FDI inflows, accounting for 60% over the 2000-09 period. The data, which are approval-based, indicate that each source country has its own particular investment focus. For example, more than one-half of Thai FDI in Lao PDR went to hydropower generation projects, followed by telecom services, then the hotel and restaurant sector. As for China's FDI flows into Lao PDR, the mining sector is the main destination. The service sector claims the lion's share of Vietnamese FDI into the country. Indeed, Vietnamese capital owns transportation and car rental services and vocational training almost in their entirety.

Entering the global market

This section examines major changes in the product composition and market distribution of CLMV exports during the past decade. In analysing trade developments in these countries, two types of statistical shortcomings should be kept in mind. One concerns the under-reporting of official trade statistics. Given the existence of long borders, informal (i.e. unrecorded) trade is considered to be extensive between CLMV and their neighbours, such as China and Thailand. For land-locked Lao PDR, in particular, border trade is often easier than internal trade within the country owing to its geographical distance and weak domestic transport networks. See Bird and Hill (2010) for further discussions.

Another type of statistical shortcoming is the limited availability of official trade statistics in Cambodia, Lao PDR and Myanmar. Trade analysis of these countries should, therefore, be based on the "mirror" trade data drawn from the UN Comtrade database that have been constructed by aggregating partner-country import statistics at the 2-digit level of the Standard International Trade Classification (SITC), Revision 3 (Rev. 3) that are contained in the UN Comtrade database (see Box 4.1).

Box 4.1. **CLMV and mirror trade data**

If a given country fails to report its data, then the data reported by a partner country are used – the approach is called mirroring data. Thus, if country "X" does not report data on its exports, then the imports that partner country "Y" reports from country "X" are used instead. In this way, imports mirror exports and reporters mirror partners.

The mirror trade data have been constructed for the CLMV countries over the period 1988-2011 from UN Comtrade database at the 2-digit commodity and product level of the Standard International Trade Classification (SITC), Revision 3 (Rev. 3). To understand the quality of such trade data, trends in total domestic exports are compared with trends in aggregated imports from partner countries ("world"). Figure 4.4 in this box shows the results for Cambodia and Viet Nam, both of which boast reasonably full yearly data as reporters.[6]

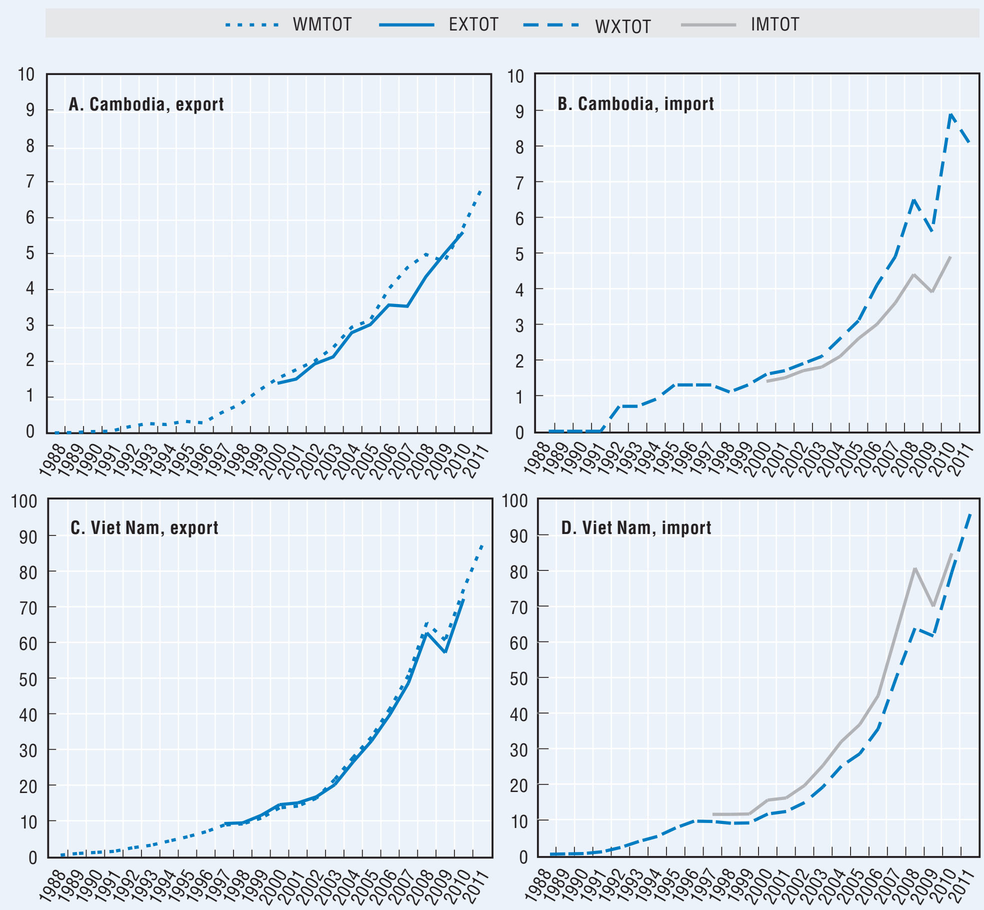
Box 4.1 Figure 4.4 shows that mirror export data (WMTOT) have a good record in tracing total domestic exports (EXTOT) for both Viet Nam and Cambodia, though Cambodia seems to have somewhat under-reported its domestic exports in 2007-08. Similarly, trends in the mirror import data (WXTOT) for Viet Nam largely meet expectations in tracing total domestic imports (IMTOT), albeit with margins that may reflect the usual differences between free-on-board (FOB) and cost, insurance and freight (CIF) valuations. On the other hand, Cambodia's domestic imports display relatively large gaps after 2007. Wide differences between the two series stem from imports of gold and, to a lesser extent, fuel and food.

Box 4.1. (contd.)

Given the results of this exercise, it is reasonable to conclude that the mirror trade data developed in this chapter can be used for a comparative analysis of trade developments in the CLMV countries.

Figure 4.4. **Domestic exports, imports and mirror trade in Cambodia and Viet Nam**

(USD billion)



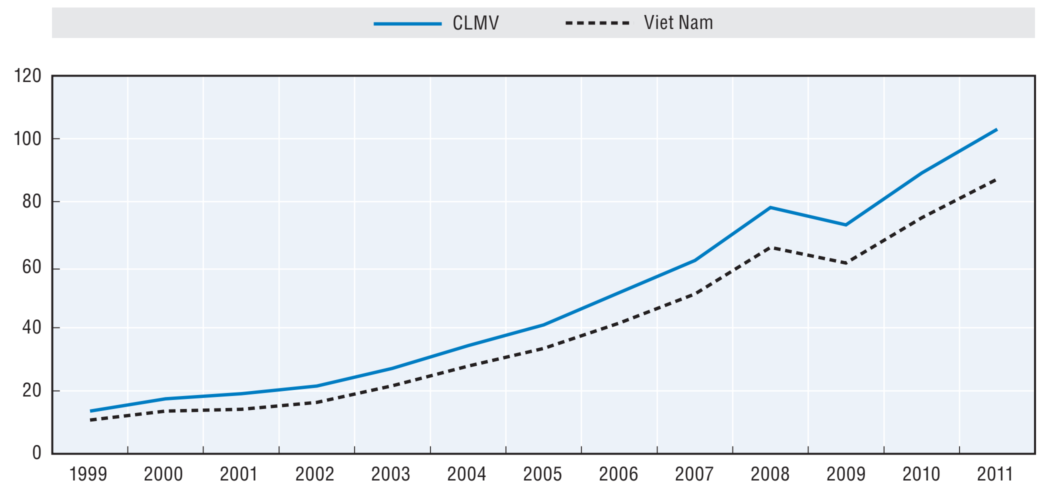
Source: Calculated from UNSO Comtrade.

StatLink http://dx.doi.org/10.1787/888932775307

Source: Calculated from United Nations Commodity Trade Statistics Database (UN Comtrade), http://comtrade.un.org.

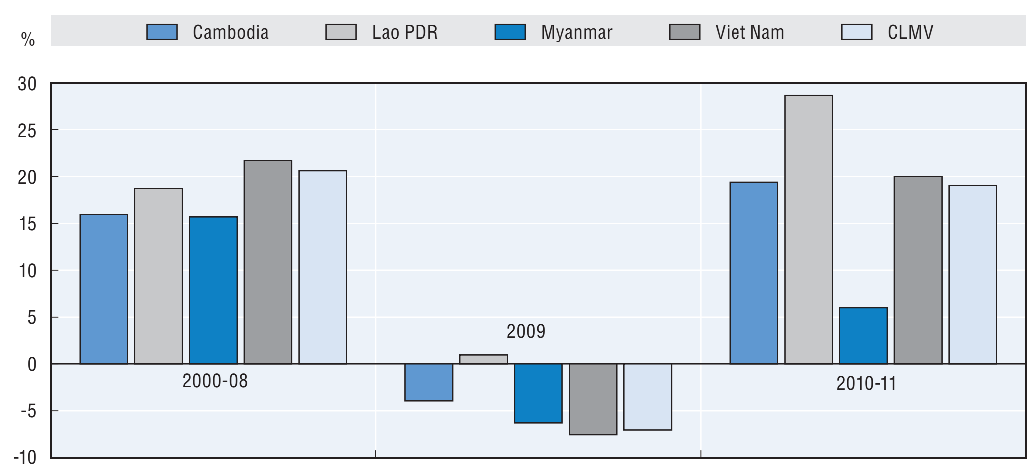
Bearing the trade statistics caveat in mind, the mirror trade data show that CLMV export growth since 2000 has been very rapid (Figure 4.5). Led by Viet Nam whose merchandise exports account for 80% of the CLMV total, the CLMV average export growth rate reached 20% a year. And although the collapse of world trade growth in 2009 hit CLMV exports badly, Cambodia, Lao PDR and Viet Nam registered strong V-shaped recoveries in 2010-11 (Figure 4.6.)

Figure 4.5. **Merchandise exports in CLMV and Viet Nam**
(USD billion)



Note: Using the mirror trade data (see Box 4.1 for explanation).
Source: Calculated from UNSO Comtrade.
StatLink http://dx.doi.org/10.1787/888932775326

Figure 4.6. **Average annual growth rates of mechandise exports in CLMV countries**



Note: Using the mirror trade data (see Box 4.1).
Source: Calculated from UNSO Comtrade.
StatLink http://dx.doi.org/10.1787/888932775345

Export growth in Southeast Asia largely the result of world trade growth

To better understand the relationship between CLMV export growth and world trade growth, the standard constant market-share (CMS) analysis developed by Leamer and Stern (1970) was applied to changes in domestic exports from Viet Nam.

Box 4.2. A definition of constant market-share (CMS) analysis

CMS analysis breaks down changes in actual exports between two points of time into four elements:

1) the world trade growth effect;

2) the initial product composition effect;

3) the initial market distribution effect;

4) a residual which indicates the difference between the actual change in export value and the hypothetical change in export value if the exporting country has maintained export shares of each product group in each import market.

Table 4.4 summarises the breakdown of Viet Nam's merchandise exports between 2000 and 2010 that results from a CMS analysis of commodities and products at the 2-digit level of the SITC, Rev. 3, in the UN Comtrade database (67 product groups excluding gold). In this analysis the world market is divided into two, i.e. the OECD area market and the rest. On average, the former accounted for 70% of Viet Nam's merchandise exports during this period.

Table 4.4. Results of constant-market-share analysis for Viet Nam's mechandise exports*

(USD millions)	Annual average 2000-08	2008	2009	2010	Annual average 2000-10
Changes in actual exports	5 683	14 124	**-5 589**	15 140	5 518
World trade growth effect (Rw)	3 425	7 582	**-14 733**	12 199	2 572
Product composition effect (Ri)	**-10**	725	1 754	**-1 320**	31
Market distribution effect (Rij)	258	43	2 124	814	478
Residual	2 010	5 773	5 266	3 447	2 436
(Percentage)					
Changes in actual exports	100.0	100.0	-100.0	100.0	100.0
World trade growth effect (Rw)	60.3	53.7	-263.6	80.6	46.6
Product composition effect (Ri)	-0.2	5.1	31.4	-8.7	0.6
Market distribution effect (Rij)	4.5	0.3	38.0	5.4	8.7
Residual	35.4	40.9	94.2	22.8	44.2

Notes:
* Analysis is based on the standard CMS model (see Box 4.2)
Subscript
i = 65 product groups defined at SITC (Rev. 3) 2 digit levels
j = OECD markets and the rest
w = world total
Source: Calculated from UNSO Comtrade.

Table 4.4 shows that Viet Nam's exports increased by USD 5.5 billion a year on average between 2000 and 2010. According to the CMS analysis, 47% of the increase was due to the effect of world trade growth, 9% to market distribution, and 44% to the unexplained residual. The effect of product composition on the country's export growth was negligible. The results also suggest that the decline in Viet Nam's exports in 2009 would have been much steeper if they had fallen at the same rate as world trade. The unexplained residual may reflect factors affecting the country's export performance other than improvements in competitiveness. Thanh and Duong (2011) argue that, for a transition economy such as Viet Nam, the unexplained residual also includes the impact of trade liberalisation, e.g. the 2001 bilateral trade agreement between Viet Nam and the United States which has significantly enhanced the access of Vietnamese exports to the US market.

Another interpretation of the residual is the increased shares of several "new" manufactured products that were virtually non-existent in the country's export profile in the 1990s. They are telecom equipment (SITC 76), office and data-processing machines (SITC 75), as well as electrical equipment (SITC 77). Added up, these "new" manufactured products now account for a far-from-negligible share of Viet Nam's total exports – 12% – and an even more significant proportion of its exports to ASEAN-6 and China. Indeed, as they enter the global market and deepen trade linkages with foreign firms, the patterns of export specialisation in individual CLMV countries are changing. That development is now examined.

CLMV to upgrade the apparel value chain central to their exports

The apparel sector has been the single most important CLMV manufacturing industry with strong export orientation. Historically, the rapid growth of an export-oriented apparel sector has played a critical role in generating more income and providing better jobs, so contributing directly to poverty reduction at early stages of industrial development in many developing countries. It has also helped to increase off-farm income-generating activities for women, who typically account for the bulk of the apparel labour force in most countries. The ASEAN countries are no exception. In fact, the CLMV countries, as latecomers to economic transition and integration, have embarked on a route similar to the one that the older members of ASEAN followed in the 1980s and 1990s.

Taking the import statistics of all partner countries, Table 4.5 presents the top 50 non-OECD countries whose annual "export value" in 2009-11 amounted to at least USD 100 million. The table also shows the Revealed Comparative Advantage (RCA) index calculated from the same dataset for 1999-2001 and 2009-11.[8] Until the end of 2004, the global apparel trade had been governed by the Multi-Fibre Arrangement (MFA) and the Agreement on Textiles and Clothing (ATC) under the auspices of the WTO. The 2009-11 period therefore saw a critical change in international trade regulations governing both textile and apparel industries in developing countries.

Table 4.5. **World imports of apparel from non-OECD countries**

	Exporters	Value (USD million)		Shares in world total (%)		RCA index		Memo item
		AVE 1999-2001	AVE 2009-11	AVE 1999-2001	AVE 2009-11	AVE 1999-2001	AVE 2009-11	
1	China	51 690	143 783	25.73	42.68	4.01	3.46	
2	Bangladesh	4 767	16 440	2.37	4.88	22.48	32.97	up
3	India	5 552	13 081	2.76	3.88	3.66	2.67	
4	Viet Nam	1 541	11 429	0.77	3.39	3.50	6.07	up
5	**Indonesia**	4 733	8 318	2.36	2.47	2.34	2.02	
6	**Thailand**	4 016	4 719	2.00	1.40	1.75	1.01	
7	***Cambodia***	1 211	4 299	0.60	1.28	23.58	29.36	up
8	Pakistan	2 070	4 137	1.03	1.23	7.12	8.87	up
9	**Malaysia**	3 169	4 064	1.58	1.21	0.90	0.69	
10	Sri Lanka	2 493	3 946	1.24	1.17	15.15	19.46	
11	Tunisia	2 806	3 752	1.40	1.11	13.10	9.80	
12	Romania	2 926	3 503	1.46	1.04	7.88	3.12	
13	Morocco	2 559	3 358	1.27	1.00	9.21	8.27	
14	Honduras	2 457	2 816	1.22	0.84	17.85	16.92	
15	Hong Kong, China	10 339	2 553	5.15	0.76	5.82	1.65	
16	Bulgaria	920	1 745	0.46	0.52	5.58	3.87	
17	**Philippines**	2 588	1 695	1.29	0.50	1.93	1.05	
18	El Salvador	1 605	1 693	0.80	0.50	15.80	15.76	
19	Egypt, Arab Rep.	688	1 636	0.34	0.49	3.42	2.76	
20	Guatemala	1 535	1 358	0.76	0.40	9.53	6.85	
21	Nicaragua	346	1 165	0.17	0.35	10.01	13.48	up
22	Peru	489	1 159	0.24	0.34	2.37	1.46	
23	Jordan	102	889	0.05	0.26	2.13	8.51	up
24	Mauritius	949	802	0.47	0.24	16.82	15.86	
25	Dominican Republic	2 457	694	1.22	0.21	14.44	4.60	
26	Macedonia FYR	325	672	0.16	0.20	8.47	7.98	
27	Colombia	585	667	0.29	0.20	1.24	0.64	
28	Haiti	261	639	0.13	0.19	22.84	34.09	up
29	***Myanmar***	695	595	0.35	0.18	9.95	3.68	
30	Ukraine	481	590	0.24	0.18	1.02	0.45	
31	Croatia	514	576	0.26	0.17	4.63	2.33	
32	Lithuania	571	472	0.28	0.14	4.69	1.20	
33	Madagascar	371	453	0.18	0.13	11.51	13.36	
34	Serbia	118	404	0.06	0.12	2.39	1.90	
35	Lesotho[a]	193	322	0.10	0.10	26.05	21.10	
36	Albania	100	316	0.05	0.09	9.49	5.52	
37	United Arab Emirates	671	301	0.33	0.09	0.60	0.09	
38	Korea Dem. Rep.	103	275	0.05	0.08	2.92	2.08	
39	Macao, China	1 852	272	0.92	0.08	22.52	9.61	
40	Moldova	100	268	0.05	0.08	3.66	6.11	up
41	Kenya	57	240	0.03	0.07	0.88	2.49	up
42	Panama	192	230	0.10	0.07	2.16	1.40	
43	Latvia	215	218	0.11	0.06	2.21	1.03	
44	Costa Rica	852	211	0.42	0.06	3.54	0.35	
45	Bosnia and Herzegovina	109	210	0.05	0.06	3.54	2.17	
46	***Lao PDR***	125	193	0.06	0.06	9.83	3.98	
47	Kyrgyz Republic	3	188	0.00	0.06	0.24	8.97	up
48	South Africa	397	187	0.20	0.06	0.34	0.08	
49	Syrian Arab Republic	195	181	0.10	0.05	1.14	1.07	
50	**Singapore**	559	162	0.28	0.05	0.19	0.03	
	Total of the above	**123 653**	**251 875**	**61.56**	**74.77**			
	ASEAN-6[b]	15 065	18 958	7.50	5.63			
	CLMV	3 572	16 515	1.78	4.90			
	World total[c]	200 865	336 858					

Notes: 'bold' indicates ASEAN member states; 'italics' the LDC status.
'Up' indicates the country whose export share and RCA index both increased between the two periods.
a. Average of 2000-01.
b. Excluding Brunei Darussalam.
c. The world total includes unspecified areas.
Source: Calculated from UNSO Comtrade.

Unsurprisingly, China has appeared as a clear "winner" in the post-MFA/ATC world in which quantitative restrictions on developing-country exports were lifted. China's apparel exports accounted for 43% of the world total in 2009-11, up from 26% a decade before. Nonetheless, several developing-country exporters have also been doing relatively well over the period concerned – namely, Bangladesh, Viet Nam, Cambodia, Pakistan, Nicaragua, Jordan, Haiti, Moldova, Kenya and the Kyrgyz Republic. They simultaneously increased both their export shares and RCA indices, as indicated in the last column of Table 4.5. On the other hand, many large developing-country exporters have lost market shares with a fall in their RCA indices. There has been a clear swing in apparel export shares from ASEAN-6 to CLMV, although it is Viet Nam and Cambodia – not Lao PDR or Myanmar – which actually managed to increase export shares and improve competitiveness in the global apparel trade.[9]

The fall in apparel export shares or RCA indices should not necessarily be regarded as a negative sign of industrial development. As discussed in OECD (2010), several larger ASEAN countries have been moving out of apparel and promoting export capabilities in other manufacturing sectors – particularly electronic products, parts, and components – and service sectors. In a recent study released by the World Bank, Lopez-Acevedo and Robertson (2012a,b) argue that the post-MFA/ATC development in global apparel trade has been a very complex process, in which many developing countries have been engaged in various strategies to upgrade the apparel value chain. Cambodia still remains at the low-cost production end as a "cut-make-trim" assembler, while Viet Nam has become a preferred supplier, enjoying scale economies and backward linkages. Both countries, however, are facing the same challenge of narrowing the skills gap in technology, design and fashion, and business management.

CLMV countries have different export focuses in different markets

Using the "mirror" trade data described in Box 4.1, Table 4.6 presents the top ten export items that individual CLMV countries supplied to both global and regional markets in 1999-2001 and 2009-11. Export product groups are defined at the 2-digit level of SITC (Rev. 3), and export markets are divided into CLMV's three biggest ones, i.e. OECD countries, ASEAN-6 and China.

After 20 years of transition and integration, the product pattern of specialisation has undergone major transformations in the CLMV countries. It has now become quite distinct from one to another. Cambodia, for instance, remains highly specialised in apparel exports which accounted for almost three-quarters of its total merchandise exports in 2009-11. On the other hand, specialisation has shifted towards natural resource-based products, particularly hydropower generation in Lao PDR and gas extraction in Myanmar, with both activities assuming prominent places in exports to neighbouring markets. At the same time, exports of food and industrial materials have continued to grow in the regional markets, whereas apparel exports have become less buoyant, principally targeting the OECD-area market where they enjoy preferential tariff treatment.

Although apparel products constitute Viet Nam's most important export item, the country's export profile has become increasingly diversified, with rising export shares of other manufactured products, particularly telecom equipment. There are signs of a new division of labour between Viet Nam and other Asian countries such as ASEAN-6 and China.

Table 4.6. **Composition of imports from CLMV countries**

(Share of total imports, %)

OECD Imports from Cambodia			OECD Imports from Lao PDR			OECD Imports from Myanmar			OECD Imports from Viet Nam		
	% Share 1999-2001	% Share 2009-11		% Share 1999-2001	% Share 2009-11		% Share 1999-2001	% Share 2009-11		% Share 1999-2001	% Share 2009-11
Apparel/ clothing/access	88.9	84.8	Apparel/ clothing/ access	78.5	57.0	Apparel/ clothing/ access	68.9	64.0	Apparel/ clothing/ access	16.1	21.7
Cereals/cereal preparatn	8.0	9.9	Coffee/tea/ cocoa/spices	9.3	15.2	Fish/shellfish/ etc.	10.0	10.3	Footwear	23.1	12.9
Crude/synthet/ rec rubber	0.0	1.5	Inorganic chemicals	0.0	7.1	Footwear	1.6	10.1	Petroleum and products	16.1	7.5
Fish/shellfish/ etc.	0.0	0.8	Metal ores/ metal scrap	0.0	3.4	Vegetables and fruit	1.4	5.6	Furniture/ furnishings	3.8	7.3
Footwear	0.7	0.7	Footwear	2.0	3.3	Oil seeds/oil fruits	1.1	2.8	Fish/ shellfish/etc.	11.0	7.2
Metal manufactures n.e.s.	0.4	0.4	Cork and wood	6.3	2.6	Vegetables and fruit	5.1	1.3	Misc manufactures n.e.s.	3.0	7.1
Misc manufactures n.e.s.	0.4	0.3	Non-ferrous metals	0.0	2.1	Non-metal mineral manuf.	1.3	1.1	Telecomms etc equipment	0.7	4.9
Organic chemicals	0.0	0.2	Misc manufactures n.e.s.	0.2	1.8	Crude/ synthet/rec rubber	0.0	1.0	Electrical equipment	2.5	4.0
Road vehicles	0.0	0.2	Sugar/sugar prep/honey	0.0	1.4	Non-ferrous metals	1.8	0.5	Coffee/tea/ cocoa/spices	6.3	3.9
Textile yarn/ fabric/art.	0.5	0.2	Textile yarn/ fabric/art.	0.1	0.7	Animal feed ex unml cer.	0.5	0.5	Textile yarn/ fabric/art.	2.1	2.7
Others	1.1	1.0	Others	3.5	5.4	Others	8.3	3.0	Others	15.4	20.8

ASEAN-6 Imports from Cambodia			ASEAN-6 Imports from Lao PDR			ASEAN-6 Imports from Myanmar			ASEAN-6 Imports from Viet Nam		
	% Share 1999-2001	% Share 2009-11		% Share 1999-2001	% Share 2009-11		% Share 1999-2001	% Share 2009-11		% Share 1999-2001	% Share 2009-11
Crude fertiliser/ mineral	0.0	27.3	Non-ferrous metals	0.0	44.1	Gas natural/ manufactured	42.7	82.7	Petroleum and products	40.7	20.8
Gold non-monetary ex ore	4.5	19.9	Electric current	0.0	34.8	Fish/shellfish/ etc.	8.0	3.5	Cereals/ cereal preparatn	17.8	18.4
Metal ores/ metal scrap	1.5	10.9	Cork and wood	70.7	6.4	Vegetables and fruit	6.3	3.2	Telecomms etc equipment	0.8	6.1
Apparel/ clothing/access	56.1	6.1	Cereals/cereal preparatn	0.1	3.0	Cork and wood	17.1	2.6	Electrical equipment	14.8	4.4
Railway/ tramway equipment	0.1	5.4	Vegetables and fruit	0.2	1.8	Crude/ synthet/rec rubber	2.2	2.2	Office/ dat proc machines	0.9	4.3
Crude/synthet/ rec rubber	19.3	4.9	Electrical equipment	0.3	1.8	Crude fertiliser/ mineral	0.0	1.3	Iron and steel	0.2	4.3
Vegetables and fruit	0.1	4.3	Coal/coke/ briquettes	2.1	1.5	Cereals/cereal preparatn	1.9	0.8	Textile yarn/ fabric/art.	0.9	3.5
Cereals/cereal preparatn	0.7	3.8	Road vehicles	1.2	0.8	Non-ferrous metals	4.2	0.7	Fish/ shellfish/etc.	2.7	2.5
Oil seeds/oil fruits	0.3	3.6	Industry special machine	0.4	0.8	Cork and wood	1.0	0.4	Non-metal mineral manuf.	0.6	2.5
Misc manufactures n.e.s.	0.1	2.8	Oil seeds/oil fruits	0.2	0.6	Metal ores/ metal scrap	1.3	0.3	Crude/ synthet/rec rubber	1.1	2.3
Others	17.2	11.0	Others	24.8	4.5	Others	15.2	2.3	Others	19.5	30.9

Table. 4.6. (contd.)

China Imports from Cambodia			China Imports from Lao PDR			China Imports from Myanmar			China Imports from Viet Nam		
	% Share 1999-2001	% Share 2009-11		% Share 1999-2001	% Share 2009-11		% Share 1999-2001	% Share 2009-11		% Share 1999-2001	% Share 2009-11
Crude/synthet/ rec rubber	11.8	31.6	Metal ores/metal scrap	0.0	60.3	Non-metal mineral manuf.	8.2	30.1	Coal/coke/ briquettes	0.5	19.4
Apparel/ clothing/access	3.1	26.8	Cork and wood	75.0	20.2	Cork and wood	60.4	20.2	Electrical equipment	0.5	9.6
Cork and wood	3.7	21.7	Non-ferrous metals	0.0	9.8	Metal ores/ metal scrap	3.7	15.9	Vegetables and fruit	4.0	8.5
Live animals except fish	0.5	5.0	Crude/synthet/ rec rubber	1.5	4.0	Vegetables and fruit	7.5	7.7	Petroleum and products	73.3	7.4
Textile fibres	0.0	4.7	Cereals/cereal preparatn	0.5	2.3	Crude/synthet/ rec rubber	0.3	5.9	Telecomms etc equipment	0.4	6.7
Footwear	0.0	4.4	Vegetables and fruit	11.7	1.3	Fish/shellfish/ etc.	4.0	5.6	Cork and wood	0.7	6.0
Perfume/ cosmetic/ cleansr	1.4	1.2	Coal/coke/ briquettes	0.0	0.5	Electric current	0.0	4.6	Textile yarn/ fabric/art.	1.5	5.8
Fish/shellfish/ etc.	0.0	0.9	Perfume/ cosmetic/cleansr	0.0	0.4	Oil seeds/oil fruits	0.3	2.8	Office/dat proc machines	0.1	5.5
Railway/ tramway equipmnt	0.0	0.8	Live animals except fish	0.9	0.3	Photographic equ/clocks	0.0	1.3	Metal ores/ metal scrap	1.8	4.9
Metal manufactures n.e.s.	0.0	0.6	Crude anim/veg mater n.e.s.	8.6	0.3	Crude fertiliser/ mineral	6.6	0.7	Crude/ synthet/rec rubber	5.3	4.1
Others	79.5	2.4	Others	1.8	0.8	Others	9.0	5.2	Others	12.0	22.0

Note: n.e.s.: not elsewhere specified.
Source: Calculated from UNSO Comtrade.

The concentration of CLMV exports in labour-intensive products – such as apparel, footwear and miscellaneous manufactured articles – has become very conspicuous in the OECD market. It raises an important question about how this pattern of specialisation may have been affected by the preferential tariff treatment granted to the CLMV countries under the generalised system of preferences (GSP) schemes. Table 4.7 provides a brief summary of the GSP schemes in the Quad countries (the USA, Canada, Japan and the EU) which are currently in operation and apply to the CLMV countries.[10] The US GSP scheme grants only Cambodia GSP-eligible status, but excludes most textiles and apparel articles, footwear and several other labour-intensive products. Apparel products imported from CLMV, therefore, tend to face less favourable market-access conditions than those imported from the African countries that are eligible for duty-free and quota-free (DFQF) treatment under the African Growth and Opportunity Act (AGOA).

The EU's "everything but arms" (EBA) scheme grants DFQF treatment to all imports from LDCs, with the exception of weapons. However, the European Commission temporarily withdrew Myanmar's access to GSP preferences (2009-11), as it did with certain labour-intensive Vietnamese imports covered by Section XIII of the Harmonised System (HS) of products and commodities.[11] On the other hand, Viet Nam has been among the beneficiaries of both Canada's and Japan's GSP schemes, although it is less favourably treated than Cambodia and Lao PDR which, as LDCs, are eligible for more generous GSP treatment.

Table 4.7. **The main generalised systems of preferences (GSP) applied to CLMV countries**

GSP Donors	Benefit	Beneficiaries			
		Cambodia	Laos	Myanmar	Viet Nam
(start year)		(LDC)	(LDC)	(LDC)	
Canada					
GSP (1974)	Variable from duty free to reduced MFN rate	x	x		x
GSP - LDCs (2003)	DFQF	x	x		
European Union					
GSP (1971)	Duty-free for non-sensitve items; Reduced MFN rate for sensitive items	x	x	(x)	x
GSP-LDCs (EBA, 2001)	DFQF (except arms)	x	x	(x)	
GSP+ (2005)	Duty-free				
Japan					
GSP (1971)	Variable from duty free to reduced MFN rate	x	x	x	x
GSP - LDCs (2001)	DFQF	x	x	x	
United States					
GSP (1976)	Duty-free (excludng certain labour-intensive articles)	x			
AGOA (2000)	DFQF				

Notes:
AGOA: African Growth and Opportunity Act.
EBA: the "Everything But Arms" scheme for LDCs.
GSP+: Special incentive arrangement for sustainable development and good governance under the EU-GSP scheme.
DFQF: Duty-free and quota-free.
MFN: Most favoured nation.
(x): temporarily withdrawn.
See the text for further explanation.
Source: UNCTAD (2011), "Generalized System of Preferences: Lists of Beneficiaries" (UNCTAD/ITCD/TSB/Misc.62/Rev.5); UNCTAD (2009), "Handbook on Duty-Free Quota-Fee and Rules of Origin, Part I Quad Countries" (UNCTAD/ALDC/2008/4); UNCTAD website: GSP Handbook on Canada, the EU, Japan and the US.

Compared with the OECD market, apparel exports from the CLMV countries have already lost out or are losing market shares in the ASEAN-6 countries, where they are dominated by food, energy and industrial materials. At the same time, Viet Nam exported a number of dynamic non-traditional manufactured products that registered very high growth rates in 2000-10. They included telecom equipment, office machines, and computers. This new phenomenon reflects the emergence of Viet Nam as a regional production platform plugged into the Asian production networks for electronic products and components – a major source of the strong trade growth in the region.

It appears that China's dominant role as the "world factory" in Asia has significantly altered the pattern of specialisation among the CLMV countries. These countries have rapidly increased the supply of industrial materials and other primary products to the Chinese market. They include rubber, cork and wood, oil seeds, non-ferrous metals, coal and cokes, and non-metal mineral materials. Coxhead (2007) has raised concerns over the nature of CLMV's trade with China from the viewpoint of the "natural resource curse" hypothesis. It suggests that the combination of higher export dependence on natural resources and lower growth in manufactured exports could result in rapid resource depletion and slower economic growth, thereby leading countries to undesirable development outcomes in eradicating poverty and reducing inequality.

Whether the CLMV countries may have been trapped in such a predicament is not clear at this stage, because there are signs of new developments which indicate strong export growth in the Chinese market in both traditional and non-traditional manufactured products, such as apparel and footwear imported from Cambodia and electrical goods, telecom equipment, and office and data-processing machines from Viet Nam. Another positive development – the increased exports of textile fibres from Cambodia and textile yarns and fabrics from Viet Nam – may be seen as a sign of supply chain upgrades through backward linkages from apparel production to the textile industry.

CLVM exports grew fast but in different ways

The results of trade analysis presented in this section show that the export growth of Cambodia, Lao PDR and Viet Nam has been very rapid over the past decade, despite a temporary setback in 2009. Much of the initial success was driven by the growth of apparel and other labour-intensive manufactured products. Strong growth of apparel exports, in particular, has continued in Cambodia and Viet Nam even in the post-MFA/ATC trading environment.

More recently, the increased importance of ASEAN-6 and China as major trading partners has significantly altered the product patterns of specialisation in the CLMV countries. On the one hand, exports from Lao PDR, as well as Myanmar, have become increasingly dominated by food, energy and other industrial commodities, driven by rising import demands from their bigger neighbours. On the other hand, there are some signs of a new division of labour in East Asian supply chains with Viet Nam becoming an export production platform not only in traditional labour-intensive products, but also in machinery and equipment. In Viet Nam, both SOEs and foreign-funded firms have played an important role in the country's industrial growth. In contrast, however, Cambodia finds itself in the special position of being the economy that has specialised most heavily in apparel exports shipped to the OECD market. The growth of Cambodia's apparel sector has been fuelled by export-oriented FDI, as the country's preferential market access and low-cost labour has attracted foreign investors.

Managing the next phase of reform and integration

The strong trade and FDI growth in the CLV countries has been a result of their open-economy reforms. The institutional and policy reforms undertaken in trade and investment have improved the business environment and attracted both domestic and foreign investors in export-oriented industries. At the same time, greater openness to foreign trade and investment has revealed further weaknesses in the economy which will necessitate more in-depth reforms at later stages.

Table 4.A6 in the Appendix shows the current CLV business and regulatory environment from both global and regional perspectives. Drawing on data from June 2010 to May 2011, collected as part of the World Bank's 2012 *Doing Business* report,[12] it shows that Viet Nam finds itself midway down the ranking of ASEAN members for ease of doing

business (Column 2) and ease of trading across borders (Column 3), while Cambodia and Lao PDR lie towards the tail end of all 183 economies considered in the report.[13]

Despite the rapid growth of exports in Cambodia, Lao PDR and Viet Nam, the data in the table point to the border effect in all three countries – i.e. the time and cost constraints hampering domestic exporters and importers at the border. They can act as real obstacles to participating in the global and regional supply chains of time-sensitive goods such as high-value apparel items and electronic products whose production relies heavily on imports of parts and components across borders. Improving port infrastructure and terminal handling facilities certainly constitutes a critical area of public intervention, but policies and regulations that facilitate customs procedures and improve inland transport and logistics services are equally important, especially for land-locked Lao PDR. Further efforts, therefore, should be made to achieve more transparent and liberal trade regimes in the CLV countries.

Further reforms for better growth from open trade

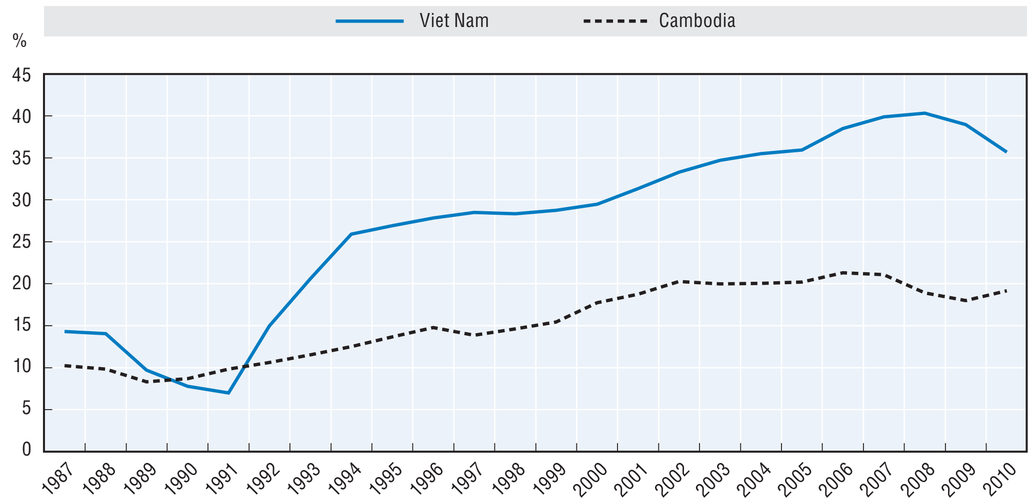
Recent research also points to the benefits of CLV undertaking complementary reforms if they are to significantly enhance the positive growth effects of trade openness (Chang et al., 2009). Past export successes in the CLV countries have created their own constituencies for pursuing more challenging microeconomic reforms to improve the regulatory environment for infrastructure development, increase skilled labour through educational reform, strengthen prudential regulation in the banking sector, and improve the governance and management of SOEs.[14] The main challenge to which CLV must rise is to implement these "second-generation" reforms as part of their national five-year development plans and share the benefits of reform across society at large. The stakes in such reform initiatives are high, because the CLV economies will face mounting competitive pressures in coming years, as ASEAN is now at the mid-point in its road map for creating an integrated single market and production base under the AEC. However, the particular reforms the CLV countries need to undertake vary according to their degree of agricultural and industrial development.

Cambodia

A close look at Individual country cases reveals that what is particularly important for Cambodia in its next phase of reform is to remove impediments to investment and start attracting diversified investment in sectors other than apparel. As Figure 4.7 shows, Cambodia's total investment as a percentage of GDP has been relatively low compared with Viet Nam's and stayed more or less flat at around 20% during the 2000s. See IMF (2012a) for further discussion. Increasing both domestic and foreign investment as part of the updated 2009-13 National Strategic Development Plan (NSDP) is therefore key to promoting broad-based industrial development and generating more and better jobs in the formal sector.

To realise its investment potential, Cambodia needs to take some specific measures. However, further budget prioritisation is particularly important in order to address critical infrastructure bottlenecks (such as reliable and affordable access to electricity) and encourage private-sector participation in infrastructure development. Other concrete measures are the implementation of anti-corruption legislation and the new rice-growing development policy to support rural development (Table 4.A1 in the Annex). Such reform commitments can help eradicate absolute poverty and reduce the relative poverty still prevalent in the country (Table 4.8).

Figure 4.7. **Total investment in Cambodia and Viet Nam**
(percentage of GDP, three-year moving averages)



Source: Calculated from IMF, World Economic Outlook database, April 2012.
StatLink http://dx.doi.org/10.1787/888932775364

Table 4.8. **Poverty headcount ratios in Southeast Asia, China and India**

Poverty headcount ratio at USD 1.25 a day (PPP) (% of population)

Country name	Initial year		Average 1990s	Average 2000s	Final year	
Cambodia	1994	44.5	n.a.	30.9	2008	22.8
Indonesia	1990	54.3	49.9	23.5	2010	18.1
Malaysia	1992	1.6	1.4	0.2	2009	0.0
Philippines	1991	30.7	26.8	21.4	2009	18.4
Thailand	1990	11.6	5.3	1.3	2009	0.4
Viet Nam	1993	63.7	56.7	26.6	2008	16.9
Memo items						
China	1990	60.2	51	19.2	2008	13.1
India	1994	49.4	n.a.	37.2	2010	32.7

Poverty headcount ratio at USD 2 a day (PPP) (% of population)

Country name	Initial year		Average 1990s	Average 2000s	Final year	
Cambodia	1994	75.2	n.a.	59.8	2008	53.3
Indonesia	1990	84.6	81.9	56.2	2010	46.1
Malaysia	1992	11.2	9.7	4.3	2009	2.3
Philippines	1991	55.4	50.6	43.8	2009	41.5
Thailand	1990	37.1	22.5	9.7	2009	4.6
Viet Nam	1993	85.7	82.0	54.3	2008	43.4
Memo items						
China	1990	84.6	73.8	39.3	2008	29.8
India	1994	81.7	n.a.	72.2	2010	68.7

Source: Calculated from the World Bank, World Development Indicators online.

Lao PDR

Lao PDR deserves special attention as its exports are heavily concentrated on hydropower and mining products reports (World Bank, 2010a). In a recent study that analyses "the Lao PDR product space", the World Bank (2010b) also shows, nevertheless, that there are numerous "emerging champion" export products outside the hydropower and mining sectors.[15] Some of those that have survived the 2009 global trade crisis are agricultural produce (cereals, vegetables and fruit) and industrial materials, such as cork and wood and rubber (Table 4.A3 in the Appendix).

Indeed, Lao PDR has recently undergone a major transformation from subsistence to commercial agriculture such as sugar cane and rubber production in Luang Natha Province and maize production in Oudomsay Province.[16] One reason is that China, as part of its "going out" policy, has been very actively channelling FDI into Lao PDR's farming sector and contributing to its transformation in two ways. One is that Laotian villages have become contract farmers in China's production and distribution networks. The other is through land concessions to the Chinese investors which, it is reported, have robbed many Laotian farmers of control over their land in the northern rural areas.[17] This development suggests, therefore, that the regulation of cross-border trade continues to be a major challenge to local authorities in Lao PDR. See also Bird and Hill (2010) – even if the national regulatory environment for trade and investment has seen considerable improvement in recent years.

Viet Nam

Despite the decline in the number of SOEs in recent years, the state sector in Viet Nam still controls a large share of the country's economy. Further reform of SOEs is necessary but politically sensitive because of internal resistance and difficulties in valuing assets. Apart from allowing for bankruptcy or mergers and acquisitions, reforming SOEs usually involves a process of equitisation which transforms SOEs into shareholding companies and then divests fully or partially the state's holdings. Modest progress has been made so far in restructuring SOEs,[18] as equitisation has focused only on smaller SOEs. Equitisation of the big ones is lagging behind schedule and the state has maintained large stakes in those SOEs that have been equitised. Indeed, the government has expressed its intention of maintaining controlling shares in a number of key sectors, such as telecommunication, power, and oil and gas. Concerns have consequently been raised about the country's industrial efficiency, as power, transport and telecommunication infrastructure are far from satisfactory, especially outside the main urban centres.

Viet Nam's banking sector has also seen the decline of state-owned commercial banks (SOCBs) as the number of joint-stock banks (JSBs) has steadily increased since 2005. The reform plan was to separate the central bank's supervision function from its ownership of SOCBs and allow for 100% foreign-owned bank branches.[19] As of 2010 there were five SOCBs, while the number of JSBs with state capital increased to 22 from 5 in 2005.[20] Nonetheless, the state continues to hold the charter capital of JSBs – mainly through the participation of SOEs in the process of equitisation. This is partly because SOEs may wish to influence the lending activities of banks even though they do not always hold a controlling stake. SOE involvement in the banking sector continues to be a source of concern owing to the lack of transparency in lending quality. A recent report on Viet Nam's enterprise reform points to the higher cost and inefficient use of capital as a result of the stalled SOE equitisation programme. After more than two decades of transition, Viet Nam's SOE reform is still considered an unfinished agenda. The country may need to launch a second *doi moi* strategy under the latest five-year National Socio-economic Development Plan (2011-15).

Conclusions

CLV should step up second-generation reform to address poverty and inequality. As ASEAN moves closer to the creation of an Asian economic community, the CLMV countries will have to deepen structural reform if they are to take full advantage of that ambition undertaking when it materialises in a few years. Some argue that the post 2009 trade and investment climate may become less conducive to the CLMV pursuit of outward-oriented industrialisation strategies. Others warn that apparently divergent approaches to the Trans-Pacific Partnership (TPP) could split and weaken ASEAN in future trade negotiations, because its members will not all be able to march together in the same direction (UNESCAP, 2012). All in all, however, it is fair to say that the reform efforts undertaken by Cambodia, Lao PDR and Viet Nam have brought huge benefits, from which two conclusions may be drawn.

The first conclusion is that all three countries have a strong record in their gradualist approach to economic transition and integration – starting with open-economy reforms, then moving on to more challenging "second-generation" changes. Once the CLV countries began their reform process in the late 1980s and the opening-up of their domestic economies to foreign trade and investment continued apace in the 1990s and 2000s, they had to adapt virtually every aspect of their economic management systems to rapidly changing external environments.

Second, geography matters in the growth and integration strategies of small, open economies like Cambodia, Lao PDR and Viet Nam. The development of their much larger neighbours, such as ASEAN-6 and China, has so heavily influenced their patterns of export specialisation that its impact on poverty and income distribution needs to be carefully assessed. In this respect, it is important to pay due attention to the social effects of burgeoning cross-border trade between Lao PDR and its neighbouring countries. There is a paucity of information and analysis on this type of trade and how it affects local communities on both sides of national borders.

Myanmar: everything to work for. The CLV transition and reform experience may hold a number of lessons for Myanmar. Although it became a WTO member in 1995, the reforms it needs to undertake to modernise its economy have not yet taken shape. However, under the new government that took office in March 2011, Myanmar is now facing a historic opportunity to kick-start those much needed reforms and promote economic integration, thereby fully realising its development potential. The landslide victory of the National League for Democracy (NLD) in the 1 April 2012 by-elections under the leadership of Aung San Suu Kyi is full of portent for the military-based Union Solidarity and Development Party (USDP): it suggests that the NLD is likely to win the next general election, scheduled for 2015 (see Pongsudhirak (2012). Moreover, Myanmar is due to host the 2013 Southeast Asian Games and chair ASEAN in 2014. These positive developments and upcoming political agenda are likely to prompt real reform efforts on the economic front. There are several priorities to consider.

First and foremost, priority should be given to making the government financially viable[21] and instituting an appropriate macroeconomic policy framework. Second, as the CLV reform experience suggests, priority should go to measures to loosen the binding constraints on growth and generate the income necessary to reduce poverty. Implementing open-economy reforms is a *sine qua non* condition for Myanmar's ability to support private-sector development and attract more export-oriented FDI into labour-intensive industries. The unification of official and market exchange rates on the day after the 1 April 2012 by-elections was a first step in the right direction. The next step should be to eliminate the broad array of import and export restrictions and promote FDI in non-gas export production through the enactment of a proper foreign investment law[22].

Priority should also be granted to reinvesting rents from exhaustible resources back into reproducible capital. One way to do this – without catching the Dutch disease – is to transfer natural resource rents into a sovereign wealth fund with clear, transparent rules in order to secure the long-term proceeds for financing a sustainable level of public investment, particularly in the ethnic minority regions where natural resources are located. The final priority, and one related to the previous point, concerns ethnic minorities. As they account for one-third of the population and one-half of Myanmar's states, they should be granted appropriate voice and representation in the formulation of the country's national development policy.

Appendix

Table 4.A1. **Reform and integration in Cambodia, Lao PDR and Viet Nam**

A: CAMBODIA

Reform Areas	1990s	2000s	2010s
		Domestic reform measures	
Major milestones	Market-oriented reforms began (1993) The country's IMF/ESAF programme disrupted due to the impact of the Asian finanical crisis	A new coalition governemnt formed (July 2004)	Launched the Cambodian stock market (July 2011)
National development plan (latest)		The updated National Strategic Development Plan (NSDP, 2009-2013) with the Rectangular strategy (Phase II): Agriculture and rural development; Infrastructure development; Private-sector development and employment creation; and Capacity building and human resource development	
Trade regulation and development		Law on Commercial Enterprise enacted (2005); National Export Strategy published (2006); The Diagonostic Trade Integration Study finalised (2007); The Customs Law and the Law on Standards adopted (2007); the Trade SWAp adopted (2008)	Law on Anti-Corruption promulgated (2010); Regulation on food safety adopted (2010); Full implementation of the TRIPS Agreement expected (July 2013)
Sectoral policy development			A new rice development policy adopted (2010)
FDI policy		Amendment to the Investment Law adopted (2005) to enhance transparency and rationalise incentives	Approved 22 special economic zones (SEZs) of which 5 are operational (January 2011)
Climate change policy	UNFCCC ratified (1995)	The Kyoto Protocol ratified (2002)	
		Market integration measures	
Global		Admitted to WTO (October 2004) Applied GSP schemes by developed countries	
Bilateral/ Regional	Joined ASEAN and accession to AFTA (1999)	Signed ASEAN-China FTA (2002), ASEAN-India FTA (2003), ASEAN-Korea FTA (2005), ASEAN-Japan FTA (2008), and ASEAN-Australia-New Zealand FTA (2009) Signed Trade and Investment Framework Agreement with the US (2006)	FTA with the EU under negotiation
Subregional	GMS initiative began (1992)		

Notes:
ASEAN-China: FTA Framework Agreement on Comprehensive Economic Co-operation signed (2002); Tariff rates of CLMV will be reduced to zero by 2015.
ASEAN-India: FTA Framework on Comprehensive Economic Co-operation Agreement signed (2003); Tariff rates of Cambodia will be reduced to zero by 2018.
ASEAN-Korea FTA: Framework Agreement on Economic Co-operation signed (2005, with the exception of Thailand); Tariff rates of Cambodia will be reduced to zero by 2018.
ASEAN-Japan FTA: Agreement on Comprehensive Economic Partnership signed (2008); Tariff rates of CLM will be reduced to zero by 2026.
ASEAN-Australia-New Zealand FTA: Agreement Establishing Free Trade Area signed (2009); Tariff rates of Cambodia and Myanmar will be reduced to zero by 2024.
GMS initiative: Build cross-border infrastructure in the Greater Mekong Subregion countries, such as the North-South Economic Corridor (Kunming-Bangkok) and the East-West Economic Corridor (Da Nang-Mawlamyaing) while at the same time fostering regional trade and investment flows and market integration.
TRIPS Agreement = Agreement on Trade-Related Aspects of Intellectual Property Rights

Source: Compiled by the author based on national sources as well as ASEAN, APEC and WTO websites.

Table 4.A1 (contd.)

B: LAO PDR

Reform Areas	1980s	1990s	2000s	2010s
Domestic reform measures				
Major milestones	Adopted the NEM (New Economic Mechanism, 1986)			First stock market launched (2011)
	Price controls removed except for utilities and some strategic products	Serious macroeconomic disruption (1998-99) in the wake of the Asian financial crisis	Macroeconomic stability regained (2000)	
National development plan (latest)				7th National Socio-Economic Development Plan (NSEDP, 2011-2015)
Trade regulation and development	Most domestic trade barriers relaxed; private firms permitted to trade internally and externally; multiple exchange rates unified (1988)	Trade reform continued; public administration reform implemented; further reforms put on hold due to the Asian financial crisis		
Climate change policy		UNFCCC ratified (1995)	The Kyoto Protocol ratified (2003)	
Market integration measures				
Global		Application for WTO accession submitted (1997)		
		Applied GSP schemes by developed countries		
Bilateral/ Regional			EU's EBA initiative applied (2002)	
		Signed Laos-Thailand FTA (1991)	US-Lao PDR Commercial Treaty signed (2004)	
			Signed ASEAN-China FTA (2002), ASEAN-India FTA (2003), ASEAN-Korea FTA (2005), ASEAN-Japan FTA (2008), and ASEAN-Australia-New Zealand FTA (2009)	
		Joined ASEAN and accession to AFTA (1997)		
Subregional		GMS initiative began (1992)		

Notes:
ASEAN-China FTA: Framework Agreement on Comprehensive Economic Co-operation signed (2002); Tariff rates of CLMV will be reduced to zero by 2015.
ASEAN-India FTA: Framework on Comprehensive Economic Co-operation Agreement signed (2003); Tariff rates of Lao PDR will be reduced to zero by 2018.
ASEAN-Korea FTA: Framework Agreement on Economic Co-operation signed (2005, with the exception of Thailand); Tariff rates of Lao PDR will be reduced to zero by 2018.
ASEAN-Japan FTA: Agreement on Comprehensive Economic Partnership signed (2008); Tariff rates of CLM will be reduced to zero by 2026.
ASEAN-Australia-New Zealand FTA: Agreement Establishing Free Trade Area signed (2009); Tariff rates of Lao PDR will be reduced to zero by 2024.
GMS initiative: Build cross-border infrastructure in the Greater Mekong Subregion countries, such as the North-South Economic Corridor (Kunming-Bangkok) and the East-West Economic Corridor (Da Nang-Mawlamyaing) while at the same time fostering regional trade and invesment flows and market integration.

Source: Compiled from national sources, Bird and Hill (2010) as well as ASEAN, APEC, IMF, World Bank and WTO websites.

Table 4.A1 (contd.)

C: VIET NAM				
Reform Areas	**1980s**	**1990s**	**2000s**	**2010s**
Domestic reform measures				
Major milestones	Adopted *Doi Moi* (renovation, 1986)	Enacted the Bankruptcy Law (1993)	Reform deepened to support private-sector development Launched the first stock market (2000) Enacted the Enterprise Law (2001); the Unified Enterprises Law (2006); and the Common Investment Law (2006)	
National development plan (latest)				The National Socio-economic Development Strategy (2011-2020) and the National Socio-economic Development Plan (2011-2015)
Trade regulation and development		Tarification of NTMs; Tariff reduciton on a MFN basis Import and capital controls imposed as a response to the Asian financial crisis		
FDI policy	Promulgated the Law on Foreign Investment (1987)			
Climate change policy		UNFCCC ratified (1994)	The Kyoto Protocol ratified (2002)	
Market integration measures				
Global			Admitted to WTO (2007)	
		Applied GSP schemes by developed countries		
Bilateral/ Regional		Signed the Framework Agreement on Co-operation with the EU (1995)	Enacted the US-Viet Nam Commercial Treaty (2001)	
		Joined ASEAN and accession to AFTA (1995)	Signed ASEAN-China FTA (2002), ASEAN-India FTA (2003), ASEAN-Korea FTA (2005), ASEAN-Japan FTA (2008) and ASEAN-Australia-New Zealand FTA (2009)	
		Joined APEC (1998)		
Subregional		GMS initiative began (1992)		

Notes:
ASEAN-China FTA: Framework Agreement on Comprehensive Economic Co-operation signed (2002); Tariff rates of CLMV will be reduced to zero by 2015.
ASEAN-India FTA: Framework on Comprehensive Economic Co-operation Agreement signed (2003); Tariff rates of Viet Nam will be reduced to zero by 2018.
ASEAN-Korea FTA: Framework Agreement on Economic Co-operation signed (2005, with the exception of Thailand); Tariff rates of Viet Nam will be reduced to zero by 2018.
ASEAN-Japan FTA: Agreement on Comprehensive Economic Partnership signed (2008); Tariff rates of Viet Nam will be reduced to zero by 2026.
ASEAN-Australia-New Zealand FTA: Agreement Establishing Free Trade Area signed (2009); Tariff rates of Viet Nam will be reduced to zero by 2024.
GMS initiative: Build cross-border infrastructure in the Greater Mekong Subregion countries, such as the North-South Economic Corridor (Kunming-Bangkok) and the East-West Economic Corridor (Da Nang-Mawlamyaing) while at the same time fostering regional trade and market integration.

Source: Compiled by the author based on national sources as well as ASEAN, APEC and WTO websites.

Table 4.A2. **Changing export composition and markets of Cambodia**

World imports from Cambodia (USD thousands)

SITC Rev3	Product description	AVE 1999-2001	AVE 2004-06	AVE 2009-11	% Share 1999-2001	% Share 2004-06	% Share 2009-11
Total	All products	1 491 877	3 370 141	5 767 930	100.0	100.0	100.0
84	Apparel/clothing/access	1 210 668	2 796 114	4 298 923	81.2	83.0	74.5
85	Footwear	104 415	186 391	522 118	7.0	5.5	9.1
23	Crude/synthet/rec rubber	40 276	79 529	138 565	2.7	2.4	2.4
27	Crude fertiliser/mineral	125	96	126 514	0.0	0.0	2.2
97	Gold non-monetary ex ore	5 011	41 079	92 257	0.3	1.2	1.6
78	Road vehicles	1 183	16 404	79 021	0.1	0.5	1.4
04	Cereals/cereal preparatn	767	5 133	69 909	0.1	0.2	1.2
05	Vegetables and fruit	1 977	20 244	60 497	0.1	0.6	1.0
28	Metal ores/metal scrap	2 265	10 464	57 920	0.2	0.3	1.0
24	Cork and wood	18 998	66 823	55 842	1.3	2.0	1.0
	Total of the top 10 items	1 385 685	3 222 276	5 501 566	92.9	95.6	95.4

OECD imports from Cambodia (USD thousands)

SITC Rev3	Product description	AVE 1999-2001	AVE 2004-06	AVE 2009-11	% Share 1999-2001	% Share 2004-05	% Share 2009-11
Total	All products	1 287 447	3 015 529	4 867 567	100.0	100.0	100.0
84	Apparel/clothing/access	1 144 096	2 732 306	4 129 360	88.9	90.6	84.8
85	Footwear	103 293	182 505	480 700	8.0	6.1	9.9
78	Road vehicles	26	14 324	75 409	0.0	0.5	1.5
04	Cereals/cereal preparatn	8	2 512	41 094	0.0	0.1	0.8
65	Textile yarn/fabric/art.	9 125	19 994	33 661	0.7	0.7	0.7
89	Misc manufactures n.e.s.	5 292	10 081	20 104	0.4	0.3	0.4
23	Crude/synthet/rec rubber	5 219	3 543	14 256	0.4	0.1	0.3
69	Metal manufactures n.e.s.	102	707	9 370	0.0	0.0	0.2
51	Organic chemicals	58	0	8 790	0.0	0.0	0.2
03	Fish/shellfish/etc.	6 700	29 441	8 164	0.5	1.0	0.2
	Total of the top 10 items	1 273 920	2 995 414	4 820 907	98.9	99.3	99.0

ASEAN-6 imports from Cambodia (USD thousands)

SITC Rev3	Product description	AVE 1999-2001	AVE 2004-06	AVE 2009-11	% Share 1999-2001	% Share 2004-06	% Share 2009-11
Total	All Products	111 410	133 058	461 985	100.0	100.0	100.0
27	Crude fertiliser/mineral	39	16	126 142	0.0	0.0	27.3
97	Gold non-monetary ex ore	5 003	25 947	91 884	4.5	19.5	19.9
28	Metal ores/metal scrap	1 632	7 884	50 208	1.5	5.9	10.9
84	Apparel/clothing/access	62 555	41 228	28 161	56.1	31.0	6.1
79	Railway/tramway equipmnt	158	731	25 118	0.1	0.5	5.4
23	Crude/synthet/rec rubber	21 556	4 834	22 819	19.3	3.6	4.9
05	Vegetables and fruit	87	151	19 885	0.1	0.1	4.3
04	Cereals/cereal preparatn	760	2 321	17 358	0.7	1.7	3.8
22	Oil seeds/oil fruits	382	4 351	16 651	0.3	3.3	3.6
89	Misc manufactures n.e.s.	90	998	12 767	0.1	0.7	2.8
	Total of the top 10 items	92 261	88 460	410 992	82.8	66.5	89.0

China's imports from Cambodia (USD thousands)

SITC Rev3	Product description	AVE 1999-2001	AVE 2004-06	AVE 2009-11	% Share 1999-2001	% Share 2004-05	% Share 2009-2011
Total	All products	50 028	30 776	104 939	100.0	100.0	100.0
23	Crude/synthet/rec rubber	5 893	4 785	33 142	11.8	15.5	31.6
84	Apparel/clothing/access	1 558	1 959	28 085	3.1	6.4	26.8
24	Cork and wood	1 861	10 171	22 727	3.7	33.0	21.7
00	Live animals except fish	244	552	5 233	0.5	1.8	5.0
26	Textile fibres	0	354	4 984	0.0	1.1	4.7
85	Footwear	0	98	4 581	0.0	0.3	4.4
55	Perfume/cosmetic/cleansr	723	1 055	1 229	1.4	3.4	1.2
03	Fish/shellfish/etc.	0	25	912	0.0	0.1	0.9
79	Railway/tramway equipmnt	0	537	821	0.0	1.7	0.8
69	Metal manufactures n.e.s.	0	0	656	0.0	0.0	0.6
	Total of the top 10 items	10 279	19 535	102 370	20.5	63.5	97.6

Source: Calculated from United Nations Commodity Trade Statistics Database (UN Comtrade), http://comtrade.un.org.

Table 4.A3. Changing export composition and markets of Lao PDR

World imports from Lao PDR (USD thousands)

SITC Rev3	Product description	AVE 1999-2001	AVE 2004-06	AVE 2009-11	% Share 1999-2001	% Share 2004-06	% Share 2009-11
Total	All products	368 269	692 663	1 905 419	100.0	100.0	100.0
68	Non-ferrous metals	44	140 399	479 781	0.0	20.3	25.2
28	Metal ores/metal scrap	3 739	4 088	380 815	1.0	0.6	20.0
35	Electric current	0	73 660	272 410	0.0	10.6	14.3
24	Cork and wood	97 700	164 544	265 777	26.5	23.8	13.9
84	Apparel/clothing/access	124 564	183 460	192 501	33.8	26.5	10.1
07	Coffee/tea/cocoa/spices	18 515	15 036	54 903	5.0	2.2	2.9
04	Cereals/cereal preparatn	233	11 404	46 129	0.1	1.6	2.4
52	Inorganic chemicals	29	927	24 373	0.0	0.1	1.3
23	Crude/synthet/rec rubber	164	6 055	23 933	0.0	0.9	1.3
05	Vegetables and fruit	1 423	6 466	23 521	0.4	0.9	1.2
	Total of the top 10 items	246 410	606 039	1 764 142	66.9	87.5	92.6

OECD imports from Lao PDR (USD thousands)

SITC Rev3	Product description	AVE 1999-2001	AVE 2004-06	AVE 2009-11	% Share 1999-2001	% Share 2004-05	% Share 2009-11
Total	All products	156 545	243 390	326 320	100.0	100.0	100.0
84	Apparel/clothing/access	122 916	180 185	185 977	78.5	74.0	57.0
07	Coffee/tea/cocoa/spices	14 596	12 756	49 614	9.3	5.2	15.2
52	Inorganic chemicals	1	867	23 312	0.0	0.4	7.1
28	Metal ores/metal scrap	35	259	11 161	0.0	0.1	3.4
85	Footwear	3 169	6 741	10 642	2.0	2.8	3.3
24	Cork and wood	9 874	6 469	8 552	6.3	2.7	2.6
68	Non-ferrous metals	1	5 405	6 834	0.0	2.2	2.1
89	Misc manufactures n.e.s.	354	4 066	5 889	0.2	1.7	1.8
06	Sugar/sugar prep/honey	3	19	4 608	0.0	0.0	1.4
65	Textile yarn/fabric/art.	174	231	2 124	0.1	0.1	0.7
	Total of the top 10 items	151 123	216 998	308 713	96.5	89.2	94.6

ASEAN-6 imports from Lao PDR (USD thousands)

SITC Rev3	Product description	AVE 1999-2001	AVE 2004-06	AVE 2009-11	% Share 1999-2001	% Share 2004-06	% Share 2009-11
Total	All products	77 329	302 088	783 671	100.0	100.0	100.0
68	Non-ferrous metals	36	107 902	345 506	0.0	35.7	44.1
35	Electric current	0	73 660	272 410	0.0	24.4	34.8
24	Cork and wood	54 659	72 534	49 988	70.7	24.0	6.4
04	Cereals/cereal preparatn	113	7 076	23 345	0.1	2.3	3.0
05	Vegetables and fruit	127	3 558	14 365	0.2	1.2	1.8
77	Electrical equipment	262	3 165	13 948	0.3	1.0	1.8
32	Coal/coke/briquettes	1 596	3 753	11 500	2.1	1.2	1.5
78	Road vehicles	912	415	6 483	1.2	0.1	0.8
72	Industry special machine	309	226	6 116	0.4	0.1	0.8
22	Oil seeds/oil fruits	176	1 641	4 908	0.2	0.5	0.6
	Total of the top 10 items	58 190	273 932	748 569	75.2	90.7	95.5

China's Imports from Lao PDR (USD thousands)

SITC Rev3	Product description	AVE 1999-2001	AVE 2004-06	AVE 2009-11	% Share 1999-2001	% Share 2004-05	% Share 2009-11
Total	All products	7 810	29 282	598 799	100.0	100.0	100.0
28	Metal ores/metal scrap	0	1 047	361 160	0.0	3.6	60.3
24	Cork and wood	5 858	14 605	120 666	75.0	49.9	20.2
68	Non-ferrous metals	0	3 479	58 977	0.0	11.9	9.8
23	Crude/synthet/rec rubber	116	5 928	23 846	1.5	20.2	4.0
04	Cereals/cereal preparatn	41	1 159	13 499	0.5	4.0	2.3
05	Vegetables and fruit	915	1 196	7 494	11.7	4.1	1.3
32	Coal/coke/briquettes	0	77	2 969	0.0	0.3	0.5
55	Perfume/cosmetic/cleansr	0	256	2 120	0.0	0.9	0.4
00	Live animals except fish	67	0	1 721	0.9	0.0	0.3
29	Crude anim/veg mater n.e.s.	673	427	1 663	8.6	1.5	0.3
	Total of the top 10 items	7 670	28 173	594 116	98.2	96.2	99.2

Source: Calculated from United Nations Commodity Trade Statistics Database (UN Comtrade), http://comtrade.un.org.

Table 4.A4. **Changing export composition and markets of Myanmar**

World imports from Myanmar (USD thousands)

SITC Rev3	Product description	AVE 1999-2001	AVE 2004-06	AVE 2009-11	% Share 1999-2001	% Share 2004-06	% Share 2009-11
Total	All products	2 030 288	3 836 857	6 370 266	100.0	100.0	100.0
34	Gas natural/manufactured	253 094	1 530 498	2 737 055	12.5	39.9	43.0
05	Vegetables and fruit	171 641	393 549	820 439	8.5	10.3	12.9
24	Cork and wood	390 237	676 441	602 723	19.2	17.6	9.5
84	Apparel/clothing/access	695 047	445 749	594 709	34.2	11.6	9.3
66	Non-metal mineral manuf.	32 797	56 061	351 934	1.6	1.5	5.5
03	Fish/shellfish/etc.	163 792	250 553	301 033	8.1	6.5	4.7
28	Metal ores/metal scrap	12 754	21 758	184 465	0.6	0.6	2.9
23	Crude/synthet/rec rubber	14 421	34 884	158 808	0.7	0.9	2.5
04	Cereals/cereal preparatn	38 936	36 282	118 759	1.9	0.9	1.9
85	Footwear	16 201	37 516	89 984	0.8	1.0	1.4
	Total of the top 10 items	1 788 920	3 483 291	5 959 909	88.1	90.8	93.6
	OECD Imports from Myanmar (US thousands)						
SITC Rev3	**Product description**	**AVE 1999-2001**	**AVE 2004-06**	**AVE 2009-11**	**% Share 1999-2001**	**% Share 2004-05**	**% Share 2009-11**
Total	All products	967 833	760 582	864 666	100.0	100.0	100.0
84	Apparel/clothing/access	666 597	414 216	553 600	68.9	54.5	64.0
03	Fish/shellfish/etc.	96 801	114 352	88 772	10.0	15.0	10.3
85	Footwear	15 782	37 439	86 928	1.6	4.9	10.1
05	Vegetables and fruit	13 381	12 035	48 281	1.4	1.6	5.6
22	Oil seeds/oil fruits	10 653	10 483	24 029	1.1	1.4	2.8
24	Vegetables and fruit	49 811	73 188	11 251	5.1	9.6	1.3
66	Non-metal mineral manuf.	12 505	17 305	9 109	1.3	2.3	1.1
23	Crude/synthet/rec rubber	312	338	8 392	0.0	0.0	1.0
68	Non-ferrous metals	17 114	2 461	4 189	1.8	0.3	0.5
08	Animal feed ex unml cer.	4 457	2 140	4 157	0.5	0.3	0.5
	Total of the top 10 items	887 413	683 957	838 708	91.7	89.9	97.0
	ASEAN-6 imports from Myanmar (USD thousands)						
SITC Rev3	**Product description**	**AVE 1999-2001**	**AVE 2004-06**	**AVE 2009-11**	**% Share 1999-2001**	**% Share 2004-06**	**% Share 2009-11**
Total	All products	592 332	2 052 055	3 310 898	100.0	100.0	100.0
34	Gas natural/manufactured	253 094	1 530 487	2 737 055	42.7	74.6	82.7
03	Fish/shellfish/etc.	47 431	104 458	117 200	8.0	5.1	3.5
05	Vegetables and fruit	37 421	43 235	104 445	6.3	2.1	3.2
24	Cork and wood	101 574	124 580	84 604	17.1	6.1	2.6
23	Crude/synthet/rec rubber	12 849	18 208	73 539	2.2	0.9	2.2
27	Crude fertiliser/mineral	100	98	43 954	0.0	0.0	1.3
04	Cereals/cereal preparatn	11 476	12 143	26 281	1.9	0.6	0.8
68	Non-ferrous metals	24 866	78 172	24 633	4.2	3.8	0.7
63	Cork and wood	5 710	5 746	12 440	1.0	0.3	0.4
28	Metal ores/metal scrap	7 497	3 358	10 227	1.3	0.2	0.3
	Total of the top 10 items	502 016	1 920 486	3 234 378	84.8	93.6	97.7
	China's Imports from Myanmar (USD thousands)						
SITC Rev3	**Product description**	**AVE 1999-2001**	**AVE 2004-06**	**AVE 2009-11**	**% Share 1999-2001**	**% Share 2004-05**	**% Share 2009-11**
Total	All products	120 227	244 662	1 097 361	100.0	100.0	100.0
66	Non-metal mineral manuf.	9 893	7 752	330 489	8.2	3.2	30.1
24	Cork and wood	72 621	161 749	221 231	60.4	66.1	20.2
28	Metal ores/metal scrap	4 434	18 185	174 048	3.7	7.4	15.9
05	Vegetables and fruit	8 971	8 568	84 737	7.5	3.5	7.7
23	Crude/synthet/rec rubber	386	12 631	65 290	0.3	5.2	5.9
03	Fish/shellfish/etc.	4 784	3 490	61 146	4.0	1.4	5.6
35	Electric current	0	224	50 955	0.0	0.1	4.6
22	Oil seeds/oil fruits	315	5 593	30 376	0.3	2.3	2.8
88	Photographic equ/clocks	0	272	14 704	0.0	0.1	1.3
27	Crude fertiliser/mineral	7 979	4 676	7 722	6.6	1.9	0.7
	Total of the top 10 items	109 383	223 141	1 040 697	91.0	91.2	94.8

Source: Calculated from United Nations Commodity Trade Statistics Database (UN Comtrade), http://comtrade.un.org.

Table 4.A5. **Changing export composition and markets of Viet Nam**

World Imports from Viet Nam (USD millions)

SITC Rev3	Product description	AVE 1999-2001	AVE 2004-06	AVE 2009-11	% Share 1999-2001	% Share 2004-06	% Share 2009-11
Total	All products	12 811	34 248	74 224	100.0	100.0	100.0
84	Apparel/clothing/access	1 541	5 148	11 429	12.0	15.0	15.4
85	Footwear	2 235	4 943	7 776	17.4	14.4	10.5
33	Petroleum and products	2 896	7 052	6 329	22.6	20.6	8.5
76	Telecomms etc equipment	96	356	5 030	0.7	1.0	6.8
03	Fish/shellfish/etc.	1 131	2 576	4 410	8.8	7.5	5.9
89	Misc manufactures nes	307	833	3 861	2.4	2.4	5.2
82	Furniture/furnishings	374	1 906	3 821	2.9	5.6	5.1
77	Electrical equipment	546	1 377	3 415	4.3	4.0	4.6
07	Coffee/tea/cocoa/spices	746	1 217	2 654	5.8	3.6	3.6
65	Textile yarn/fabric/art.	275	713	2 499	2.1	2.1	3.4
	Total of the top 10 items	10 146	26 123	51 224	79.2	76.3	69.0
	OECD Imports from Viet Nam (USD millions)						
SITC Rev3	**Product description**	**AVE 1999-2001**	**AVE 2004-06**	**AVE 2009-11**	**% Share 1999-2001**	**% Share 2004-05**	**% Share 2009-11**
Total	All products	9 206	24 662	50 044	100.0	100.0	100.0
84	Apparel/clothing/access	1 478	5 003	10 857	16.1	20.3	21.7
85	Footwear	2 128	4 516	6 473	23.1	18.3	12.9
33	Petroleum and products	1 479	3 474	3 749	16.1	14.1	7.5
82	Furniture/furnishings	351	1 846	3 654	3.8	7.5	7.3
03	Fish/shellfish/etc.	1 009	2 280	3 598	11.0	9.2	7.2
89	Misc manufactures n.e.s.	272	733	3 542	3.0	3.0	7.1
76	Telecomms etc equipment	64	196	2 437	0.7	0.8	4.9
77	Electrical equipment	233	872	2 012	2.5	3.5	4.0
07	Coffee/tea/cocoa/spices	581	940	1 938	6.3	3.8	3.9
65	Textile yarn/fabric/art.	196	474	1 362	2.1	1.9	2.7
	Total of the top 10 items	7 790	20 334	39 622	84.6	82.5	79.2
	ASEAN-6 imports from Viet Nam (USD millions)						
SITC Rev3	**Product description**	**AVE 1999-2001**	**AVE 2004-06**	**AVE 2009-11**	**% Share 1999-2001**	**% Share 2004-06**	**% Share 2009-11**
Total	All products	1 968	4 615	8 880	100.0	100.0	100.0
33	Petroleum and products	801	2 360	1 850	40.7	51.1	20.8
04	Cereals/cereal preparatn	350	513	1 631	17.8	11.1	18.4
76	Telecomms etc equipment	17	28	538	0.8	0.6	6.1
77	Electrical equipment	292	351	395	14.8	7.6	4.4
75	Office/dat proc machines	18	208	381	0.9	4.5	4.3
67	Iron and steel	3	32	380	0.2	0.7	4.3
65	Textile yarn/fabric/art.	17	79	314	0.9	1.7	3.5
03	Fish/shellfish/etc.	52	126	226	2.7	2.7	2.5
66	Non-metal mineral manuf.	12	32	221	0.6	0.7	2.5
23	Crude/synthet/rec rubber	22	22	203	1.1	0.5	2.3
	Total of the top 10 items	1 584	3 752	6 138	80.5	81.3	69.1
	China's Imports from Viet Nam (USD millions)						
SITC Rev3	**Product description**	**AVE 1999-2001**	**AVE 2004-06**	**AVE 2009-11**	**% Share 1999-2001**	**% Share 2004-05**	**% Share 2009-11**
Total	All products	765	2 507	7 616	100.0	100.0	100.0
32	Coal/coke/briquettes	3	397	1 481	0.5	15.8	19.4
77	Electrical equipment	4	63	729	0.5	2.5	9.6
05	Vegetables and fruit	30	135	649	4.0	5.4	8.5
33	Petroleum and products	561	1 088	562	73.3	43.4	7.4
76	Telecomms etc equipment	3	12	510	0.4	0.5	6.7
24	Cork and wood	5	61	455	0.7	2.4	6.0
65	Textile yarn/fabric/art.	12	35	443	1.5	1.4	5.8
75	Office/dat proc machines	1	32	420	0.1	1.3	5.5
28	Metal ores/metal scrap	14	136	377	1.8	5.4	4.9
23	Crude/synthet/rec rubber	40	100	315	5.3	4.0	4.1
	Total of the top 10 items	673	2 060	5 943	88.0	82.2	78.0

Source: Calculated from United Nations Commodity Trade Statistics Database (UN Comtrade), http://comtrade.un.org.

Table 4.A6. **Ease of doing business and trading across borders in selected Asia-Pacific economies**

Economy	Ease of doing business (ranking)	Ease of trading across borders (ranking)	Time to export (days)	Cost to export (USD per container)	Time to import (days)	Cost to import (USD per container)
Singapore	1	1	5	456	4	439
Hong Kong, China	2	2	5	575	5	565
New Zealand	3	27	10	855	9	825
Korea, Rep.	8	4	7	680	7	695
Australia	15	30	9	1 060	8	1 119
Thailand	17	17	14	625	13	750
Malaysia	18	29	17	450	14	435
Japan	20	16	10	880	11	970
Chinese Taipei	25	23	12	655	12	720
Brunei Darussalam	83	35	19	680	15	745
Sri Lanka	89	53	21	715	19	745
China	91	60	21	500	24	545
Viet Nam	98	68	22	580	21	670
Pakistan	105	75	21	660	18	705
Bangladesh	122	115	25	965	31	1 370
Indonesia	129	39	17	644	27	660
India	132	109	16	1 095	20	1 070
Philippines	136	51	15	630	14	730
Cambodia	138	120	22	732	26	872
Lao PDR	165	168	44	1 880	46	2 035

Notes:
Economies in italics are ASEAN member states (excluding Myanmar where data are not available).
The order of economy is sorted according to the ease of doing business ranking.
Ease of doing business and trading across borders: individual economy's ranking among 183 economies surveyed.
Time to export /import: Time necessary to comply with all procedures required to export/import goods.
Cost to export/import: Cost associated with all the procedures required to export/import goods.
Source: World Bank (2012), *Doing Business in a More Transparent World* (www.doingbusiness.org).

Notes

1. *Doi moi* refers to the reforms Viet Nam undertook in 1986 to transform its centrally planned economy into one that was market oriented.
2. For example, Viet Nam promulgated its Law on Foreign Investment in 1987 to facilitate FDI inflows. This law was subsequently revised five times to increase the rights of foreign investors as against domestic investors, simplify the registration procedures for foreign investors and make the investment environment more friendly (Thanh and Duong, 2011).
3. In Cambodia, the two parallel exchange rates were unified in 1993 (Pum and Vanak 2010). In Laos, the unification of multiple exchange rates took place in 1988, two years after the economic reform in 1986 (Kyophilavong, 2011). In Viet Nam, the two official rates were merged in 1989 into a single rate at a level close to the market rate (Dinh 2010).
4. As for Asia's rising regionalism, see ADB (2008), Pomfret (2011) and UNESCAP (2012).
5. It should be noted here that the Asia-Pacific Economic Co-operation (APEC) forum was created in 1989 under the principle of "open regionalism". At the Bogor summit meeting in 1994, the member states of APEC, which included ASEAN-6, announced their intention to pursue "free trade and investment" in the region by 2010 for developed members or 2020 for the rest. The APEC process is informal without involving any preferential trade arrangement. Its approach is based on voluntary and concerted unilateral liberalisation and trade and investment facilitation. Among the CLMV countries, Viet Nam joined APEC in 1998.
6. Note that at the time of writing UNSO Comtrade has no data for Laos and very few data for Myanmar (1992 and 2010 for domestic exports, and 1992, 2001 and 2010 for domestic imports).
7. Revealed comparative advantage indices (RCA) use the trade pattern to identify the sectors in which an economy has a comparative advantage, by comparing the country of interest's trade profile with the world average. (Source: United Nations Social and Economic Commission for Asia and the Pacific, www.unescap.org/tid/artnet/RCA.pdf)
8. See OECD (2010, Chapter 3) for calculation and discussion of the RCA index.
9. According to Lopez-Acevedo and Robertson (2012a), Cambodia's apparel labour force is around 300 000 – nearly 30% of industrial employment – while in Viet Nam it amounts to more than 2 million people.
10. According to UNCTAD, there are currently 13 national GSP schemes: Australia, Belarus, Bulgaria, Canada, Estonia, the EU, Japan, New Zealand, Norway, Russia, Switzerland, Turkey, and the US.
11. These products include footwear, headgear, umbrellas, artificial flows and so on which fall into Section XII of the Harmonised System.
12. "The Doing Business project provides objective measures of business regulations for local firms in 183 economies and selected cities at the subnational level." (Source: www.doingbusiness.org.)
13. The correlation coefficient of these two ranking series is found to be very high (0.720).
14. These reform challenges are reiterated in a background study prepared by Davading (2010) for the World Bank's Lao PDR Development Report 2010.
15. Record and Nghardsaysone (2010) define the "emerging champions" as those products in which Lao PDR's RCA index was low (less than one) in the 1985-89 period but was high (one or above) in the 2004-06 period, using 4-digit SITC trade data. Products are then filtered to select only those where annual exports were on average above USD 500 000 per year in 2004-06.
16. See Goto (2011) for the impact of cross-border trade with China on the northern rural communities in Laos.
17. Ibid.
18. See World Bank (2011, Chapter 2) for a recent review of SOE reform.
19. Opening up the banking sector was stipulated in the US-Viet Nam Bilateral Trade Agreement which entered into force in December 2001 with a maximum phase-in period of ten years. The Vietnamese government also considered liberalisation of its banking sector as a necessary step to prepare the membership of the WTO which was realised in 2007, as its companies and its banks needed to compete on an equal footing in the global market.
20. These five SOCBs are Agribank and the Bank for Investment and Development of Viet Nam (BIDV) with 100% state ownership; and the Mekong Housing Bank, Vietcombank and Vietinbank with state ownership of more than 80 % (World Banks, 2011).

21. This includes the cancellation of debts in arrears owned by the ADB and the WB (Myanmar's external debt arrears are about USD 5.5 billion).
22. See the article "Myanmar: Opening up", by Gwen Robinson, *Financial Times*, 18 April 2012.

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CHAPTER FIVE

Poverty and inequality disparities in Cambodia, Lao PDR, Myanmar and Viet Nam

Abstract

This chapter considers how and if economic reform in Cambodia, Lao PDR, Myanmar and Viet Nam (CLMV) has reduced poverty and income inequality. It opens with a brief introductory section that puts CLMV in a regional context and outlines the themes the chapter addresses. The section on the CLMV experience of poverty and inequality – country by country – examines each country in turn, sketching its history from independence, its experience of war, and its transition from a centrally planned people's democracy to a market economy in the 1980s and 1990s. In this respect, Myanmar is an exception as it is only now ushering in its first tentative reforms. Cambodia, Lao PDR and Viet Nam, however, have effectively rebuilt and reaped the benefits. Their export-driven economic growth has been strong. Cambodia and Viet Nam have diversified their economies away from agriculture and both are currently fostering eco-tourism and new green industries. All three have reduced poverty – Viet Nam by half. Income disparities, however, persist between men and women, urban areas and rural regions, and ethnic groups. Inequality has actually widened in Lao PDR. CLMV have much to do to ensure development is inclusive and sustainable: further build infrastructure and institutional capacity, widen equitable access to education and employment, make the business environment investor-friendly, invest in human capital, nurture small and medium-sized enterprises, weed out corruption. The section on CLMV countries briefly compares the four countries and their performance in reducing poverty and inequality. Myanmar is a constant exception, principally because so little data are available. However, the final section "Conclusion", also applies to Myanmar: economic growth does not of itself deliver equally shared benefits for all.

Introduction

As a group, the Association of Southeast Asian Nations (ASEAN) is aware that, if the region it represents is to grow, there must be closer economic integration between the ASEAN-6 and Cambodia, Lao PDR, Myanmar and Viet Nam (CLMV). Accordingly, it has drawn up an initiative – the Initiative for ASEAN Integration (IAI) – to accelerate economic growth in CLMV. These formerly socialist states engaged in reforms to develop market economies in the late 1980s and the IAI is designed to reinforce their efforts.

Since CLMV embarked on the path of reform, they have seen their foreign trade expand greatly. The exception is Myanmar, where trade growth has been slow, due primarily to the trade sanctions imposed by the United States and the European Union. Even so, its economy has grown steadily since the late 1990s as a result of measures to liberalise the market taken by the military government. Now, following the introduction of political and economic reforms in early 2011, there is new found optimism that most trade sanctions will be removed. Foreign investment inflows have surged and there is growing confidence that Myanmar's economy will perform even better than it has done in the last few years.

As discussed in Chapter 4, another factor – in addition to trade growth – that has contributed to ASEAN's strong economic performance in recent decades is foreign direct investment (FDI). Singapore has attracted large inflows of FDI, as have Malaysia, Indonesia and Thailand, albeit to a lesser degree. CLMV, especially Viet Nam, have also benefited. Myanmar is again the exception. It received little FDI until 2011, when the new civilian government introduced political and economic reforms.

While economic growth remains a concern in all ASEAN countries because of the uncertain global economic environment, income disparities and poverty alleviation have emerged as major policy issues. Table 5.1 suggests that recent income inequality trends vary across the ASEAN member states. The data for Cambodia, Thailand, the Philippines and Viet Nam show a decline in their Gini coefficients since the 2000s. On the other hand, Indonesia and Lao PDR have experienced an increase in inequality since 2002. Malaysia and Singapore have also seen income inequality rise for reasons that are complex, but probably related to their greater global integration and mounting dependence on unskilled foreign workers, which has depressed the wages of competing local workers. No tentative conclusion may be drawn for Myanmar because of the absence of time-series data.

While the factors contributing to income disparity trends are open to debate, it is clear from the experience of CLMV that economic growth has reduced the proportion of the population classified as poor. As Table 5.2 shows, Viet Nam more than halved the number of its people living in poverty – from 29% in 2002 to 14% in 2008-09. Cambodia and Lao PDR, too, have made progress, while data are too scant to draw any conclusions about Myanmar's experience. Of the original ASEAN members, only the Philippines has made little headway in cutting poverty. Indonesia, Malaysia and Thailand have all reduced the share of their populations living below the poverty line.

Table 5.1. **Income inequality in Southeast Asia, 1990-2011**

Country	Gini coefficient of inequality				
	1990	1995	2000	2005	2011
Brunei	-	-	41.3 ('03)	41.3	-
Cambodia	-	38.3 ('94)	-	41.9 ('04)	37.9 ('08)
Indonesia	29.2	31.3 ('96)	29.7 ('02)	34.0	38.9
Lao PDR	30.4 ('92)	34.9 ('97)	32.6 ('02)	-	36.7 ('08)
Malaysia	46.7 ('92)	48.5	-	37.9 ('04)	46.2 ('09)
Myanmar	-	30.0 ('01)	-	-	-
Philippines	43.8 ('91)	46.2 ('97)	46.1	44.0 ('06)	43.0 ('09)
Singapore	-	-	43.4	45.1	45.2
Thailand	45.3	42.9 ('96)	42.8	42.4 ('06)	40.0 ('09)
Viet Nam	35.7 ('93)	35.5 ('98)	37.6 ('02)	36.8 ('04)	35.6 ('08)

Note: The Gini coefficient is the most commonly used measure of inequality. It ranges from 0 to 1 (or 100 on percentile scale), where 0 denotes perfect equality (all other values being equal) and 1 (or 100 on percentile scale) expresses complete inequality, with a single person having all income. For Indonesia, the Gini coefficient for 2011 is an estimate combining the separate urban and rural distributions weighted by share of urban/rural to total population. For Singapore, the Gini coefficient refers to household income from work including employer CPF contributions per household member after accounting for government transfers and taxes.

Source: World Bank (2012a), *World Development Indicators* online, http://data.worldbank.org/data-catalog/world-development-indicators. ADB *Asian Economic Outlook 2012*, Department of Statistics, Singapore

Table 5.2. **Proportion of the population under national poverty lines in Southeast Asia, 2000-10**

Country	2000/2001	2003/2004	2005/2006	2007/2008	2009/2010
Brunei	n.a	n.a	n.a	n.a	n.a
Cambodia	37.0	34.7	33.0	30.1	26.0
Indonesia	19.1	17.4	16.0	16.6	13.3
Lao PDR	36.0	33.5	30.0	27.6	24.0
Malaysia	8.5	5.7	5.7	3.6	3.8
Myanmar	26.6	32.0	–	–	–
Philippines	26.0	24.9	26.0	26.4	24.0
Singapore	n.a	n.a	n.a	n.a	n.a
Thailand	21.0	11.2	9.6	8.5	8.1
Viet Nam	28.9 ('02)	19.5	16.0	14.5	–

Notes: n.a. denotes "not applicable"; – denotes "data not available".

Source: ASEAN Secretariat (2012), ASEAN Community in Figures 2011, Jakarta.

Poverty levels have fallen in Cambodia, Lao PDR and Viet Nam, even though all three are widely perceived to have corrupt institutions and poor governance. Table 5.3 shows that they rank poorly in Transparency International's Corruption Perceptions Index (CPI).

Table 5.3. **CLMV countries' scores in the Corruption Perceptions Index, 2003-11**

Country	2003	2004	2005	2006	2007	2008	2009	2010	2011
Brunei	-	-	-	-	-	-	5.5	5.5	5.2 (44/183)
Indonesia	1.9	2.0	2.2	2.4	2.3	2.6	2.8	2.8	3.0 (100/183)
Malaysia	5.2	5.0	5.1	5.0	5.1	5.1	4.5	4.4	4.3 (60/183)
Philippines	2.6	2.5	2.6	2.5	2.5	2.5	2.3	2.4	2.6 (129/183)
Singapore	9.4	9.4	9.3	9.2	9.3	9.2	9.2	9.3	9.2 (5/183)
Thailand	3.3	3.6	3.8	3.6	3.3	3.5	3.4	3.5	3.4 (80/183)
Cambodia	1.2	1.3	1.5	2.3	2.1	2.0	1.8	2.1	2.1 (164/183)
Lao PDR	-	-	-	3.3	2.6	1.9	2.0	2.1	2.2 (154/183)
Myanmar	-	1.6	1.7	1.8	1.9	1.4	1.3	1.4	1.5 (180/183)
Viet Nam	2.4	2.4	2.6	2.6	2.6	2.6	2.7	2.7	2.9 (112/183)

Note: The corruption perceptions index ranks countries/territories based on how corrupt their public sector is perceived to be. A country/territory's score indicates its perceived level of public sector corruption on a scale of 0-10, where "0" denotes "highly corrupt" and "10" means "very clean".

Source: Transparency International (2011), Corruption Perceptions Index 2011, Berlin, http://cpi.transparency.org/cpi2011/results.

The CLMV experience of poverty and inequality – country by country

As data on poverty and inequality in CLMV are incomplete, it is difficult to draw firm conclusions as to the countries' comparative performances. Deeper understanding requires analysis of each one's reform policies for dealing with growth, poverty and inequality. Also necessary is a sound grasp of the role played by such regional and international organisations as ASEAN, the World Bank and the Asian Development Bank (ADB) in promoting growth and reducing poverty. To plug the data gap, the following sections consider the experience of the four CLMV countries.

Cambodia

High-growth rebuilt from the ruins of civil strife

Cambodia suffered decades of internal conflict and, from 1970, full-blown civil war that destroyed its educated elite and destroyed its economic base, administrative structure and political institutions. The 1991 Paris Peace Agreement re-established peace and stability, while the Constitution of 1993 enabled democratic development and a market economy. Reforms and generous international assistance have helped Cambodia recover from war, the Khmer Rouge's disastrous economic experiment and decades of socialist economics.

Cambodia's economic performance has been impressive since 2000, with gross domestic product (GDP) growing at an average of 8% a year and reaching an unprecedented 11% per annum between 2004 and 2007. The global economic downturn slowed GDP growth to nearly zero in 2009, although it has since picked up.

Sustained growth from 1997 to 2007 cut the proportion of people living below the poverty line by 10 percentage points from 40.1% in 1997 to 30.1% in 2007. In the same period, income per capita tripled from USD 260 in 1998 to USD 795 in 2010. Even so, Cambodia remains a very poor country, deficient in natural resources and still weak in institutional capacity and human talent.

Growth has diversified the economy, raising exports to 68% and domestic savings to 30.3% of GDP in 2008. Nevertheless, agriculture remains the backbone of the economy, accounting for 36% of GDP and employing over two-thirds of the workforce. In recent years, garments, tourism and construction have contributed significantly to the country's diversification from agriculture. Foreign investment inflows have increased, reducing the country's dependence on foreign aid.

While export-dependent industrialisation and tourism have quickened growth, they have also increased the economy's exposure to external shocks. Garment exports to the United States fell sharply in the 2008-09 global recession, causing factories to lay off some 20 000 workers out of 380 000 in the industry. For many rural families dependent on income earned by members working in urban factories, the contraction was painful (ADB, 2012a).

Incomes grow but inequality remains persistent

While it has reduced poverty, economic growth has not been accompanied by a clear trend toward greater income equality. Although Table 5.4 shows that Cambodia's Gini coefficient (where 100 denotes maximum inequality) decreased from 41.9 in 2004 to 37.9 by 2008, income inequality remains widespread.

Table 5.4. **Income inequality in Cambodia**

	1994	2004	2008
		Gini coefficient	
	38.3	41.9	37.9
Cambodia		**Share of income by quintile (%) – top 20%**	
	46.8	49.3	45.9
		Share of income by quintile (%) – lowest 20%	
	8.0	6.9	7.5

Source: World Bank (2012a), *World Development Indicators* online, http://data.worldbank.org/data-catalog/world-development-indicators.

Table 5.4 points to a stable trend of the concentration of incomes between 1994 and 2008, with a slight decrease in the share of total income of the top quintile of households from 46.8% in 1994 to 45.9% in 2008. Furthermore, Table 5.5 indicates that daily per capita consumption for all quintiles rose in the 1990s, suggesting that households at all income levels were better off thanks to economic growth.

Table 5.5. **Daily per capita household consumption in Cambodia, by quintile, 2004-07**

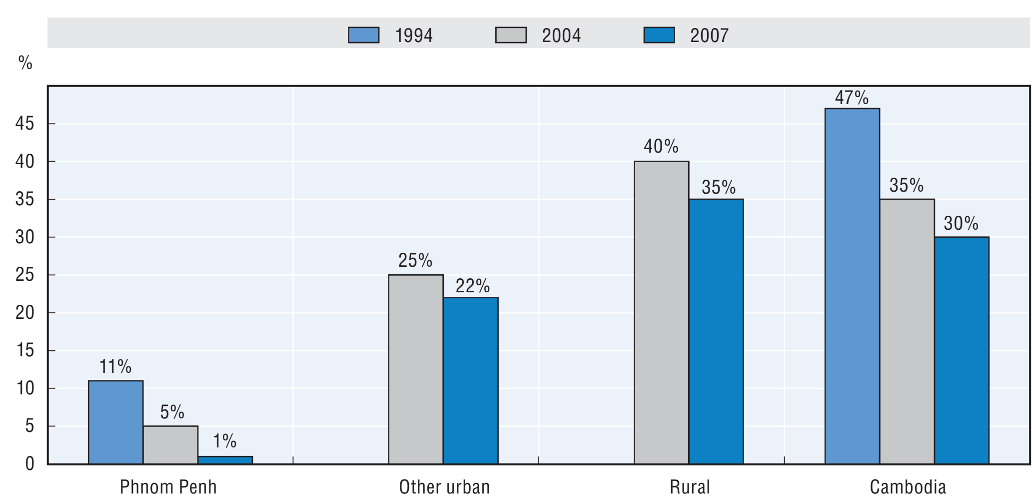
Per capita consumption per day (in KHR, current prices)	2004	2007	% Change 2004-07
Poorest 20%	1 106	1 608	+44.4
Next poorest 20%	1 656	2 407	+44.3
Middle 20%	2 224	3 227	+44.1
Next richest 20%	3 180	4 710	+47.1
Richest 20%	7 957	12 889	+61.0
Cambodia	3 224	4 964	+53.0
Per capita consumption per day (in 2004 prices)			
Poorest 20%	1 377	1 524	+10.7
Next poorest 20%	2 060	2 296	+11.5
Middle 20%	2 743	3 093	+12.7
Next richest 20%	3 852	4 458	+15.7
Richest 20%	8 990	11 723	+30.4
Cambodia	3 804	4 616	+21.4

Source: Knowles, J.C. (2009), "Poverty Profile and Trend in Cambodia: Findings from the 2007 Cambodia Socio-Economic Survey (CSES)", Report No. 48618-KH, World Bank, Washington, DC.

Growth good for urban dwellers and women

Economic growth since the 1990s has reduced the incidence of poverty in both rural and urban areas, but not to the same extent. As Figure 5.1 indicates, the percentage of households living in poverty in the capital city, Phnom Penh, fell steeply from 11% in 1993-94 to just 1% in 2007. In rural areas, however, the decline was much smaller – from 40% to 35% over the same period.

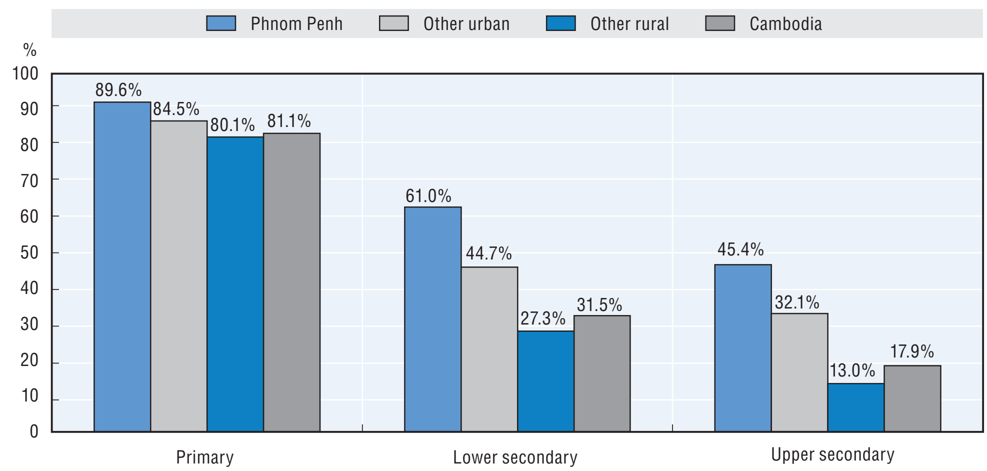
Figure 5.1. **Poverty levels in Cambodia, 1994-2007**



Source: Asian Development Bank (ADB) (2011a), Cambodia Country Poverty Analysis, ADB Publishing, Manila.
StatLink http://dx.doi.org/10.1787/888932775383

One reason why rural areas have higher poverty levels is the lack of educational and employment opportunities. They also have poor access to health-care services and a lack of transport connections to urban areas. Figure 5.2 shows that, while rural primary school attendance rates are not too far below those in urban areas, children are much less likely to be enrolled in secondary education.

Figure 5.2. **Cambodia's net enrolment/attendance rates in education, by geographical area, 2009**



Source: National Institute for Statistics (NIS) (2009), Cambodia Socio-Economic Survey 2009, Ministry of Planning, Phnom Penh.

StatLink http://dx.doi.org/10.1787/888932775402

As in other developing countries, the income gap in Cambodia is not only geographical. There are significant gender differences in educational and employment opportunities. Proportionately fewer women than men are enrolled in secondary and tertiary education (World Bank, 2007). Since the late 1990s, employment opportunities for women in Cambodia have expanded greatly with the proliferation of garment factories where the workforce is chiefly female. By making women the main income earners in many families, the factories have their improved the status of women. Women are also increasingly better represented in public life. They hold one-fifth of the seats in Parliament and nearly two-fifths of public sector jobs (MOP, 2011).

Economic, financial and social reforms help reduce inequality

In Cambodia, as in other countries that have embarked on market reforms, income distribution has been very much affected by globalisation and technological progress. Both factors favour workers with skills and knowledge and those who live in urban areas. Cambodia is no exception. Its rural population does not enjoy the same access as urban dwellers to the opportunities created by market reforms and foreign investment. Rural dwellers have consequently moved to urban areas, so swelling Cambodia's urban population from 13% in 1990 to 23% in 2010.

The Cambodian government has long recognised the need for equitable growth. In 2004, it adopted its Rectangular Strategy to promote economic growth, create jobs and improve equity and efficiency. The strategy, updated in 2008, has four pillars:

- enhance the agricultural sector;
- rehabilitate and improve physical infrastructure;
- develop the private sector and job creation;
- develop capacity and human resources.

The key to the success of the strategy is good governance which, in turn, involves effective efforts to tackle corruption and reform the public sector. In addition to the Rectangular Strategy, the government is promoting agricultural diversification and exports. Complementing the Rectangular Strategy is the National Social Protection Strategy (NSPS) for the Poor and Vulnerable. The NSPS aims to provide social services to the poor and expand opportunities for the disadvantaged so as to afford them access to health care and education and training opportunities.

Another measure the government has introduced as part of its inequality reduction drive is the 2001 Land Management and Administration Programme (LMAP), designed to redistribute land to poor households. Under the LMAP, households can claim ownership rights if they have occupied and used an allotted piece of land for five continuous years. The new legislation has reduced land disputes and facilitated land dealings. It has also enabled rural households to raise capital, using land for which they have secured tenure as collateral.

Thus far, the land redistribution programme has chiefly benefited communities in urban areas and the Mekong and Tonle Sap plains. It has still not reached many rural areas, where access to electrical power and roads is limited and uncleared landmines prevent the land from being farmed.

Government efforts to reduce inequality must be seen as part of a package of measures to further diversify the economy (away from garments, tourism and construction which account for 40% of the GDP) and address new problems arising from rapid urbanisation and threats to the environment. These challenges are daunting but would be easier to overcome if the economy could grow at more than 6% a year. Such a growth rate is attainable if Cambodia can maintain its current competitiveness in tourism and export-oriented garment production while improving agricultural productivity and grooming additional growth engines.

If the country is to develop new export sectors, whether in manufacturing or agriculture, it will need to foster a more business-friendly environment. Cambodia ranks low among countries in competitiveness – 97th out of the 142 countries in the Global Competitiveness Index (Viet Nam ranks 65th) (WEF, 2011). It takes an average of 85 days to register a new business, a lengthy period that is often made worse by the need to pay unofficial fees to expedite the issue of required permits (World Bank, 2012b).

Besides diversifying the manufacturing sector, the government needs to devote more resources to increasing agricultural productivity. A recent ADB report (ADB, 2012a) identified the chief weaknesses that Cambodia must address if it is to rise to this challenge. They include poor infrastructure, insecure property rights, corruption, lack of market co-ordination and inadequate investment. Rural entrepreneurship cannot flourish in an environment characterised by great uncertainties in rules and rewards.

To encourage it, the government must move in infrastructure, human resources and financing arrangements, all of which will take time. On the financing front, the government has promoted the development of microcredit institutions which have provided loans to farmers. There is a risk, though, they may use them for consumption if infrastructure bottlenecks deter them from making productive investments.

The government recognises that, in the meantime, it must also continue to widen the social safety net for those households, especially in the remote rural areas, which have been left behind. For many years now, it is non-government organisations and aid agencies that have provided support for the poor and vulnerable groups in Cambodia. This support is declining, however, and fails to reach many groups in remote rural areas. The government, therefore, must expand its role to the extent its finances allow. It will be a huge challenge as the institutional capacity to manage an expanded social safety is still lacking: government ministries and agencies do not co-operate or co-ordinate their activities well.

Development aid addresses infrastructure and education to reduce poverty

International development assistance in the form of loans or grants can play an important role in helping Cambodia to reduce poverty and inequality. The ADB, which Cambodia joined in 1966, has loaned it USD 1.24 billion for projects to develop infrastructure and promote inclusive growth. The bank has identified five sectors in its 2011-13 strategy for Cambodia – transport, water, natural resources and commercial agriculture, education and training, and finance. Projects currently underway in these fields are designed to improve institutional capacity and remove bottlenecks to growth. They are listed in Table 5.6.

Table 5.6. **Current ADB-supported projects in Cambodia**

Sector	Projects
Transport development	New road sections from Siem Reap to Poipet, Cambodia's main border crossing to Thailand.
Water supply, sanitation and urban development	The Power Rehabilitation Project and Provincial Power Supply Project have connected nearly 42 000 households in Phnom Penh and provincial towns to reliable electricity supplies.
Commercial agriculture and natural resources	The Northwest Irrigation Sector Project has completed 12 irrigation schemes covering 11 000 hectares of land.
Education and training	ADB loans and grants have built 329 lower secondary schools, 25 upper secondary schools and 26 secondary resource centres to broaden school access for children in rural areas.
Finance	Financial Sector Programme.

Source: Asian Development Bank (ADB) (2012b), *Asian Development Bank and Cambodia: Fact Sheet*, Manila, April.

The World Bank is another major lender to Cambodia. It is, in fact, Cambodia's third largest donor (after China and Japan) and its loans account for 10% of all the aid the country receives. World Bank loans support Cambodia's Millennium Development Goals (MDGs) and focus on removing governance obstacles to growth and reducing poverty. The World Bank suspended new lending to Cambodia in December 2010 to demonstrate its disapproval of the government's eviction of residents from the Beoung Kak Lake area, part of a World Bank-supported land management project. Table 5.7 lists current World Bank-funded projects, all of which are designed to address inadequacies in physical infrastructure and human resources.

Table 5.7. **Current World Bank projects in Cambodia**

Sector & projects	Impact
Education Education Sector Support Project Cambodia – Education for All Fast Track Initiative	Expanded educational facilities in poor areas. Provided training and capacity building at local levels to improve educational services.
Health Health Sector Support Project Health Equity Fund Scheme	Provided support for national disease control, sexually transmitted infections and HIV/AIDS programmes. Reduced dengue fever outbreaks and the mortality rates of tuberculosis and malaria infections. The Health Equity Fund covers 2.3 million poor people.
Water Urban Water Supply Project Provincial and Peri-Urban Water Supply and Sanitation Project (PPUWSSP)	90% of Phnom Penh's residents have access to a reliable, permanent water supply (100% coverage by 2020). Expanded water supply network in Phnom Penh to 1 966 kilometres with 192 000 connections, provided subsidised connections to 3 827 poor households in the city and built 11 water plants around the country.
Energy National Improved Cook Stove Programme	Provided technical assistance to develop a model production facility for Neang Kongrey stoves, which are cheap and environmentally friendly.

Source: World Bank.

Lao PDR

Economic reform drives fast growth, but poverty, income disparities and corruption persist

One of the poorest countries in Southeast Asia, Lao PDR, gained independence from France in 1953, the same year as Cambodia. From the 1950s to the mid-1970s, Lao PDR was under a succession of "neutral" governments who co-operated with the United States and allowed it to use its landlocked territory in its war with North Viet Nam. It was only after the Americans left Viet Nam that the Lao People's Democratic Republic (PDR) was proclaimed in December 1975. Ruled by the Lao People's Revolutionary Party, Lao PDR enacted socialist economic policies which caused much hardship, prompted a brain drain, particularly to Thailand where a language similar to Laotian is spoken. Recognising the failure of its socialist policies, the government introduced reforms in the early 1980s to promote a market economy. By July 1997 Lao PDR had joined ASEAN and was continuing with its economic reforms.

Like Cambodia, Lao PDR has experienced rapid growth since the introduction of market reforms. In the 1990s and 2000s up to the 2008-09 global economic crisis, it achieved annual growth rates of over 6%. Steady growth reduced the proportion of households living in poverty from more than one-third in 2000 to around one-quarter in 2008. Rising incomes have not narrowed income disparities, however, as the Gini inequality coefficient rose from 0.326 in 2002 to 0.367 in 2008. In absolute terms, Lao PDR remains a very poor country with more than one-half of its population of 6.2 million having no access to electricity. It is also perceived as a country where corruption is rife: Transparency International ranked it 154th out the 183 countries in its 2011 Corruption Perceptions Index (Transparency International, 2011).

Poverty in Lao PDR is most prevalent in the country's South-Central highlands, a region where minorities are concentrated and shifting cultivation is widely practised (Riggs, 2005). A study by Epprecht et al. (2008) suggests a positive correlation between the incidence of poverty and altitude. As Table 5.8 shows, the poverty rate is over 60% in the South-Central Highlands, but less than 30% in the Northern Lowlands and 15% in the Vientiane Plain. Highland farming is not only less productive, but villagers there have limited access to functioning markets, unlike those in the higher-income border areas.

Table 5.8. **Poverty rate in Lao PDR, 2002-03**

	Poverty rate (percentage)	
	2002-03 Lao PDR Expenditure and Consumption Survey (LECS)	Small-area estimation
National	33.6	34.7
By urban and rural areas		
Urban	19.7	19.8
Rural	37.7	40.0
By region		
Vientiane (capital city)	16.8	17.0
Northern	38.0	38.1
Central	35.4	38.4
Southern	32.6	33.1
By topography		
Vientiane Plain	15.6	16.9
Mekong Corridor	33.2	35.4
Northern Lowlands	27.5	33.5
Northern Midlands	46.2	41.6
Northern Highlands	42.4	42.2
South-Central Lowlands	60.0	59.9
South-Central Midlands	64.9	69.8
South-Central Highlands	75.4	75.8
Boloven Plateau	14.7	15.3

Source: Epprecht et al. (2008), *The Geography of Poverty and Inequality in the Lao PDR*, International Food Policy Research Institute (IFPRI), Washington, DC. and the National Centre of Competence in Research (NCCR) North-South, Berne.

Government focuses on road construction to ease regional and ethnic inequities

Lao PDR has 49 main ethnic groups. It classifies as "lowland", "midland" and "upland" citizens, as part of its officially non-discriminatory approach to ethnicity, whereby all groups are considered equal. However, the Tai Kadai group forms two-thirds of the population, but accounts for only one-fifth of the poor, while minority groups make up one-third of the population and 80% of those living in poverty. In practice, the Tai Kadai majority group, who live chiefly in the plains, have benefited most from market reforms and infrastructure development, particularly road construction. They also enjoy greater access to educational opportunities and health care.

The Lao PDR government recognises the ethnic and geographical dimensions that shape the country's poverty profile. Yet it also understands that its terrain makes road building in upland areas difficult. Accordingly, its anti-poverty development strategy is to focus on certain sites and to resettle people in them, expanding education and other services, and providing villagers with support to help them switch from shifting cultivation to commercial agriculture. Its success has been limited. A 1996 study of 67 resettled villages by the United Nations Development Programme (UNDP) noted that planning was poor – not enough suitable land was set aside for field agriculture and resettled villagers were not given training or support to help them move to wet-rice farming.

The government is also aware that roads, though costly, are needed to link remote, thinly populated upland areas to the more populous ones. Accordingly, it spends a fair proportion of its budget on building roads, which can help draw poor people "into the mainstream as part of a nation-building and security-enhancing exercise" (Riggs, 2005). However, Riggs also quotes a 1999 ADB report which observes that road construction may increase inequality, as some farm-based households make better use than others of such opportunities. While this may indeed be true, households that take advantage of newly built roads may also set an example to others, earning higher incomes have strong multiplier effects in the village economy (Lao PDR, 2000). Furthermore, roads can expand linkages and create opportunities. Their construction, though, must be planned as part of an integrated growth strategy that also produces other social goods.

International organisations back five-year development plan and institutional capacity building

Like Cambodia, Lao PDR has been a beneficiary of development loans and assistance. In addition to the Asian Development Bank which it joined in 1966, Lao PDR's development partners include the International Fund for Agricultural Development, the Japan International Cooperation Agency, the Nordic Development Fund, the World Bank and the governments of China, the Republic of Korea, Viet Nam and Thailand (ADB, 2012c). International assistance in the 1970s and 1980s focused on infrastructure development in transport, energy and agriculture. Since the early 1990s, however, the ADB has broadened its assistance to include the development of Lao PDR's financial sector, rural infrastructure, social development and the environment.

The country partnership strategy (CPS) that the ADB has with Lao PDR spans almost the same five-year period as the country's Seventh National Socio-Economic Development Plan (NSEDP) for 2011 to 2015. The purpose of the NSEDP is that Lao PDR should graduate from its least developed country (LDC) status by 2020, driven by the boom in hydropower generation and mining. Current ADB-assisted projects include:

- the transnational north-south and east-west transport corridors;
- all-weather roads;
- the Decentralised Irrigation Development and Management Sector Project;
- assistance in skills training for civil servants and health programmes to mitigate the spread of cross-border communicable diseases such as HIV/AIDS.

The transport corridors have boosted tourism (visitors exceed 2 million a year), external trade and foreign investment. Irrigation projects have increased rice yields and more farmers have moved into commercial banking.

The World Bank, too, has a CPS with Lao PDR. Running from 2012 to 2016, its time span is closely aligned with the NSEDP and its objectives of improving competitiveness, developing natural resources and promoting inclusive development. The World Bank is also providing assistance to help Lao PDR build effective public sector institutions without which it will be hard pressed to carry out its five-year plan. Table 5.9 sets out the goals of Lao PDR's CPS with the World Bank and its desired outcomes. Developing stronger public institutions is the key to meeting those goals.

Table 5.9. **The framework of Lao PDR's country partnership strategy with the World Bank**

	Objective	Outcome
1.1	Competitiveness and connectivity	Strengthened government capacity to support diversified growth and competitiveness.
1.2		Greater access to improved infrastructure services in transport and energy.
2.1	Sustainable natural resource management	Stronger governance and management of hydropower and mining sectors.
2.2		Sustainable environmental, social and water resource management.
2.3		Sustainable management and protection of forests and biodiversity.
3.1	Inclusive development	Greater use and higher quality of essential mother and child health-care services.
3.2		Improved access to and quality of primary education in specifically targeted disadvantaged areas.
3.3		Improved access to basic services and markets.
4.1	Stronger public sector management	Stronger government capacity for macroeconomic management and policy co-ordination.
4.2		Strong linkages between planning, taxation, borrowing strategy and annual budgeting.
4.3		Improved financial management for appropriate revenue management.

Source: World Bank (2012c), Lao People's Democratic Republic - Country Partnership Strategy for the Period FY12-FY16, World Bank, Washington, DC.

Myanmar

Have Aung San Suu Kyi's release and political reforms of 2011 ushered in a new era?

Myanmar became an independent country in 1948. Since then, it has been under military administration.

General Ne Win seized power in 1962 and embarked on an inward-looking economic strategy the nationalisation of industries. The failure of its economic programme prompted the junta to introduce reforms to free up the economy in 1988 and hold general elections in 1990. They were won by the opposition party, the National League for Democracy (NLD), led by Aung San Suu Kyi. It placed Aung San Suu Kyi under house arrest from which she was not released – except for short periods – until 2010.

In 2008, the junta drew up a new constitution as part of a road map to democracy. It provided for the election of a civilian government, but reserved 25% of seats for the military. General elections, boycotted by the NLD, whose leader remained under house arrest, were held in 2010. The military-backed Union Solidarity and Development Party (USD) won and appointed Thein Sein, a general, as the country's president.

The ruling party held by-elections in April 2012. The NLD took part, winning all but four of the 44 seats and Aung San Suu Kyi was elected to Parliament. The by-elections, widely seen as fair, marked a turning point for Myanmar in the eyes of the international community. Since then, foreign leaders have paid visits to Myanmar and Japan has written off the USD 4 billion of debt that Mynamar owes it. India has offered soft loans and many sanctions and travel bans on Myanmar leaders have been lifted.

Reforms are not limited to the political sphere, but have also been introduced – or soon will be – in the banking sector, import regime, foreign investment rules and many more areas of the economy besides. Change is afoot in a country that is at last returning "from the cold". The general view is that the reform process is unlikely to be reversed. The outlook for a country so long out of the mainstream appears bright. A construction boom in the major cities, particularly Yangon, is taking place and there has been a huge surge of foreign investments since 2011. The Asian Development Bank, which stopped lending to Myanmar in 1987, is preparing a country partnership strategy and, in August 2012, the ADB and the World Bank opened country offices in Myanmar's new capital, Naypyidaw. The World Bank has pledged USD 85 million for development programmes that will give local communities the power to decide whether to invest the grants in schools, roads, water or other projects.

Huge economic and political challenges remain, however. Relations between Buddhist Burmans and Muslim Rohingyas are tense, while conflicts between central government and a number of provinces have yet to be resolved. Economic reforms to boost productivity and create new, competitive sectors will take time to bear fruit. Rooting out corruption and reducing poverty and inequality will not be easy, especially as the reforms have raised expectations, both domestically and internationally.

Although Myanmar is today entering uncharted waters, it can draw lessons from the development experience of other countries. And it can count on a growing reservoir of goodwill from the region and the rest of the world. But it must choose a path that balances the imperatives of development with democratic aspirations and national security with individual human rights.

Poverty built into the economy and perpetuated by corruption and disregard for education

Like Cambodia and Lao PDR, Myanmar is an agrarian economy with two-thirds of its population of more than 60 million working the land for a living. Much of the low productivity and inequality that characterise the country's agriculture can be traced back to a plan to nationalise land and ensure food security implemented soon after independence from Britain (Fujita et al., 2009). The plan allowed small landowners to keep their holdings, but created a whole class of poor, landless labourers. They were, however, shielded from the effects of inflation because they were paid in grains of rice until 1988, when they began receiving their wages in the national currency, the kyat, which depreciated in value and exposed them to inflation. As a result they become even worse off, unlike the farmers, who benefited from rising rice prices. Lacking capital, they had to borrow at exorbitant rates to meet their family needs. They could not afford school for their children, many of whom became child labourers working not only in agriculture, but in construction, domestic work and mining (ICFTU, 2003). Their access to primary education grew even more limited as the country's military rulers diverted funds away from education to the military. In the early 1990s, spending on education accounted for only 1% of Myanmar's GDP – far below that in any other ASEAN country.

The plight of the landless labourer is one aspect of the inequality picture. Another important contributory factor is corruption. Myanmar came 180th out of 183 countries in Transparency International's 2011 Corruption Perceptions Index. Corruption presents the government with huge challenges because it is deeply rooted and widespread. Left unaddressed, it could deter foreign investors, undermine the growth-enhancing reforms being undertaken, and further widen income disparities. A sustainable, comprehensive approach to fighting corruption should remove incentives for corrupt behaviour and impose heavy penalties on offenders. Underpaid officials operating in a highly regulated, opaque environment with unchecked powers to help or hinder are likely to be open to temptation, especially if they risk mild punishment or none at all. The fight against corruption should require those at the highest levels of the government to set an example of accountability and transparency.

FDI and microlending – two facets of the same need for a business-friendly environment

If Myanmar is to transform its economy, it will need a more business-friendly, transparent environment conducive to investment. In 1988, it passed a foreign investment law as part of its economic reform drive to create a vibrant market economy, encourage entrepreneurial activity and open up to trade and investment. Tasked with overseeing application of the law was the Myanmar Investment Commission, formed in 1994. It has the authority to approve foreign investment and was restructured in 2011 to spearhead Myanmar's bid to attract FDI. It hopes to attract more than USD 4 billion of FDI in 2012-13 (Kyaw, 2012).

How this key agency fares in a reform-minded Myanmar will be watched closely by foreign investors keen to seize new opportunities, especially in Myanmar's resource sectors. As of June 2011, Chinese investment in Myanmar amounted to USD 12.3 billion. Other major investors include Thailand (USD 9.6 billion), South Korea (USD 2.9 billion), Great Britain (USD 2.7 billion) and Singapore (USD 1.8 billion) (Xinhuanet, 2011). Most investment has been in the energy, oil and gas sectors, but the commission is seeking to promote investment in tourism, agriculture and small and medium industrial enterprises, all with great potential for creating jobs.

To sustain FDI inflows, Myanmar must speed up the reform of its capital and currency markets. Also, as host to the Southeast Asian Games in 2013 and chair of ASEAN in 2014, it needs to develop its infrastructure fast, a priority that will create many new urban jobs.

Creating job opportunities will help reduce poverty and inequality – especially for rural people. Improved access to finance, particularly microfinance, could help the poorest of them – the landless labourers – set up as self-employed workers. Since the early 1990s, Myanmar has seen the development of institutions seeking to provide targeted microfinance to different groups in different areas of the country. The Myanmar Agricultural Development Board (MADB) makes small loans for agricultural investment (Kubo et al., 2009) and claims to have helped 1.5 million borrowers.

For small business ventures outside the agricultural sector, non-profit organisations offers loans – primarily to women who account for the bulk of borrowers. As a group, non-profit organisations have lent a total of USD 28 million to fewer than 400 000 people, a mere fraction of the number of rural women in Myanmar (Vincent, 2010). The average loan is about USD 70 and even if all loans are effectively used, their aggregate impact on job creation and poverty is slight.

Table 5.10 lists loans made by non-profit microlenders and the groups they target. Of particular note is the UNDP-associated organisation, Private Agencies Collaborating Together (PACT), the largest lender. The Asia Society Task Force Report says PACT has the "potential to allow small-scale capital formation, consumption smoothing and money-lender debt retirement" through small loans of USD 32 on average. One reason for PACT's high reimbursement record is that it lends chiefly to women and uses peer-group pressure to motivate borrowers.

The activities of micro-lenders should be seen as part of the bigger picture of a financial sector that is in need of reform if it is to play its proper role of collecting funds and providing loans at market rates for business activities that have the potential to create many new jobs.

Table 5.10. **Loans and target groups of micro-lenders in Myanmar, 2009**

Organisation	Started microlending	Targeted population	Active borrowers	Percentage of women	Gross loan portfolio (USD thousands)
Association of Medical Doctors of Asia (AMDA)	2002	Beneficiaries of AMDA NGOs programme	1 510	100	55.1
Groupe de Recherche et d'échanges Technologiques (GRET)	1995	Poor people in rural areas	4 332	57	300.1
PACT (UNDP Projects)	1997	Poor entrepreneurs: to help the business growth of their micro-enterprises	319 744	93	24 513
PACT (Non-UNDP)	2005		33 713	100	1 396.5
Save The Children (Dawn Microfinance Programme)	2002	Poor women in the urban area of Yangon	16 656	100	400
Total (Yadana Suboo Microfinance)	1997	Poor entrepreneurs seeking to start or expand micro-enterprises in the pipeline projects	1 197	75	165.1
World Vision	1998	Poor entrepreneurs, beneficiaries of other World Vision programmes	8 131	71	1 000
Total			**385 283**	**93**	**27 829.9**

Source: Vincent, S. (2010), *Microfinance Industry Report: Myanmar, Agence d'Aide a la Coopération Technique et au Développement* (ACTED), Banking with the Poor Network (BWTP), Foundation for Development Cooperation (FDC).

Viet Nam

Two opposing war-torn economies unite, rebuild and deliver fast, diversified growth

When Viet Nam's war with the United States came to an end and the US pulled out in 1975, reunified Viet Nam faced two serious challenges:

- how to rebuild an economy devastated by decades of war;
- how to integrate the collapsed market economy in the south of the country with the socialist economy in the north.

The reform process took a while to gather momentum, taking off only in the late 1980s when the ruling Communist Party launched *doi moi*, a strategy to renew and decentralise the economy while keeping centralised political control of the country. *Doi moi* ushered in market-oriented measures, encouraged private sector growth, promoted foreign investment and reduced subsidies to state-owned enterprises (Tuan, 2009).

Results have been impressive. GDP growth has averaged 7% a year since the early 1990s. Per capita income rose from USD 98 in 1990 to USD 1 224 in 2010 and the country moved off the United Nations' LDC. Viet Nam today is an active member of many regional and international bodies, including ASEAN, World Trade Organization (WTO) and the United Nations. Its growth has been extraordinary in that it achieved so much with so little development assistance from abroad.

Growth has been accompanied by diversification. Agriculture's shares of GDP and employment have fallen as the country moved away from inefficient collective farms to the export of commercial agricultural products such as rice and coffee. Today, Viet Nam is one of the biggest exporters of rice, coffee, fish and rubber. Manufactured export goods such as garments, footwear, machinery and electronics have grown by 10% a year since the early 1990s. The manufacturing industries share of total employment rose from 12.4% in 2000 to 28% in 2010.

Growth has reduced poverty but not income inequality and has narrowed the gender gap

Rapid growth brought Viet Nam's poverty rate steadily down from 58% of the population in 1993 to 14.2% in 2010. The decline of poverty has been faster among urban than rural households and for the main Kinh-Hoa group than for ethnic minorities (World Bank, 2011a). One-third of Viet Nam's population of 84 million is no longer classified as poor. Per capita monthly income rose four times between 2002 and 2010, climbing slightly faster among urban than rural households (GSO, 2011). Non-income indicators such as access to such basic services as roads, safe water and electricity show equally impressive gains. In 1993, only 37% of the lowest quintile had access to electricity. The proportion today is over 90%.

Growth, however, has not narrowed income inequality. Although the recent trend of the Gini coefficient shows positive signs towards reducing inequality, World Bank data suggest that income distribution in Viet Nam since the early 1990s has remained much the same, despite the great expansion in job opportunities. As Table 5.11 shows, the income shares of the top and bottom quintiles have also remained stable. Data from the 2010 Viet Nam Household Living Standards Survey (VHLSS) indicate a higher level of income inequality but the same stable trend since 2002.

Table 5.11. **Income inequality in Viet Nam, 1993-2008**

	1993	1998	2002	2004	2008
			Gini coefficient		
Viet Nam	35.7	35.5	37.6	36.8	35.6
			Share of income by quintile – top 20%		
	43.98	44.01	45.6	44.5	43.4
			Share of income by quintile – lowest 20%		
	7.8	8.0	7.5	7.2	7.4

Source: World Bank (2012a), *World Development Indicators* online, http://data.worldbank.org/data-catalog/world-development-indicators.

The VHLSS suggests that income inequality is greater in urban than in rural areas. It also reveals that while urban income inequality has remained stable, rural income disparity has widened, with the Gini coefficient climbing from 0.36 to 0.39 between 2002 and 2010. In part, the trend may be due to greater crop productivity and higher commodity prices. Remittances from family members working in urban areas may also have been a contributory factor.

Compared with urban households, rural and ethnic minority households are under-served by basic services including schools, health care, roads, safe water and electricity. Ethnic minority families suffer higher school dropout rates, benefit less from government services, farm less productive land, earn less off-farm incomes and engage less in trade (World Bank, 2009a; Dang, 2010).

Viet Nam has made greater progress in reducing gender inequality as part of its efforts to achieve gender-related MDGs. Table 5.12 shows how female enrolments at all levels of education have caught up with men's. Women form 45% of the workforce and earn 75% as much as men, both ratios being much higher than in Cambodia, Lao PDR and Myanmar. The maternal mortality ratio fell from 233 per 100 000 births in 1990 to 69 in 2009. As for women's empowerment, one in four parliamentarians is a woman. While women's status has improved, it could be even better. Women are still more likely to be in lower-wage jobs and Vietnamese society as a whole still shows a slight preference for boys over girls.

Table 5.12. **Viet Nam's gender-related Millennium Development Goals**

MDG 3: Promote gender equality and empower women		**2010**
3.1	Ratio of girls to boys in primary education	93.9%
	Ratio of girls to boys in secondary education	109.0%
	Ratio of girls to boys in tertiary education	100.1%
3.2	Share of women in wage employment in the non-agricultural sector	40.4% ('04)
3.3	Proportion of seats held by women in Parliament	25.8%
MDG 4: Reduce child mortality		
4.1	Infant mortality rate (per 1 000 births)	18.6
	Under-5 mortality rate (per 1 000 births)	23.3
MDG 5: Improve maternal health		
5.1	Maternal mortality ratio (per 100 000 live births)	69 ('09)

Source: World Bank (2012a), *World Development Indicators* online, http://data.worldbank.org/data-catalog/world-development-indicators.

Data from both the World Bank and the 2010 Viet Nam household survey suggest a stable income distribution despite rapid growth since the early 1990s. Globalisation, technological change and market-oriented reforms appear not to have had a negative impact. The huge expansion of employment opportunities in export industries, together with the greatly improved position of women, may have offset the income-widening impact of market reforms and globalisation.

Five-year plan to cut income inequality through restructuring, fostering new industries and supporting SMEs

There is much that Viet Nam can do to further reduce income inequality – between the majority ethnic group and ethnic minorities, between men and women, between the country's different regions and between rural and urban areas. It must ensure macroeconomic stability and low inflation – conditions that benefit vulnerable groups. And, as continues its successful labour-intensive, export-oriented, investment-driven development strategy, it should also promote competitive new industries and restructure the economy (Ketels et al., 2010). Through investments in infrastructure like roads and other services, it should encourage new economic activities in areas outside the two main cities, Ho Chi Minh City and Hanoi. Otherwise, economic activities risk becoming further concentrated and rural dwellers will still have a strong incentive to migrate to urban areas. Meanwhile, Viet Nam must provide more basic services for rural migrants to the city and, even as it nurtures new competitive sectors, find ways to raise farm productivity with new technology, agricultural extension services and finance.

Developing its small and medium enterprise (SME) sector would contribute significantly to further reducing poverty and improving income distribution. At present, the non-agricultural economy of Viet Nam is dominated by inefficient state-owned enterprises (SOEs) and relatively efficient foreign-invested enterprises producing for exports. A better balance between SMEs, SOEs and foreign enterprises is critical to help Viet Nam move on to its next stage of development. SMEs would particularly benefit from transparent regulations, SOEs from stronger pressure to reform and foreign enterprises from additional incentives to decentralise their operations.

These policy priorities are reflected in Viet Nam's revised ten-year Socio-Economic Development Strategy (SEDS) for 2011 to 2020. The SEDS vision is that of a modern, industrialised society created by promoting human resources and skills development, improving market institutions and developing infrastructure development. SEDS also undertakes specific action programmes that pay particular attention to inclusive development and environmental sustainability.

Regional and international organisations support for equitable, sustainable growth

Like Cambodia and Lao PDR, Viet Nam is a member of the Asian Development Bank and World Bank. It has received some USD 11 billion from the ADB in loans and grants, support that has greatly helped it to develop its physical and human infrastructure. Some of the projects the ADB has supported are shown in Table 5.13.

Table 5.13. **Some ADB-supported projects in Viet Nam**

Sector	Projects
Transport development	Rehabilitation of Highway 1 in northern and southern Viet Nam. Development of the Greater Mekong Subregion (GMS) East-West Economic Corridor and Ho Chi Minh City – Phnom Penh Highway. ADB's assistance portfolio for rural road projects.
Power (Energy)	Investments in hydropower and thermal power generation as well as transmission networks. Biogas project in Bac Ninh Province converting animal waste into clean energy to improve health, cut fuel costs and raise crop production.
Rural development and irrigation	Improved access to markets and inputs. Introduction of high-value crops and crop diversification. Improved water resources management practices.
Water supply and sanitation	Provincial Towns Water Supply and Sanitation Project.

Source: Asian Development Bank (ADB), (2012d), Asian Development Bank and Viet Nam: Fact Sheet, Manila.

The World Bank has also played a significant role in helping Viet Nam to improve its infrastructure, providing USD 15 billions' worth of financial assistance since 1993. It launched its current country partnership strategy (CPS) for Viet Nam in co-operation with the Ministry of Planning and Investment in May 2002. The CPS builds on three pillars – strengthening Viet Nam's competitiveness in the regional and global economy; enhancing the sustainability of its development; and broadening access to social and economic opportunity. At the same time, it addresses three cross-cutting themes: strengthening governance, promoting gender equality, and improving resilience to external economic shocks, natural hazards and the impact of climate change (ADB, 2012e).

Apart from the ADB and World Bank, Viet Nam has also received support from ASEAN as well as ASEAN's dialogue partners, including Japan, Korea and the European Union. In 2000, ASEAN leaders at the Fourth ASEAN Informal Summit launched the IAI as part of a strategic framework for regional co-operation. The IAI was designed to narrow the development gap between the older ASEAN members and CLMV, so helping to create an ASEAN Economic Community by 2016. The IAI Work Plan gives priority to four areas, namely, infrastructure development, human resource development, information and communications technology, and regional economic integration (ASEAN, 2010). Compared to the ADB and World Bank projects, IAI has had a smaller impact because its funding level is much lower and its focus more limited.

Another regional programme that has benefited Viet Nam (as well as Cambodia and Lao PDR) is the Greater Mekong Subregion (GMS) Economic Co-operation Programme, which the ADB helped set up in 1992. Involving six countries (Cambodia, China, Lao PDR, Myanmar, Thailand and Viet Nam) through which the Mekong flows, the GMS programme has completed, or is carrying out, infrastructure projects worth USD 10 billion. One such project is to upgrade the Ho Chi Minh to Phnom Penh Highway, while another is developing the East-West Economic Corridor which will ultimately stretch from the Andaman Sea in Myanmar to Danang in Viet Nam. At their 2011 summit, GMS leaders endorsed a ten-year plan to boost growth and reduce poverty by promoting environmentally friendly tourism and infrastructure development, while improving management of the sub-region's rich ecosystems (ADB, 2012f). Key to the plan is green innovations to encourage clean energy, fuel-efficient water transport and reduced use of chemical fertiliser.

CLMV countries compared

The CLMV experience of boosting development and reducing inequality has been mixed. By adopting market reforms in the past two decades Cambodia, Lao PDR and Viet Nam have all made significant progress in lifting a large proportion of their population out of poverty. For instance, in Viet Nam, one-third of the population has moved above the poverty line, thanks to sustained high growth rates and employment creation in export-oriented manufacturing and agriculture.

Reliable time-series statistics for Myanmar are not available. In recent years, a modicum of market liberalisation has quickened economic growth, especially in the city of Yangon, and benefits have trickled down. The recent wave of major economic and political reforms begun in early 2011 has led many analysts to believe that Myanmar is on the threshold of irreversible change, that will transform the economy and polity and have profound consequences for poverty and inequality.

While the evidence for poverty reduction is strong in Cambodia, Lao PDR and Viet Nam, the data on income inequality are mixed. Although the recent trend of income inequality since the 2000s shows signs of improvement in Cambodia and Viet Nam, income disparities remain persistent. In general, disparities between urban and rural areas and between the main ethnic groups and minorities have worsened across CLMV countries. It would appear that the experience of Lao PDR, where income disparities have even widened, albeit from a low base, is not inconsistent with the Kuznets hypothesis which postulates that income inequalities widen in the early stages of development and narrow as a country reaches full employment. Viet Nam's record shows a different pattern, with sustained growth being associated with a stable distribution of income since the early 1990s. As for Myanmar, there being no reliable income figures, a firm conclusion is not possible. The impression many analysts have is that income distribution has worsened because of highly unequal access to income-earning opportunities and long years of economic stagnation.

None of the four CLMV countries began their reform process with a clean slate. By the late 1980s, they had all concluded that their socialist economic policies had brought them to a dead end and that change was imperative. However, it had to be initiated in a political environment in which some groups, such as top civil servants, the high-ranking military and their families and associates, were well placed to capitalise on new opportunities created by market liberalisation and deregulation. Rapid growth entrenched their initial advantages and strengthened their networks, even if a wider cross-section of groups also benefited.

Economic growth is not a universal solution for a country's economic problems; its benefits should be equitably shared. Groups enjoying initial advantages always do well. The challenge is to enact policies and undertake programmes that will spread the benefits of growth quickly. Creating educational and employment opportunities has clearly made a difference to poverty in Cambodia, Lao PDR and Viet Nam. Effective, rule-based, transparent governance will ensure that gains from rapid growth are sustained while deterring corrupt officials and their associates from appropriating a disproportionate share of the spoils.

Corruption does more than widen income disparities. It engenders resentment and cynicism, leading the public to question the legitimacy of the political system. Although inequality is a fact in all societies, it can undermine social cohesion when perceived to be unacceptably great. Aggrieved citizens may pressure governments to introduce short-term populist measures. The outcome is a lower long-term growth trajectory and slower social and economic development. Regional and international agencies can play a useful role in curbing corruption by supporting plans and strategies that underscore the importance of openness, transparency and the rule of law.

In the coming decade, the challenge for CLMV countries is especially daunting. With young and growing populations familiar with the new media and impatient with the old guard, their governments cannot assume that rapid growth will assure social stability. They must meet the aspirations of the young and evolve a responsible, responsive political system. Only an inclusive strategy will increase their legitimacy and allow them to address effectively the pressing issues of poverty and inequality over the long term.

Conclusion

Although, in recent decades, the CLVM countries have progressively reduced poverty, many of their inhabitants are living with inequality. The interaction of trade, technology and market-oriented reforms is actually one driver of inequality, yet that is no reason to reverse the openness, technological progress, or reform processes now in train. The response should be to direct infrastructure investment to lagging regions and remove barriers to migration to the fast-growing regions. Three sets of policy measures are recommended to address the constraints and challenges that need to be faced to alleviate inequality.

First, an efficient fiscal policy should be implemented. Because CLVM economies draw their fiscal revenue from a small base, they should broaden their tax bases and improve their tax administration. In this way they would increase their revenue and free up funds for increased spending on education and health, especially for the poor. CLVM governments should also develop better targeted social protection schemes and conditional cash transfers that would be granted to the poor on condition that they invest in the human capital of their children.

Second, each CLVM government should intervene to address the economic development and capacity-building needs of regions that lag behind the rest of the country. Measures should include building transport and communication infrastructure to improve regional connectivity; fostering new growth poles; and stepping up fiscal transfers for greater investment in human capital. Access to public services should be improved and barriers to migration from poor to prosperous areas removed.

Lastly, the CLVM countries should act to narrow the labour income gap created by technology which, because it favours capital at the expense of labour, is a key driver of rising inequality. Employment policy should incorporate measures to create more productive, better-paid jobs for a much wider section of the population. Such measures should include:

- facilitating structural transformation and maintaining balanced growth between the manufacturing, services and agricultural sectors;
- supporting the development of SMEs;
- removing factor market distortions that favour capital over labour;
- strengthening labour market institutions;
- introducing public employment schemes to temporarily alleviate pockets of unemployment and underemployment.

Since the CLVM economies are still based chiefly on agricultural output, it is essential to increase productivity in the sector and sustain it at a high growth rate of growth through structural transformation. Governments should implement agricultural policies that increase production per hectare and include provisions that ensure the rural poor enjoy access to irrigation, electricity, transport, new technology and improved seeds, as well as to agricultural extension and financial services – all vital for boosting farm productivity.

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Statistical annex

Table A.1. **Real GDP growth of Southeast Asia, China and India**
(annual percentage change)

	2011	2017	2000-07	2013-17
ASEAN-6 countries				
Brunei	2.2	2.9	-	2.4
Indonesia	6.5	6.6	5.1	6.4
Malaysia	5.1	5.5	5.5	5.1
Philippines	3.9	5.3	4.9	5.5
Singapore	4.9	3.7	6.4	3.1
Thailand	0.1	5.3	5.1	5.1
CLMV countries				
Cambodia	7.1	7.3	9.6	6.9
Lao PDR	8.0	7.6	6.8	7.4
Myanmar	5.5	6.7	-	6.3
Viet Nam	5.9	6.1	7.6	5.6
China and India				
China	9.3	8.0	10.5	8.3
India	6.9	7.0	7.1	6.4
ASEAN-10 average	**4.6**	**5.8**	**5.5**[a)]	**5.5**
CLMV average	**6.0**	**6.4**	**7.8**[b)]	**5.9**
Emerging Asia average	**7.9**	**7.4**	**8.6**[a)]	**7.4**

Notes: The cut-off date for data is 1 November 2012. For more detailed information on MPF, see www.oecd.org/dev/asiapacific/mpf.
Emerging Asia includes ASEAN-10 countries, China and India.
a) Excludes Brunei Darussalam and Myanmar; b) Excludes Myanmar.
Source: OECD Development Centre, MPF-2013.

Table A.2. **Current account balance of Southeast Asia, China and India**
(percentage of GDP)

	2011	2017	2000-07	2013-17
ASEAN-6 countries				
Brunei	48.5	55.5	-	54.1
Indonesia	0.2	-3.9	2.8	-3.7
Malaysia	11.0	6.3	11.8	6.2
Philippines	3.1	2.0	1.0	2.7
Singapore	21.9	17.0	18.5	18.9
Thailand	3.4	1.6	3.0	0.8
CLMV countries				
Cambodia	-8.1	-7.9	-2.3	-8.3
Lao PDR	-21.4	-21.5	-13.4	-20.8
Myanmar	-2.6	-5.1	-	-4.6
Viet Nam	0.2	-1.2	-1.9	-1.5
China and India				
China	2.8	1.9	4.6	2.1
India	-3.2	-2.4	0.0	-2.9
ASEAN-10 average	**5.6**	**4.3**	**2.4[a)]**	**4.4**
CLMV average	**-8.0**	**-8.9**	**-5.9[b)]**	**-8.8**
Emerging Asia average	**4.7**	**3.5**	**2.4[a)]**	**3.6**

Notes: Emerging Asia includes ASEAN-10 countries. China and India.
a) Excludes Brunei Darussalam and Myanmar; b) Excludes Myanmar.
Source: OECD Development Centre, MPF-2013.

Table A.3. **Consumer prices of Southeast Asia, China and India**
(percentage change, 12-month average)

	2011	2017	2000-07	2013-17
ASEAN-6 countries				
Brunei	2.0	2.0	-	1.8
Indonesia	5.4	4.8	8.7	4.9
Malaysia	3.2	2.9	2.0	2.5
Philippines	4.7	4.5	4.6	4.0
Singapore	5.2	2.5	1.0	3.4
Thailand	3.8	3.6	2.5	3.4
CLMV countries				
Cambodia	5.5	4.5	3.0	4.0
Lao PDR	7.6	5.7	10.8	5.7
Myanmar	4.0	5.3	-	5.7
Viet Nam	18.7	6.0	4.7	7.0
China and India				
China	5.5	1.5	1.5	1.6
India	8.9	6.0	4.5	7.0
ASEAN-10 average	**6.0**	**4.2**	**4.7[a)]**	**4.2**
CLMV average	**9.0**	**5.4**	**6.2[b)]**	**5.6**
Emerging Asia average	**6.2**	**4.1**	**4.3[a)]**	**4.3**

Notes: Emerging Asia includes ASEAN-10 countries, China and India.
a) Excludes Brunei Darussalam and Myanmar; b) Excludes Myanmar.
Source: OECD Development Centre, MPF-2013.

Table A.4. **Private consumption of Southeast Asia, China and India**
(percentage change)

	2011	2000-07	2013-17
ASEAN			
Cambodia	5.8	7.4	6.3
Indonesia	5.0	3.7	4.8
Malaysia	7.1	8.0	6.9
Philippines	6.8	4.9	5.2
Singapore	4.6	4.6	4.2
Thailand	3.6	4.6	4.9
Viet Nam	5.0	7.1	6.6
China and India			
China	9.4	6.7	9.0
India	5.5	6.3	6.2
ASEAN average	**5.4**	**5.8**	**5.5**
Emerging Asia average	**5.9**	**5.9**	**6.0**

Note:
ASEAN average includes Cambodia, Indonesia, Malaysia, Philippines, Singapore, Thailand, Viet Nam.
Emerging Asia average includes seven countries of ASEAN, China and India.
Source: OECD Development Centre, MPF-2013.

Table A.5. **Gross fixed capital formation of Southeast Asia, China and India**
(percentage change)

	2011	2000-07	2013-17
ASEAN			
Cambodia	19.0	13.9	12.7
Indonesia	9.2	8.3	10.6
Malaysia	6.0	6.7	6.9
Philippines	9.5	4.2	4.9
Singapore	3.3	4.3	5.7
Thailand	5.2	6.8	4.6
Viet Nam	5.1	12.5	8.3
China and India			
China	9.2	12.2	8.0
India	5.5	11.8	7.6
ASEAN average	**8.2**	**8.1**	**7.7**
Emerging Asia average	**8.0**	**9.0**	**7.7**

Note:
ASEAN average includes Cambodia, Indonesia, Malaysia, Philippines, Singapore, Thailand, Viet Nam.
Emerging Asia average includes seven countries of ASEAN, China and India.

Source: OECD Development Centre, MPF-2013.

Table A.6. **Fiscal balance* of Southeast Asia, China and India**
(percentage of GDP)

	2011	2000-07	2013-17
ASEAN			
Cambodia	-2.8	-3.6	-2.7
Indonesia	-1.1	-1.6	-1.2
Malaysia	-5.5	-4.7	-4.8
Philippines	-0.6	-3.4	-1.7
Singapore	7.3	6.9	4.2
Thailand	-0.6	-1.1	-2.6
Viet Nam	-2.8	-2.8	-2.5
China and India			
China	-1.2	-	-1.4
India	-8.1	-7.3	-7.5
ASEAN average	**-0.9**	**-1.5**	**-1.6**
Emerging Asia average	**-1.7**	**-2.2**	**-2.2**

Notes:
* Fiscal balance of general government.
ASEAN average includes Cambodia, Indonesia, Malaysia, Philippines, Singapore, Thailand, Viet Nam.
Emerging Asia average includes seven countries of ASEAN, China and India.
Emerging Asia average 2000-07 does not include China, owing to data availability.

Source: OECD Development Centre, MPF-2013.

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Narrowing Development Gaps

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