Economic Outlook for Southeast Asia, China and India 2014

BEYOND THE MIDDLE-INCOME TRAP

OECD DEVELOPMENT CENTRE

ASEAN SECRETARIAT

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Please cite this publication as:
OECD (2013), *Economic Outlook for Southeast Asia, China and India 2014: Beyond the Middle-Income Trap*, OECD Publishing.
http://dx.doi.org/10.1787/saeo-2014-en

ISBN 978-92-64-20399-0 (print)
ISBN 978-92-64-20400-3 (PDF)

Annual: Economic Outlook for Southeast Asia, China and India
ISSN 2310-1105 (print)
ISSN 2310-1113 (online)

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Foreword

The *Economic Outlook for Southeast Asia, China and India* is an annual publication on Asia's regional economic growth, development and regional integration process. It focuses on the economic conditions of the Association of Southeast Asian Nations (ASEAN) member countries (Brunei Darussalam, Cambodia, Indonesia, Lao PDR, Malaysia, Myanmar, the Philippines, Singapore, Thailand and Viet Nam) and two large economies in the region, China and India. This Outlook evolved from the *Southeast Asian Economic Outlook*.

The 2014 edition is designed to inform the debate on the challenges of the middle-income trap and key policies for avoiding it, while seeking to promote further economic and social integration across 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 in order to address these challenges. The Centre enjoys the full membership of three Southeast Asian countries, namely Indonesia, Thailand and Viet Nam, as well as India. This project also benefited from the generous support of other Emerging Asian countries.

This Outlook is the result of policy dialogue and consultation at regional level, mainly in Singapore in July 2013, and country-based consultations in Asia in June-July 2013. It should be noted that the country-specific "Structural Policy Country Notes" in the Outlook were prepared after taking into consideration important determinants of economic growth and development mentioned in each country's medium-term economic development plans.

Like other regional economic outlooks produced by the OECD Development Centre, the report was prepared in collaboration with a regional partner, in this case the ASEAN Secretariat. 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.

Acknowledgements

The 2014 edition of the *Economic Outlook for Southeast Asia, China and India: Beyond the Middle-Income Trap* was prepared by the Asia Desk of the OECD Development Centre in Paris, in co-operation with the ASEAN Secretariat in Jakarta.

The team was led by Kensuke Tanaka, Head of the Asia Desk and overall guidance was provided by Mario Pezzini, Director of the OECD Development Centre. This edition was drafted by a core team composed of Kensuke Tanaka, Gabor Fulop, Charles Pigott, Koon Hui Tee, Pitchaya Sirivunnabood, Anna Mae Tuazon and Rony Soerakoesoemah. Gabor Fulop managed statistical work related to the report. Nguyen Tu Anh, Stephanie Mak and Pang Eng Fong provided useful inputs in preparing the publication. Administrative support provided by Elisabeth Turner was highly appreciated. Selcuk Ozsahin, participant of the OECD Corporate Traineeship Programme, provided statistical assistance. Charles Pigott and Ken Kincaid provided extensive editorial advice and Quah Boon Haut provided useful comments on the draft.

This publication benefited from discussions with experts at the 2nd Asian Regional Roundtable, jointly organised by the ASEAN+3 Macroeconomic Research Office (AMRO) and the OECD, in Singapore in July 2013. The authors are grateful to Rintaro Tamaki, Deputy Secretary General of the OECD and Yoichi Nemoto, Director of the AMRO, as well as Satoshi Nakagawa, Eckhard Wurzel and Matthew Yiu. The *Outlook* was presented at the occasion of the 23rd ASEAN Summit in Brunei Darussalam, in October 2013.

Support from OECD delegations and embassies of ASEAN countries in Paris, in particular, Ambassador Stefan Flückiger, Ambassador Kazuo Kodama and Ambassador Sihyung Lee, as well as Rapunzel Acop, Deena Amatong, Philippe Besson, Jai-chul Choi, Hideaki Chotoku, Tsutomu Himeno, Wasana Honboonheum, Sang Hee Hong, Daniel Koh, Anindita Kosala, Tran Phan Linh, Kumiko Nada, Ju-Hyun Oh, Yukiko Okano, Chanol Rith, Widya Sadnovic and Sirichada Thongtan is gratefully acknowledged.

A large number of government and central bank officials and experts in Emerging Asian countries were involved in successive consultations during OECD Development Centre missions, seminars and meetings. Particular thanks go to Luky Alfirman, Armida S. Alisjahbana, Irfa Ampri, Aris Ananta, Allauddin Bin Anuar, Zainon Bt Bakar, Prijambodo Bambang, Wichayayuth Boonchit, Bui Tat Thang, David W. Carbon, Chonlatee Chanrachakul, Rosemarie Edillon, Emmanuel Esguerra, Jude Esguerra, Rodrigo Garcia, Carla Hernandez, Haji Abdul Amin Haji Hashim, Asnawi Kamis, Le Luong Minh, Vincent Kong, Don Nakomthab, Paul van den Noord, Nguyen Duc Thanh, Nguyen Hoang Ha Nguyen Thi Lan Huong, Kunta W.D. Nugraha, Aung Naing Oo, Phan Ngoc Mai Phuong, Pradit Phataraprasit, Bambang Prijambodo, Hetti Arachchige Gamini Premaratn, Muhammad Bin abd Rahaman, Zakariah Abdul Rashid, Purbaya Yudhi Sadewa, Mahendra Siregar, Thammanoon Sodsrichai, Wismana Adi Suryabrata, Syaifullah, Pattama Teanravisitsagool, Teresa Peralta, Li Jun Tan, Arkhom Termpittayapaisith, Leonard Thampubolon, Thia Jang Ping, Tran Anh Vu, Trang Thu Vu, Ma. Cyd n. Tuano-amador, Suthirat Vansrisawasd, Porametee Vimolsiri, Prasetijono Widjojo, Perry Warjiyo, Ajaree Amalia Adininggar Widyasanti, Wongwan, Anugrah E. Yogyantoro, Kan Zaw and Joseph Ernest Zveglich, Jr.

The Asian Business Cycle Indicators (ABCIs) and the 2014 version of the Medium-Term Projection Framework for Growth and Development (MPF-2014) used in this publication were prepared by a team managed by Kensuke Tanaka, Gabor Fulop and Masakazu Someya.

Elizabeth Nash, Delphine Grandrieux, Louise Schets, Vanda Legrandgerard and Studio Pykha turned the manuscript into the publication. Aida Buendia designed the cover page of the publication. Bochra Kriout, Naoko Kawaguchi and Yumiko Murakami, media and press relations, provided excellent support.

Last but not least, the OECD Development Centre would like to acknowledge gratefully the financial support received from the Governments of Japan, Korea and Switzerland.

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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
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
ISO	International Organization for Standardization
JICA	Japan International Cooperation Agency

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	Purchasing Power Parity
PPP	Public Private Partnership
PRC	People's Republic of China
PSC	Public Sector Comparator
QE	Quantitative Easing
R&D	Reseach and Development
RCA	Revealed Comparative Advantage
RTA	Regional Trade Arrangement
SAEO	Southeast Asian Economic Outlook
SITC	Standard International Trade Classification
SMEs	Small and Medium-sized Enterprises
SOCBs	State-Owned Commercial Banks
SOEs	State-Owned Enterprises
THB	Thailand Baht
TMS	Target Management System
TVET	Technical Vocational Education and Training
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
WEF	World Economic Forum
WEO	World Economic Outlook
WIPO	World Intellectual Property Organization
WTO	World Trade Organization

Editorial

Countries in the Emerging Asian region - over-dependent on export-led growth in the past - are now rebalancing their economies towards domestic demand as part of a deliberately engineered shift in their growth and development strategies. Indeed, many Emerging Asian economies continue to post impressive growth, and the region's investment prospects look strong.

Yet there are several downside risks and concern is growing that the region cannot continue forging ahead heedless of fluctuations in global demand. Economic destabilisation is also to be feared if inflows from the quantitative easing programmes of the US Federal Reserve turn into outflows, thus exposing hidden flaws in regional economies. The management of capital flows will therefore be an important policy challenge. In addition, ASEAN needs to foster deeper integration: the development gaps between members remain substantial and more rigorous policies are needed to narrow them and to reduce poverty.

This edition of the *Economic Outlook for Southeast Asia, China and India* focuses on the theme of growing beyond the middle-income trap. I believe this is a timely choice, coming as it does amid fears that some of the region's economies are already caught in the middle-income trap as their pace of growth falters. The *Outlook* examines key learning points, drawing on successful development experiences of advanced economies such as Japan, Korea and Singapore, and considers the issues and challenges for selected Emerging Asian countries – China, India, Indonesia, Malaysia, the Philippines, Thailand and Viet Nam.

In particular, the *Outlook* argues that the further development of institutional capacities must be central to development strategies and that growing regional integration both among Emerging Asian countries and with the broader Asian region would be a major asset in their efforts to rise into the high income ranks. Indeed, as they move towards a more advanced stage of development Emerging Asian economies will need to strengthen their institutional capacities in human capital, infrastructure and innovation, in order to support the transformation to increasingly sophisticated industries. Markets and competition must also be enhanced to encourage a more favourable climate for investment and business. And finally services should also be developed due to their critical contribution to countries' moving-up in the global value chain, and to the achievement of broader goals, such as reducing poverty and meeting the needs of the growing middle classes.

It is of particular importance to underline the increasingly strong emphasis that Emerging Asian countries are placing on quality, sustainable growth as part of their medium-term development plans. This and many other concerns, trends and issues are discussed in this latest edition of the *Outlook*.

Accordingly, in its country-specific "Structural Policy Country Notes", the *Outlook* examines important components of sustainable, inclusive growth as human capital development, strengthening the business environment to boost productivity, social security reform and green growth strategy. Coverage includes the ten ASEAN member countries as well as China and India, the two largest emerging economies in the region. Such a country-specific feature is intended to facilitate policy dialogue between Emerging Asian and OECD countries. It further enhances the relevance of this annual publication to on-going work between ASEAN countries and their development partner countries and agencies.

It is my belief that this latest volume will continue to serve as a tool for fostering a better understanding of the growth and development of Asian economies.

Mario Pezzini
Director
OECD Development Centre
Paris, October 2013

Executive summary

Medium-term economic outlook

Despite growth moderating in 2013, Emerging Asia (Southeast Asia, China and India) **will continue to play an important role in global economic growth over the medium term.** The outlook in the region remains resilient, although the pace of growth is forecast to moderate compared to before the global financial crisis (2000-07).

Growth moderating but outlook remains resilient: Overall, the 12 Emerging Asian economies are forecast to see growth moderating to 6.9% in 2014-18, against 8.6% in 2000-07. This largely reflects moderating growth in the two largest economies – China (7.7% in 2014-18 vs. 10.5% in 2000-07) and India (5.9% vs. 7.1%). By contrast, for the 10 ASEAN countries as a whole, growth in the two periods should remain broadly similar (5.4% vs. 5.5%).

Domestic demand growing: Exports will play a diminishing role in driving growth, giving way to domestic demand and, in particular, private consumption. This will be supported by tight labour markets and wage growth as well as an expansion of the middle class. The region's investment prospects look strong. Public finances should improve broadly, with fiscal deficits projected to narrow or stabilise.

Volatility in financial markets poses risks: During the early part of the third quarter of 2013, the region saw large capital outflows as investors returned funds to developed economies, especially the United States. The resulting financial turbulence brought back memories of the Asian Financial Crisis of 1997-98, and highlighted the risks posed by unpredictable capital flows and financial instability. These risks are real, but the region is better equipped to manage them than in the 1990s, thanks partly to strong foreign reserves. More could be done, especially to strengthen monitoring of capital flows and the capacity for collective action.

ASEAN needs deeper integration: ASEAN, the ten-member regional grouping, faces challenges in meeting its objective to create a common market by 2015. Development gaps between members remain substantial, and more rigorous policies are needed to narrow them and to reduce poverty. The region would also benefit from greater co-operation to attract investment and liberalise trade.

Structural policy challenges

While the Emerging Asian economies appear well equipped to manage short-term volatility, they need to do more to meet their long-term potential. Further structural reforms are vital. To this end, the 2014 edition of the *Economic Outlook for Southeast Asia, China and India* offers specific proposals for each country. Some broad themes:

- ***Invest in quality human capital:*** Education and skills are essential to raising productivity and encouraging innovation and to improving individuals' economic prospects. Further investment is vital, although challenges vary: India and Indonesia, for example, need to broaden access to basic education; by contrast, adult education is a priority for Singapore.
- ***Improve the business environment to boost productivity:*** Growth would benefit from measures designed to encourage business. These could include: simplifying business procedures; encouraging small to medium-sized businesses, which are strong job creators; creating a level playing field for state- and non-state-owned enterprises; and easing access to credit.
- ***Enhance green growth and strengthen disaster risk management:*** In some countries, enhancing green growth will be important. For example, Singapore can optimise land use and allocation by following a green growth strategy, while Thailand could improve institutional co-ordination to achieve green growth. Some countries such as the Philippines and Indonesia are at particular risk from natural disasters. Reforms to improve disaster management and to foster environmentally sustainable growth are also vital. A range of other structural reform challenges also exist, including reducing poverty and creating jobs and developing more productive and sustainable approaches to agriculture.

Growing beyond the middle-income trap

Sustaining the economic progress of Emerging Asia will be a challenge and requires a new approach to development. History is littered with examples of economies that jumped from low-income to middle-income status by adopting existing technologies and by raising productivity as workers moved from farm to factory. But many then failed to take the next step forward. Hence growing beyond this "middle-income trap" requires a fundamentally different approach – one based on raising productivity through investment in human capital and innovation and a shift towards an increasingly technology-intensive economy.

Institutions are key: The failure to move beyond the middle-income trap can be largely traced to the failure of institutions to keep pace with the needs of the economy. As they move towards a more advanced stage of development, many of Emerging Asia's economies will need to strengthen their institutional capacities in several key areas:

- *Human capital*, *infrastructure* and *innovation*, to support the transformation to increasingly sophisticated industries;
- *Markets and competition*, to encourage a favourable climate for *investment and business*; and
- *Financial and macroeconomic stability*, to ensure resources are allocated efficiently and avoid costly interruptions to growth and development.

"Factory Asia" needs to evolve: Several factors, including rising wages, may cause a shift in the region's role in global value chains. A rapid rise in regional demand should make up some of this shortfall, and Factory Asia will remain important in global manufacturing. But to take full advantage of such a shift, the region's manufacturers need to move up from assembly towards and into sophisticated activities based on higher productivity and a greater dependence on technology.

Modern services sector needs to grow: Services account for between 37% and 45% of gross domestic product in middle-income ASEAN economies and China, largely unchanged since the mid-1990s. Regulatory barriers that limit entry, stifle competition and inhibit investment are holding back the sector's development, especially in modern services such as finance, business services, and information and communication technology.

Financial system needs to be developed: Much has been done since the late 1990s to put financial institutions and markets on a sound footing. This work should continue to ensure they can effectively manage risk at a time of rapid change. Banks and other financial institutions also need to offer a wider range of financial instruments and services to meet evolving needs, especially those of small businesses.

Regional co-operation can aid national development: The region has taken numerous steps to deepen co-operation and integration. Such approaches can bolster national economies by allowing a more efficient allocation of the region's labour and resources, providing scale for bond markets, for example, and encouraging cross-border banking competition.

Overview

Medium-term economic outlook: Prospects and assessments

The economic outlook in Emerging Asia (Southeast Asia, China and India) remains robust over the medium term, anchored by the steady rise in domestic demand.

Real gross domestic product (GDP) growth in Emerging Asian economies is projected to be moderating gradually but remains robust over the 2014-18 period, according to the results of the OECD Development Centre's Medium-Term Projection Framework (MPF-2014) for this 2014 edition of the *Economic Outlook for Southeast Asia, China and India*.

As a whole, the Emerging Asian economies are expected to grow by 6.9% per annum in 2014-18. It is a robust pace, albeit less than the 8.6% registered before the global financial crisis (2000-07). This slower rate of growth largely reflects the moderate rates of expansion in the two large Emerging Asian economies of China and India. In the Southeast Asian region, growth will remain robust in the medium term, growing at a pace which is comparable to the pre-global financial crisis. The real GDP growth rate in the Southeast Asian region is projected to average 5.4% per annum between 2014-18, against 5.5% in 2000-07 (Table 0.1).

The GDP growth projections for individual countries reflect their different stages of development and medium-term growth drivers. Indonesia is projected to be the fastest-growing economy within the ASEAN-6, with an average annual growth rate of 6.0% in 2014-18, followed by the Philippines with 5.8%. These projected medium-term growth rates are considerably higher than the average growth prior to the global financial crisis (5.1% and 4.9% respectively). The strong medium-term economic outlook for Indonesia and the Philippines will be underpinned by robust growth in domestic demand, strong infrastructure spending and implementation of structural economic reforms.

Led by rising growth in domestic demand, especially in infrastructure investment and private consumption, real GDP in Malaysia and Thailand is projected to grow by an average annual rate of 5.1% and 4.9%, respectively, over the period 2014-18. While their projected growth rates compare favourably to those of other developing countries at similar stages of economic development, both Malaysia and Thailand should improve their productivity in order to grow beyond the middle-income trap.

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

	2012	2018	2014-18	2000-07
ASEAN-6 countries				
Brunei Darussalam	1.0	2.4	2.3	-
Indonesia	6.2	6.1	6.0	5.1
Malaysia	5.6	5.3	5.1	5.5
Philippines	6.8	5.9	5.8	4.9
Singapore	1.3	3.1	3.3	6.4
Thailand	6.5	5.3	4.9	5.1
CLMV countries				
Cambodia	7.2	7.1	6.8	9.6
Lao PDR	7.9	7.5	7.7	6.8
Myanmar	-	7.0	6.8	-
Viet Nam	5.2	6.0	5.4	7.6
Average of ASEAN 10	5.5(*)	5.6	5.4	5.5(**)
2 large economies in Emerging Asia				
China	7.7	7.5	7.7	10.5
India	3.7	6.1	5.9	7.1
Average of Emerging Asia	6.4	6.9	6.9	8.6

Notes: The cut-off date for data is 6 September 2013. Emerging Asia includes ASEAN-10 countries plus China and *India*. *) Exclude Myanmar **) Exclude Brunei Darussalam and Myanmar.

Source: OECD Development Centre, MPF-2014. For more detailed information on the MPF, see www.oecd.org/dev/asiapacific/mpf. Emerging Asia includes ASEAN-10 countries, China and India.

Singapore's economy is projected to grow by 3.3% per annum over the period 2014-18. The rate of growth reflects the country's more advanced stage of economic development as its economy shifts towards more sustainable, inclusive growth led by rising productivity and innovation.

The CLMV countries (Cambodia, Lao PDR, Myanmar and Viet Nam) are projected to grow at a robust pace over the medium term, led by Lao PDR at 7.7% per annum. Real GDP growth in Cambodia and Myanmar is projected to average close to 7% between 201418, underscoring the significant improvement in these countries' investment appeal as they open up to foreign investment. As for Viet Nam, while its real GDP is projected to remain robust in the medium term, growth will be slower than prior to the global financial crisis because of slower external demand from advanced economies and weak macroeconomic management policies which could jeopardise growth.

China's real GDP growth is expected to moderate to around 7.7% in 2014-18 (compared to 10.5% between 2000 and 2007), as the country rebalances its growth model towards growth driven by domestic consumption. Implementation of structural reforms will also be a critical factor in driving the Chinese economy towards sustainable development and growing beyond the middle-income trap. The slowdown in China, in particular, could weaken the growth momentum of Southeast Asian economies, as they become more dependent on China as a key trading partner. At the same time, India's growth is expected to moderate to 5.9% (2014-18), compared to 7.1% between 2000-07.

The other main results of MPF-2014 are as follows:

- Over the medium term, growth in private consumption and investment will continue to be robust, providing a key anchor for *domestic demand* and making an important contribution to overall GDP growth in many countries in Emerging Asia.
- Most ASEAN-6 countries will remain in current account surplus, while CLMV countries will remain in deficit in the medium term.
- Fiscal deficits will narrow in most countries, leading to stable or lower public debt-to-GDP ratios that are lower or stable.

Labour markets in Emerging Asia are expected to remain relatively tight and this will help to continue to support growth in wages and private consumption. Macroeconomic policies have also helped to support the increase in **private consumption** by pursuing price stability over the medium term. Moreover, structural factors are becoming important drivers of private consumption growth. Indeed, the rise of the middle class – especially in China and India but also across Southeast Asia – will help to boost spending on household durables, automobiles, education and health care services. More importantly, government policies – such as fiscal reforms and policies to narrow income gaps and promote inclusive growth – will play an increasingly critical role in driving sustainable growth in private consumption over the medium term.

Investment growth is also projected to remain robust in Emerging Asia, supported by government infrastructure spending to drive long-term development plans. Critically, private investment will be the key to underpinning sustainable growth in overall investment. Indeed, private-public partnership (PPP) programmes will play an increasingly critical role in infrastructure projects across emerging Asian economies. Emerging Asia's resilient macroeconomic fundamentals are an important competitive advantage in attracting FDI. In the medium term, such a competitive advantage will help to sustain strong FDI inflows into the region and support growth in domestic investment.

Key macroeconomic policy challenges

The success of Emerging Asian countries in realising the favourable prospects for their medium-term growth and development will hinge on managing several key challenges. Overcoming these challenges will be critical to harnessing medium-term growth potential in Emerging Asia.

Managing the spillover impacts of quantitative easing on capital flows

One of the key imminent downside risks facing Emerging Asia is volatility in the financial markets, triggered by the prospects of tapering of quantitative easing (QE) policy in the United States. Emerging Asian economies which ran large current account deficits and were more prone to macroeconomic risks of *capital outflows* – such as India and Indonesia – bore the brunt of the financial turbulence during the early part of the third quarter of 2013. Against this backdrop, managing international capital flows while ensuring sustainable economic growth will continue to be a key medium-term macroeconomic policy challenge facing emerging Asian economies.

The financial turbulence buffeting Emerging Asia early in the third quarter of 2013 has heightened fears of contagion, aggravated by concerns over the impending economic crisis in the region – suggesting parallels with past episodes such as the Asian Financial Crisis (AFC) in 1997-98 and India's balance of payment crisis in 1991. Indeed, there are signs of macroeconomic weaknesses, particularly in India and Indonesia, where persistent current account deficits warrant concern.

Stepping up efforts towards ASEAN economic integration

ASEAN has vast strengths to draw upon for playing an increasingly important role on the global economic stage. However, as its integration into the world economy intensifies, ASEAN finds itself facing great opportunities as well as challenges, particularly the need to better integrate its newer members into the regional and global economy. ASEAN therefore needs to capitalise on its strengths while overcoming a number of distinct challenges in order to attain the medium-term goal of a regional common market by 2015.

Hence, another of ASEAN's key medium-term policy challenges is to narrow the social and economic development gaps between its members. Indeed, the journey towards an ASEAN Community by 2015 requires member countries, including the newer ones, to not only stay on the same track but to keep pace. The implementation of the Initiative for ASEAN Integration (IAI) work plan will be the main driver behind efforts to narrow development gaps in ASEAN and support the three ASEAN Community Blueprints. The Narrowing Development Gap Indicators (NDGIs) – first published by the OECD Development Centre and the ASEAN Secretariat in the 2013 edition of the *Outlook* – indicated that greater efforts are required in the area of poverty and human capital development to narrow development gaps in the region.

Structural policy country notes

Further structural reforms are key to realising Emerging Asia's long-term potential

The Emerging Asia region has positioned itself well to weather short-term economic volatility. However, this success serves only to underscore the need to focus on how to realise the region's long-term potential. On-going economic uncertainties in the advanced economies constantly drive home the point that the region cannot take for granted the steady increase in its capacities and uninterrupted economic growth. To achieve them will require considerable skill and effort from policy makers.

This edition of the *Outlook* includes "Structural Policy Country Notes" on the ten ASEAN member countries as well as on China and India, the two large emerging economies in the region. Each Note discusses the most important priorities set out in the country's medium-term development plan. The Notes also discuss relevant experiences in OECD countries, providing useful insights and suggestions for "best practices" that may be useful for steering mutual learning with policy makers in Emerging Asia.

Countries in Emerging Asia need to ensure that the new growth and development strategies do indeed lead to sustainable growth. To meet that goal, structural policy reforms should be put in place to ensure that (among other things) there is sustained and robust productivity growth, the cornerstone of every nation's economic growth and competitiveness. Reforms should also target economic upgrading to enable the region's economies to participate competitively in global value chains in the face of changing domestic and international conditions. Failure to undertake the necessary reforms could put some of the countries at risk of being caught in the so-called "middle-income trap".

There has been a broadening in the development strategies of Southeast Asian economies, with increasing focus on *quality of growth* (Table 0.2). For example, Thailand has redirected its five-year development plan towards a new model of holistic people-oriented development. The Philippine Development Plan has much the same objectives, adopting a framework for growth that is both sustainable and inclusive in that it seeks to generate widespread employment and reduce poverty. Indonesia's vision looks to the "realisation of [a country] that is prosperous, democratic and just", while that of Cambodia trains its sights on "growth, employment, equity and efficiency".

Table 0.2. **Medium-term development plans in Southeast Asia, China and India**

Country	Period	Theme/Vision
ASEAN 10 countries		
Brunei Darussalam	2012-17	Knowledge and innovation to enhance productivity and economic growth
Cambodia	2009-13	Growth, employment, equity and efficiency
Indonesia	2010-14	Realisation of an Indonesia that is prosperous, democratic and just
Lao PDR	2011-15	Socio-economic development, industrialisation and modernisation towards the year 2020
Malaysia	2011-15	Charting development towards a high-income nation
Myanmar	2012-15	Development of industry, balanced development, improvements in education, health and living standards and improved statistical capacities.
Philippines	2011-16	Pursuit of inclusive growth
Singapore	2010-20	Highly skilled people, innovative economy, distinctive global city
Thailand	2012-16	A happy society with equity, fairness and resilience under the philosophy of a Sufficiency Economy
Viet Nam	2011-20	A modern, industrialised country by 2020
2 large economies in Emerging Asia		
China	2011-15	Rebalancing the economy, ameliorating social inequality and protecting the environment
India	2012-17	Faster, more inclusive and sustainable growth

Source: OECD Development Centre based on national sources.

Medium-term policy challenges and responses in Emerging Asia

While each country's policy objectives may focus on high-quality sustainable growth, the policy challenges faced will depend largely on the country's particular situation and level of development (Table 0.3).

Table 0.3. **Summary of medium-term policy challenges and responses in Emerging Asia**

ASEAN-6

Country		Policy focus
Brunei Darussalam	Human capital development	Improve private sector development to diversify beyond the hydrocarbon economy
	Private sector development	Legislate and implement competition policy
	Innovation	Improve tertiary education attainment
Indonesia	Education	Widen access to education, in particular for low-income households
	Disaster management	Strengthen natural disaster management and protection infrastructure
	Social security reform	Accelerate reform of the pension system to improve transparency and quality
Malaysia	Education	Improve the quality of education
	SME development	Improve the productivity of SMEs
	Taxation	Widen the tax base and improve tax administration and compliance
Philippines	Poverty	Create more jobs for sustainable poverty reduction
	Human capital development	Build holistic disaster risk reduction and management capacities to reduce vulnerability to natural hazards
	Governance	Improve agricultural productivity and transport infrastructure in Mindanao
Singapore	Land use	Optimise land use and allocation by incorporating a green growth strategy
	SME development	Raise SME productivity through well co-ordinated assistance programmes
	Education	Strengthen life-long learning to increase labour market flexibility
Thailand	Education	Upgrade human capital by improving the national curriculum and teaching standards
	Agriculture	Improve agricultural productivity through modernisation and education
	Green growth	Improve institutional co-ordination to achieve green growth

CLMV

Country		Policy focus
Cambodia	Agriculture	Improve productivity of agriculture, in particular rice production
	Financial sector	Improve the prudential and supervisory framework for the financial sector
	Tourism	Develop tourism-specific infrastructure
Lao PDR	Poverty	Reduce poverty through inclusive growth
	Natural resource management	Improve national resource management, in particular mining, to ensure environmental sustainability
	Infrastructure	Develop transport infrastructure to speed up rural development
Myanmar	Private sector development	Create a business-enabling environment
	Human resource development	Upgrade education and anticipate future demands for skilled labour
	Financial sector development	Create a stable and efficient financial system
Viet Nam	Human capital development	Increase access to education and strengthen TVET to improve the quality of human capital
	Private sector development	Ease access to credit and lower transport costs to develop the private sector
	Financial sector development	Restructure the financial system to enhance the effectiveness of monetary policy

Two large Emerging Asian economies

Country		Policy focus
China	Fiscal policy	Improve fiscal efficiency through institutional reform
India	Education	Improve teaching and national assessment systems to raise education standards

Source: OECD Development Centre.

The six most advanced ASEAN economies should address the common challenges of improving their capacity to provide the education and job skills that will be needed to develop greater productivity and technology-intensive industries. The fostering of inclusive growth and greater resilience to natural disasters and climate change are also becoming increasingly important priorities.

Brunei's economy needs to become less reliant on the oil and gas sectors, which accounted for more than 60% of GDP and 95% of total exports in 2010. The development of other high-value-added manufacturing and services sectors is a key priority. The Tenth National Development Plan is based on six strategic development thrusts. Three of these are particularly important to the goal of creating a more diversified economy: an environment conducive to business; an educated, highly skilled population; and a progressive, productive economy based on knowledge and innovation.

Indonesia needs to focus on reforms to make education more widely accessible, to strengthen its ability to deal with natural disasters and to accelerate reform of its social protection provision, particularly of its pension system. It should also improve the business environment.

Improvements to government policies, through measures such as reforms to make the current scholarship and conditional cash transfer (CCT) programmes more efficient, will be key to widening access to education. Indonesia is highly exposed to natural disasters that have claimed lives and wreaked financial and economic damage, with the poor disproportionately affected. Given this exposure, which may well increase with climate change, the country's natural disaster management system, particularly with regard to flooding, urgently needs to be strengthened.

The country's pension system, one of the pillars of its social protection system, is currently ill-suited to providing the majority of the retired population with a secure income. Reforms in this area need to be accelerated. Indonesia also needs to improve its business climate to ensure that its economic growth can be sustained. A key priority is to build on and reinforce the recent progress made in improving the investment climate by simplifying business procedures.

The **Malaysian** economy has proved to be resilient at a time of global uncertainty. Over the medium term, however, there are important long-standing structural issues that may affect its march towards developed country status by 2020.

Structural problems affecting the education system continue to be a stumbling block in efforts to improve productivity and to attract value-adding high-tech industries that require skilled labour. Small and medium-sized enterprises (SMEs), which contribute so heavily to employment, are especially hard-hit by difficulties in finding skilled labour. While the fiscal balance continues to improve, uncertainties in the external environment – coupled with the failure so far of fiscal reforms to rein in spending on subsidies or to implement a goods and services tax (GST) – raise questions as to whether the improvement in public finances can be sustained.

Singapore's priorities for 2020 are to boost skill levels across job categories, to strengthen companies' abilities to seize business opportunities in Asia, and to make Singapore a distinctive global city and endearing home.

To boost job skills in an ageing population, the Singapore government has strengthened its adult learning policies. The authorities recognise the key role that SMEs play in the economy and have instituted policies to improve their productivity. SME support is provided through a multi-agency assistance framework that offers a variety of schemes, ranging from tax cuts to loans and grants that help defray the costs of productivity improvements in areas such as research and development (R&D), automation and business capacity building. The government has also recently formed a new workgroup to lead and co-ordinate efforts to raise awareness of the productivity-enhancing schemes, to help the SMEs overcome difficulties faced in economic restructuring and to raise productivity. Land scarcity is a key challenge that the government must address in its efforts to make the city state a distinctive global city and an endearing home. Policies need to manage the competition for different land uses while ensuring a quality environment for all.

Key priorities in the **Philippines** are to improve job creation, to strengthen resilience to natural disasters and climate change, and to promote development of the country's poorest regions. A weak job-creating capacity that has led to chronically high unemployment and – even more significantly – under-employment has been a critical contributory factor in persistent poverty and inequality. Job creation also needs to be bolstered through reforms to foster a more favourable business and investment climate, particularly for the small and medium-sized enterprises which contribute so much to employment. The Philippines' poorest island grouping, Mindanao, has been largely overlooked by rural development policies. To help Mindanao capitalise on its natural assets, invigorate its economy and lift its people out of poverty, rural development needs to focus on improving agricultural productivity and the island's woeful transport infrastructure.

The Philippines is one of the countries most prone to natural disasters in the world. It is exposed to multiple natural hazards, ranging from typhoons and earthquakes to volcanic eruptions and especially flooding. Serious aggravating factors are environmental degradation, climate change and uncontrolled urbanisation. Reforms to improve disaster management and to foster environmentally sustainable growth will be essential to improving and sustaining the country's development.

Although **Thailand** has carried out some reforms in the two years since the latest medium-term development plan was initiated, it needs to do more – specifically to upgrade educational quality, to strengthen the agriculture sector and to restructure the economy with an emphasis on green growth.

In education, there needs to be a co-ordinated effort to elevate the quality of learning and teaching if outcomes are to be improved. In agriculture, meeting the challenge of greater productivity and income and employment security requires further efforts to modernise the sector and to educate farmers in the use of technology. As regards green growth, Thailand can make its national strategy more effective by strengthening institutional co-ordination and by raising levels of public awareness of the benefits of a green lifestyle.

Sustainable development of natural resources and agriculture are key priorities for the CLMV countries. A number of them also need to focus on strengthening institutional capacities for preserving macroeconomic and financial stability.

Cambodia's economic development has been fast paced. To keep growth sustainable and strong, there are three priority areas on which the government should focus in the medium term. First, agriculture, particularly rice production, needs to be further developed. The government has introduced a new system of rice intensification (SRI) to improve the productivity of rice-field irrigation and has taken measures to diversify agriculture as a whole. The second priority is to further develop the prudential and supervisory framework of the financial sector to ensure financial stability in a context of fast credit growth. Finally, development of the tourism industry needs to be strengthened by increasing the number of tourist destinations and by improving transport and other essential infrastructure.

Lao PDR's resource-based economy – driven by forestry, agriculture, hydropower and minerals – is on a robust, impressive growth path. However, development has been uneven and poverty remains widespread. The government needs to adopt a sustainable, inclusive growth model so as to reduce poverty, while implementing sound strategies for natural resource management to ensure that the country's economic growth is environmentally sustainable. The development of infrastructure needs to keep pace with the country's fast economic growth and rapid urbanisation in order to ensure that growth is sustainable and help improve the welfare of the people as a whole.

Fortunate to be endowed with a wealth of natural assets, **Myanmar** is well positioned to engage a multi-pronged development strategy that draws on agriculture, mining and extraction, manufacturing and services. For the strategy to be a success, the internal peace process and renewed relations with major bi-lateral and multi-lateral partners will be important. Myanmar can also benefit from its advantageous location between major growth poles and markets, such as China and India, and its proximity to the ASEAN tigers to regain – or even exceed – the importance it once enjoyed as a regional hub.

Myanmar has already undertaken some major reforms and the political will to take them even further appears strong. However, the country will need to address important, long-standing issues related to the economy, such as an environment that is still not very conducive to business, the lack of skilled labour, and underdeveloped infrastructure.

Since **Viet Nam** initiated its Doi Moi Policy of economic reform in 1986, it has made considerable progress in modernising its economy and has achieved impressive results in growth and poverty reduction. However, growth has slowed in the last five years. Sustaining economic development will require increasingly sophisticated labour skills to enable industry to shift towards higher productivity and technology-intensive activities. Viet Nam urgently needs to improve schooling and technical and vocational education and training (TVET) if it is to rectify the mismatch between skills supply and demand.

Viet Nam needs to foster an equitable, stable business environment and to ensure a level playing field for non-state and state-owned enterprises. Only then will it be able to fully harness the essential and growing economic contributions of its SMEs. The country also urgently needs to reform its monetary policy framework so that policy can more effectively sustain macroeconomic stability. In the medium and long term, it should direct its monetary policy towards controlling inflation and reducing macroeconomic fluctuations.

The two large countries in the region face the challenge of strengthening the capacity of government institutions to support development and maintain macroeconomic stability.

China has made significant progress over the last decade in sustaining and broadening its economic development, in continuing to raise living standards, and in enhancing its status in the international community. Improvement in the government's institutional capacity to further promote those goals has become a key priority.

One important policy direction laid out in the 12th Five-Year Plan (FYP) is to improve the provision of basic public services – notably public education, health care and social security – by undertaking more effective institutional reforms and defining more clearly the responsibilities of different levels of government. The FYP goes on to state the government's intention of deepening fiscal reform through improvements to transfer payment, budget management and tax systems. While China has made progress in these areas, it can do more to streamline administrative efficiency and to accelerate budgetary reforms.

India's economy has developed quickly in the last decade, improving living standards and experiencing strong growth in such critical sectors as information and communciation technology (ICT). In recent years, however, circumstances have become less conducive to growth: macroeconomic conditions in the developed economies point to a prolonged external slowdown, while domestic constraints such as high inflationary pressures and rising fiscal and current account deficits have emerged.

The 2013-14 budget focuses on the poor as part of the overarching goal of creating opportunities for young people to acquire the education and skills that will enable them to get decent jobs or become self-employed. Similarly, the educational focus of the 12th FYP is on teacher training, evaluation and accountability. It also stresses the need for higher quality in research, infrastructure, teachers and curriculum content.

Policy priorities for growing beyond the middle-income trap in Emerging Asia

Emerging Asia has made remarkable progress over the past four decades in raising income levels, reducing poverty and developing manufacturing. Some Emerging Asian countries – China, India, Indonesia, Malaysia, the Philippines, Thailand and Viet Nam – are poised to join Japan, Korea and Singapore in the ranks of the advanced high-income countries within the next few decades, as long as they can sustain their fast growth at rates comparable to those they have enjoyed until now (Figure 0.1).

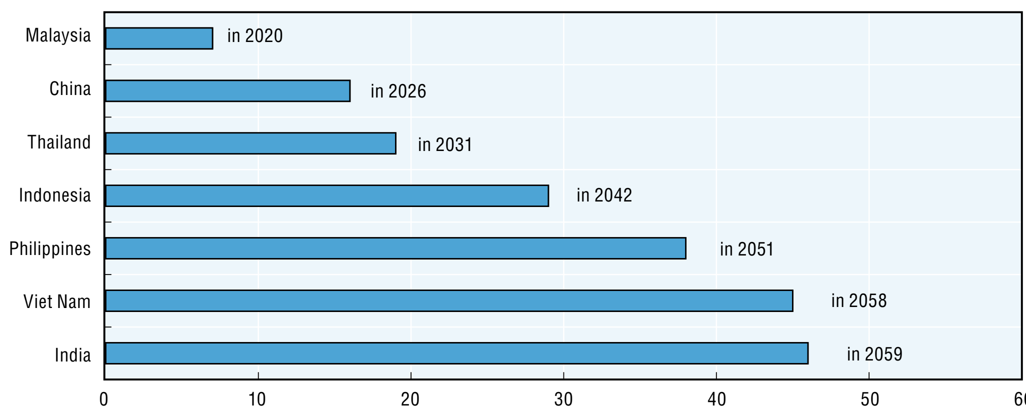
Developing institutional capacities, changing the character of "Factory Asia", further developing service industries and promoting regional integration are some of the policy priorities that will help Emerging Asia to avoid the middle-income trap, sustain long-term growth and consequently become advanced economies.

To sustain long-term growth beyond the middle-income trap, Emerging Asian economies must develop institutional capacities and keep pace with changing economic needs

Many other countries have grown rapidly in their initial stages of development only to falter at a later stage and fail to progress much further. The inability to grow beyond the so-called "middle-income trap"[1] underscores the fact that the challenges of sustaining development become more difficult and complex as development evolves.

Figure 0.1. **"Best scenario" simulation of estimated time required to become high-income countries for middle-income countries in Emerging Asia**

Years



Note: Based on World Bank's criterion for classifying economies, high income countries are defined as having gross national income per capita above USD 12 000 in 2013. Growth, consumer price index and exchange rate prospects in this simulation are in line with MPF-2014. Population projections are based on UN data.

Source: OECD Development Centre.

StatLink http://dx.doi.org/10.1787/888932937111

To sustain development beyond the middle-income trap, countries need to shift away from growth that is driven primarily by factor accumulation and productivity increases from the reallocation of labour from agriculture to industry and the adoption of existing technologies. They should rather embrace *extensive* growth based on productivity increases driven by improvements in the quality of human and other capital and by innovation. Such a shift entails substantial changes in economic structures toward higher productivity and increasingly technology-intensive sectors.

Government policies will be crucial in determining the success of the middle-income ASEAN countries, China and India, in orienting their economic and industrial structures towards sustained productivity-led growth. Historical experience – e.g. the success stories of Japan, Korea and Singapore – underscores the importance of focusing policies on building and strengthening institutions which supply the key ingredients needed for industrial transformation and shape businesses' incentives and ability to respond to changing market conditions and opportunities.

***Institutional development* is critical to achieving that necessary economic transformation:**

- Institutional capacities to provide human capital, infrastructure and innovation need to be created and strengthened to support the transformation to increasingly sophisticated industries.
- Institutions that support efficiently functioning markets, competition, and a favourable investment and business development climate are critical.
- Institutional capacities to sustain financial and macroeconomic stability are equally important to ensure that resources are allocated efficiently and that costly interruptions to growth and development are avoided.

The institutional requirements for development tend to be more demanding once countries reach middle-income status than in the earliest stages of development. The inability of countries in the past to sustain their development beyond the middle-income trap can be traced in large part to the failure of institutions to keep pace with the needs of the economy.

Human capital and innovation

Building and growing institutional capacity in human capital and innovation will be critical to making the changes in economic structure. Development of human capital and innovation capacity are critical to successfully move up the value chain into higher-productivity manufacturing and service activities. Middle-income ASEAN countries face a range of challenges in strengthening the institutions, such as schools and other educational establishments and research and development facilities, that are critical to providing those inputs.

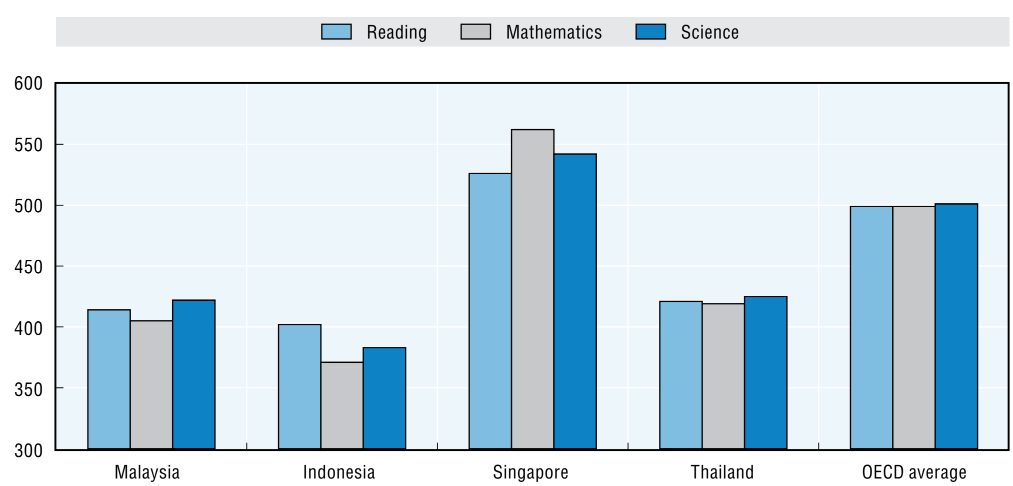
• ***Human capital***

Educational attainment, as measured by scores in the OECD's Programme for International Student Assessment (PISA), is lower in most middle-income ASEAN countries than in OECD countries and the more advanced Asian economies (Figure 0.2). This lower attainment partly reflects marked disparities in access to basic education, particularly between rural and urban areas, and weaknesses in teacher qualifications and the quality of curricula.

Mismatches between the skills required by industry and those provided by schools and universities and by TVET are widespread and are becoming a significant impediment to industrial development in some cases. Recognising the crucial importance of human capital to their overall development, many countries in the regions have been making strenuous efforts to remedy their educational weaknesses.

Figure 0.2. **OECD PISA score in Southeast Asia and OECD countries, by area, 2009**

Score



Note: The PISA scale was set such that approximately two-thirds of students across OECD countries score between 400 and 600 points.

Source: OECD, *PISA database.*

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• ***Innovation***

Innovation capabilities are equally important to economies' ability to become competitive in higher-productivity sectors. More sophisticated, higher value-added products – such as consumer electronics, ICT equipment and pharmaceuticals – are heavily dependent on research and development. Effective innovation capabilities require a business environment that facilitates entrepreneurship and provides the access to finance necessary for the creation and growth of innovative firms. Such an environment needs to be supported by effective university and research institutions with strong links to industry. China, India, Malaysia, Thailand and the Philippines have been making especially strong efforts to develop their innovation capabilities. They offer fiscal and other incentives for R&D, and have created science and technology parks to attract and strengthen linkages among foreign and domestic knowledge-intensive firms.

It is critical to build a business-friendly environment and strengthen business-enabling arrangements

Institutional reforms to strengthen the enabling conditions that support properly functioning markets, business capacity, and the environment for business development and investment will be especially critical to the success of industrial development in middle-income Emerging Asian countries. Various studies, such as the World Bank's Doing Business survey and the Global Competitiveness Index published by the World Economic Forum (WEF), indicate that Malaysia and Thailand rank relatively favourably overall in relation to their income levels, while Indonesia, the Philippines and China rank lower. The surveys indicate that high costs of starting and operating a business are considerable obstacles to business development in most countries in the region.

Indicators also reveal comparative weaknesses in insolvency regimes in Indonesia, the Philippines and Viet Nam. They also point to weaknesses in many of the region's countries in areas like intellectual property rights, the protection of minority shareholders, corporate governance, and labour market efficiency. Corruption and inefficient government bureaucracy are among the most problematic factors in the business environment in most middle-income ASEAN countries.

Governments across the region have been making strong, wide-reaching efforts to address weaknesses in their business environment. For example, Viet Nam has recently enacted reforms that have significantly improved the protection of property rights and investors. China, for its part, reformed its Bankruptcy Law in 2007, thereby significantly improving its insolvency resolution ranking. This and past editions of the *Outlook* have further documented the efforts of many countries in the region to reform regulatory procedures and, in some cases, to streamline tax systems in order to reduce their cost burdens on businesses.

Countries across the region will need, however, to do more to improve their business-enabling conditions if they are to achieve the quality of institutions characteristic of more advanced economies. There are a number of priority areas for reform.

- Further regulatory reforms to reduce costs and obstacles to starting new businesses for domestic entrepreneurs, particularly in China, Indonesia, the Philippines and Viet Nam.
- Reduced incentives for corruption and better enforcement of laws against it, especially in Indonesia, Thailand, the Philippines and Viet Nam.

- Further corporate governance reform and improvements in investor protection in most countries.
- Further efforts, especially in China and Viet Nam, to increase the role of non-state enterprises in sectors still dominated by state-owned enterprises (SOEs), in parallel with further reforms deemed essential to strengthening the corporate governance and market discipline of SOEs.

Financial systems need to develop further and better serve SMEs

The success of middle-income Emerging Asia in growing beyond the middle-income trap will depend critically upon the capabilities of their financial systems. Credit will need to be channelled efficiently and on financially sound terms to sectors and businesses leading the transformation of the economy. Such sectors and businesses will often have different characteristics from those to whom credit has traditionally gone. Increasingly sophisticated economies will need to be served by greater diversity in financial instruments and facilities, while financial institutions and markets will need to manage the risks associated with rapid economic changes.

Although considerable progress has been made since the 1997-98 Asian financial crisis in improving the soundness of banks and other financial institutions and in developing a wider array of financial outlets, more will need to be done, particularly to address the following weaknesses:

- Efficiency and competition in banking systems are still limited in some countries, owing in part to restrictions on private sector or foreign participation.
- Capital markets, especially bond markets, are comparatively underdeveloped, perpetuating the high dependence and concentration of financial risks in the banking system.
- The diversity and sophistication of financial instruments and services – e.g. consumer credit, financial derivatives for managing risks and vehicles for longer-term investment in areas such as infrastructure development and retirement savings – is still limited.
- Key segments of the population and business community – notably SMEs – are presently underserved as regards access to credit and to the financial services and instruments that they need.
- The international integration of domestic financial systems is not yet complete, due in part to remaining capital controls.

Given the key contribution that SMEs will make to further development in the region, improving their access to finance needs to be a key priority in efforts to strengthen financial systems. SMEs in the formal sector in the middle-income ASEAN countries account for between one-third and nearly 60% of GDP, and more than one-half to as much as 80% of total employment. SMEs that work as sub-contractors to large exporting firms play an important role in intra-regional ASEAN trade. SMEs are also crucial to the success in sustaining innovative growth and development – in part because highly innovative enterprises tend to start out as SMEs.

SMEs in developing countries, including middle-income Emerging Asia, face a range of barriers to their development. Limited access to financing, however, is one of the largest concerns. Financing barriers in Emerging Asia are especially detrimental to SMEs' ability to compete in regional and international markets or participate in regional production chains. The difficulties that SMEs experience in accessing external finance stem in part from their comparatively high risk (due to some extent to their more limited management capabilities compared to larger firms). However, they are further aggravated by their lack of acceptable collateral, information asymmetries, the abilities of banks and other lenders to assess the risks associated with SMEs, and the proportionately high costs of lending to smaller borrowers. The limited development of capital markets further constrains the development of innovative SMEs with high-growth potential by retarding the development of venture capital facilities.

A number of countries have also been strengthening the institutional underpinnings for venture capital. SMEs' access to credit in the region could be further improved through additional reforms in some countries to: broaden acceptable collateral to receivables and intangible property; increase coverage of credit registries and bureaux; improve the design of credit guarantee schemes; and strengthen capacities of smaller financial institutions and micro-credit facilities to lend to the smallest SMEs.

Macroeconomic stabilisation frameworks have been strengthened but will need greater flexibility

Frameworks to maintain macroeconomic and financial stability will be critical to avoid the prolonged setbacks to growth that can prevent countries from developing beyond the middle-income trap. The middle-income Emerging Asian countries have made considerable progress since 1997 in improving their monetary policy frameworks for price stabilisation and in dealing with growth shocks. Indonesia, the Philippines and Thailand have adopted explicit inflation-targeting frameworks, while the more eclectic frameworks of India, Malaysia and China have been considerably refined. Monetary policies are now implemented mostly through indirect instruments, such as central bank lending rates and reserve requirements that influence the economy through market signals rather than direct controls. Central banks in the region have made considerable efforts to improve the transparency of their policies through periodic reports, press statements and other means.

There has also been impressive progress in broadening stabilisation frameworks to include macroprudential capabilities. Middle-income Emerging Asia macroprudential frameworks now include the basic elements that have emerged (and are still being developed) as international "best practices". Responsibility for monitoring macro-prudential risks has been explicitly assigned – in most instances – to the central bank or the unified financial regulatory authority (where it exists). The responsible authorities carry out periodic macroprudential assessments, including simulations (or "stress tests") of the effects of potential shocks to the financial system and economy. Instruments to address macro-prudential risks are more limited than in advanced economies, but they are developing.

"Factory Asia" will remain important but its character will need to change

The development of middle-income ASEAN countries and China has been characterised by a high reliance on exports of manufactured goods to advanced economies whose production is distributed across regionally based global value chains ("Factory Asia"). Participation in global value chains and the contribution of manufacturing to GDP is generally higher in middle-income ASEAN countries and China than in comparably developed countries in other regions.

The participation of most middle-income Emerging Asia economies in global value chains is still largely limited to assembly and other less sophisticated, lower-productivity stages. Malaysia participates at somewhat more advanced stages and China has also made some progress in moving into higher value-added activities. The participation in lower-productivity stages may be partly responsible for the somewhat mixed productivity performances in the region since the mid-1990s. While China has sustained impressive growth in both labour and total factor productivity, productivity increases have been rather modest to lacklustre in the middle-income ASEAN countries and India.

A number of external forces, along with structural changes in the region, are likely to change the future role and character of Factory Asia. Somewhat slower growth than in the past, difficulties in managing distant supply chains arising from exchange rate fluctuations and natural disaster risks, and rapidly rising wages in China and most ASEAN countries may curb the growth in demand from advanced economies for manufacturing exports. However, that trend is likely to be at least partly offset by the rapid growth in incomes in Emerging Asia, its rising share of world consumption, and growing economic integration among Asian countries. As a result, Factory Asia is likely to remain of major importance in world manufacturing and a major contributor to regional GDP and economic growth. It will, however, probably evolve towards greater emphasis on supplying regional markets.

To fully realise the benefits of these changes, the middle-income ASEAN countries, China and India will all need over time to foster the progressive transformation of their manufacturing industries towards more sophisticated and demanding activities with higher productivity and greater dependence on technology. Individual countries face specific challenges that differ according to their stage of development and intrinsic comparative advantages. For example, Malaysia and the Philippines need to develop a more diversified, higher-productivity manufacturing base. Thailand and China will need to manage the gradual erosion of their competitiveness in labour-intensive activities which are shifting to lower-wage countries in Asia and other regions. Indonesia needs to build its infrastructure and other capacities in order to exploit its natural resources and assets and supply regional markets. Although Viet Nam is likely to remain competitive in labour-intensive production for a longer period than the other middle-income countries, it will need to diversify its export markets as it gradually moves into higher value-added segments of the global value chain.

Emerging Asian countries must further develop their service industries to become advanced economies

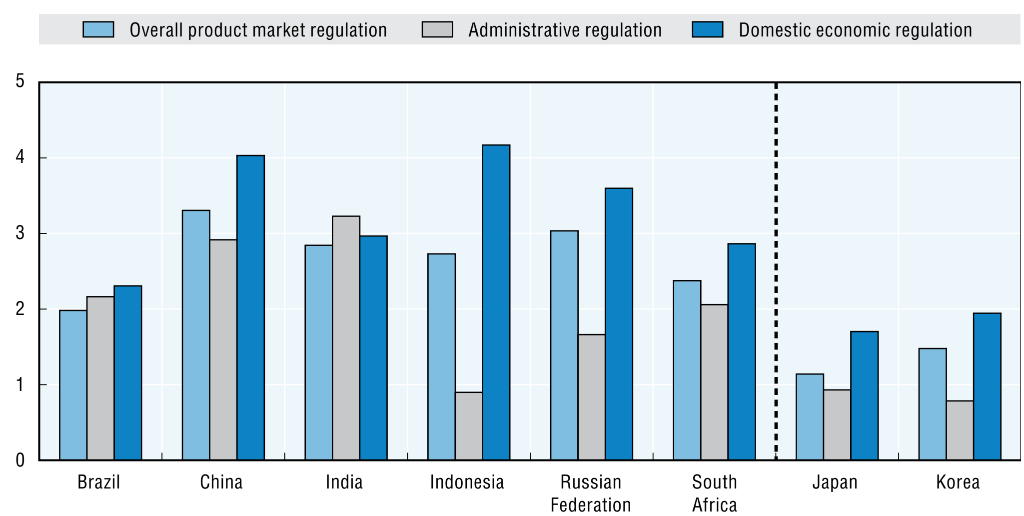
While the manufacturing sector will continue to be important, further economic development of Emerging Asia is likely to depend increasingly on the services sector. Services already account for between 37% and 45% of GDP in the middle-income ASEAN countries and China, and between 30% and 60% of total employment. However, services sector development lags behind that of advanced economies and its share of GDP has fallen or remained largely unchanged in most middle-income ASEAN countries since the mid-1990s. Services are concentrated mainly in lower-productivity segments, such as the wholesale and retail trade. And – with the exception of Malaysia to some extent – sophisticated, high-productivity modern services such as finance, ICT and business services account for relatively small shares of GDP that are well below those in advanced economies.

Further development of the services sector, especially in modern services, will be critical to the success of efforts by middle-income ASEAN countries to become advanced economies. Services provide critical support to their participation in the global value chain, and modern services are essential to their ability to move up the value chain. Service sector development will also be important to the achievement of broader goals, such as reducing poverty and meeting the needs of the growing middle classes. The potential contributions of services to economic development have been further increased by technological changes and liberalisation of trade and investment that have greatly expanded the scope for international trade in services.

Regulatory barriers that limit entry, stifle competition and inhibit investment have been major obstacles to the development of services sectors in developing Asian countries. These barriers tend to be greater in services compared to manufacturing in most developing countries and more of an obstacle in emerging countries in Asia than in other regions (Figure 0.3). Domestic regulatory barriers are reinforced by restrictions on cross-border trade and investment in services. Reducing and, where possible, removing regulatory barriers is essential if services are to provide the support needed to further advance the region's economies.

Figure 0.3. **OECD Product Market Regulation (PMR) Indicators in BRIICS, Japan and Korea, in 2008**

Index scale of 0-6 from least to most restrictive



Source: OECD, *PMR Database*.

Note: The indicators are based on qualitative information that is coded by assigning a numerical value to each of the possible responses to a given question. The coded information is normalised over a scale of 0 (=least restrictive) to 6 (=most restrictive), reflecting increasing restrictiveness of regulatory provisions for competition.

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Regional co-operation and integration will reinforce national development efforts

Since the early 1990s, Emerging Asian countries have been engaged in a range of regional initiatives to promote co-operation and greater integration. These initiatives have included various agreements for trade liberalisation among ASEAN countries and with regional partners, beginning with the ASEAN Free Trade Agreement in 1992 and followed by numerous multilateral and bilateral agreements. Later initiatives have included the creation of frameworks for relaxing barriers to cross-border investment and forums for discussing such wide-ranging regional economic issues as monetary and prudential policies, financial integration and cross-border infrastructure.

The various initiatives include programmes for: the development of Asian bond markets (the Asian Bond Markets Initiative), currency swap arrangements among ASEAN+3 countries and frameworks for the integration of services. More recently, such efforts within the ASEAN region have been harmonised with the target of the ASEAN Economic Community, which aims to establish the free flow of goods, services and investments, and a freer flow of capital by 2020.

These regional initiatives have great potential for reinforcing national development initiatives and so increasing the prospects for Emerging Asia in becoming high-income advanced economies.

- Regional integration will enable more efficient division of labour and allocation of resources in the region. The potential for improving the efficiency and competitiveness of service sectors through these initiatives is particularly high.
- Regional integration can help to make up for the constraints arising from the limited scale afforded by domestic markets alone – by allowing bond markets to evolve towards a more optimal size, for example.
- Regional co-operation and integration will help to facilitate capital account liberalisation and increase exchange rate flexibility by internalising the externalities associated with liberalisation and by improving the management of their consequences.
- The regional initiatives provide incentives for national liberalisation efforts. For example, the prospect of cross-border competition in banking is already spurring banks and their supervisors in individual countries to greater efforts to improve their efficiency and competitiveness.

Note

1. There are various definitions and reasons behind the "middle-income trap" and it is still a debated issue. While the World Bank's criterion provides a general rule of thumb in terms of defining the income range of middle-income economies, the crux of definition of middle-income trap is much deeper. In this *Outlook*, we define this as a structural transformation phenomenon where economies require a range of structural reforms in the process of changing from a model of "intrinsic" growth based mainly on factor accumulation to a model of "extrinsic" or productivity-led growth driven by improvements in the quality of human and physical capital and in the organisation of production and related business activities. This transformation is usually needed in economies that are categorised in the middle-income group.

CHAPTER ONE

Medium-term economic outlook for Emerging Asia: Prospects and assessments

Abstract

The economic outlook in Emerging Asia (Southeast Asia, China and India) remains robust over the medium term, anchored by the steady rise in domestic demand. In particular, real GDP growth in the Southeast Asian region will remain robust in the medium term, growing at a pace which is comparable to the pre-global financial crisis period. Growth in domestic demand, particularly private consumption and investment, will be the main driver of growth in most countries. Current account surpluses will remain relatively stable as shares of GDP in the region. Growth will be less reliant on net exports than in the past. In the near term, while downside risks to growth remain, particularly from financial volatility and capital flows, Emerging Asian economies will weather this as underlying fundamentals are resilient.

Nevertheless, Emerging Asian economies face important policy challenges in realising their medium-term growth potential. Capital mobility is a key component of international finance and the management of risks arising from fluctuating capital inflows will continue to be a key challenge. The scope for using capital controls to deal with surge in capital inflow will become even more limited as Emerging Asian countries further liberalise their capital accounts. More importantly, implementation of structural policy reforms in areas such as financial and product market regulation will be the key to maximising the long-term benefits of capital flows and minimising their associated risks. In addition, to sustain robust real economic growth in the region, structural policy changes will be needed to narrow development gaps and enhance regional integration. These regional integration efforts have reached a critical stage and their expected progress over the next several years is a positive factor in the favourable medium-term outlook for Emerging Asia.

Introduction

Emerging Asian economies continued to face headwinds during 2013 from sluggish growth in the global economy and turbulence in financial markets arising from the uncertainties surrounding the future monetary policies in major OECD countries. In the near term, economic growth is expected to improve gradually as domestic demand will continue to provide growth support, alongside gradual recovery in external demand. However, downside risks to growth and financial stability remain as there are signs that the surge in capital inflows into the region driven by international investors' search for higher yields is beginning to reverse in response to an expected onset of the tapering of quantitative easing in the United States possibly in the latter part of 2013.

Economic growth prospects over the medium term nevertheless remain favourable. Real GDP growth in Emerging Asia should recover gradually from the slowdown in 2013 to achieve robust growth over 2014-18. In some cases, notably that of China, growth will be slower than during the years prior to the global financial crisis. On balance, growth in the medium term will be driven more by domestic demand, particularly private consumption. Exports growth is projected to be slower than in the past and the regional current account surplus should narrow appreciably in relation to GDP. Inflation rates are projected to remain low, or to fall in those cases where they are presently high, and fiscal deficits should decline, leading to stable or falling debt to GDP ratios.

The management of risks arising from fluctuating capital inflows will be a key challenge in the medium term. The scope for using capital controls to deal with surge in capital inflow – whose effectiveness is in any case limited in magnitude and duration – will become even more limited as Emerging Asian countries further liberalise their capital accounts. In the near and medium term, macro-prudential measures will be key instruments for containing the financial risks from large movements in capital flows.

More importantly, over the longer term, structural reforms will be the key to improve the benefits of capital flows and minimising their associated risks. Structural policy changes will be needed to sustain robust real economic growth. The various projects for economic integration in the Emerging Asian region promise to considerably reinforce and boost the efforts of individual countries to achieve their development goals. These regional integration efforts have reached a critical stage and their expected progress over the next several years is a positive factor in the favourable medium-term outlook for Emerging Asia.

Overview and main findings: The economic outlook for 2014-18

Real GDP growth in emerging Asian economies (Southeast Asia as well as China and India) should improve gradually and remain robust over the 2014-18 period, according to the results of the OECD Development Centre's Medium Term Projection Framework for this Outlook (MPF-2014, see www.oecd.org/dev/asiapacific/mpf and Box 1.2 for more details). Growth in the Southeast Asian region is projected to average a robust rate of 5.4% per annum between 2014-18, comparable to the pre-global financial crisis period during 2000-07 (Table 1.1).

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

	2012	2018	2014-18	2000-07
ASEAN-6 countries				
Brunei Darussalam	1.0	2.4	2.3	-
Indonesia	6.2	6.1	6.0	5.1
Malaysia	5.6	5.3	5.1	5.5
Philippines	6.8	5.9	5.8	4.9
Singapore	1.3	3.1	3.3	6.4
Thailand	6.5	5.3	4.9	5.1
CLMV countries				
Cambodia	7.2	7.1	6.8	9.6
Lao PDR	7.9	7.5	7.7	6.8
Myanmar	-	7.0	6.8	-
Viet Nam	5.2	6.0	5.4	7.6
Average of ASEAN 10	5.5(*)	5.6	5.4	5.5(**)
2 large economies in Emerging Asia				
China	7.7	7.5	7.7	10.5
India	3.7	6.1	5.9	7.1
Average of Emerging Asia	6.4	6.9	6.9	8.6

Notes: The cut-off date for data is 6 September 2013. Emerging Asia includes ASEAN 10 countries plus China and *India*. *) Excludes Myanmar; **) Excludes Brunei Darussalam and Myanmar.

Source: OECD Development Centre, MPF-2014. For more detailed information of, MPF, see www.oecd.org/dev/asiapacific/mpf. Emerging Asia includes ASEAN-10 countries, China and India.

Within the Southeast Asian economies, the growth projection for individual countries reflects their different stages of development and medium-term growth drivers. Indonesia is projected to be the fastest growing economy in the ASEAN-6 countries, followed by the Philippines, with average annual growth rates of 6.0% and 5.8% respectively over 2014-18. Notably, the projected medium-term growth rates in these two countries are considerably stronger than their average growth prior to the global financial crisis. The strong medium-term outlook for Indonesia and the Philippines will be underpinned by robust growth in domestic demand, as well as strong infrastructure spending and implementation of structural economic reforms.

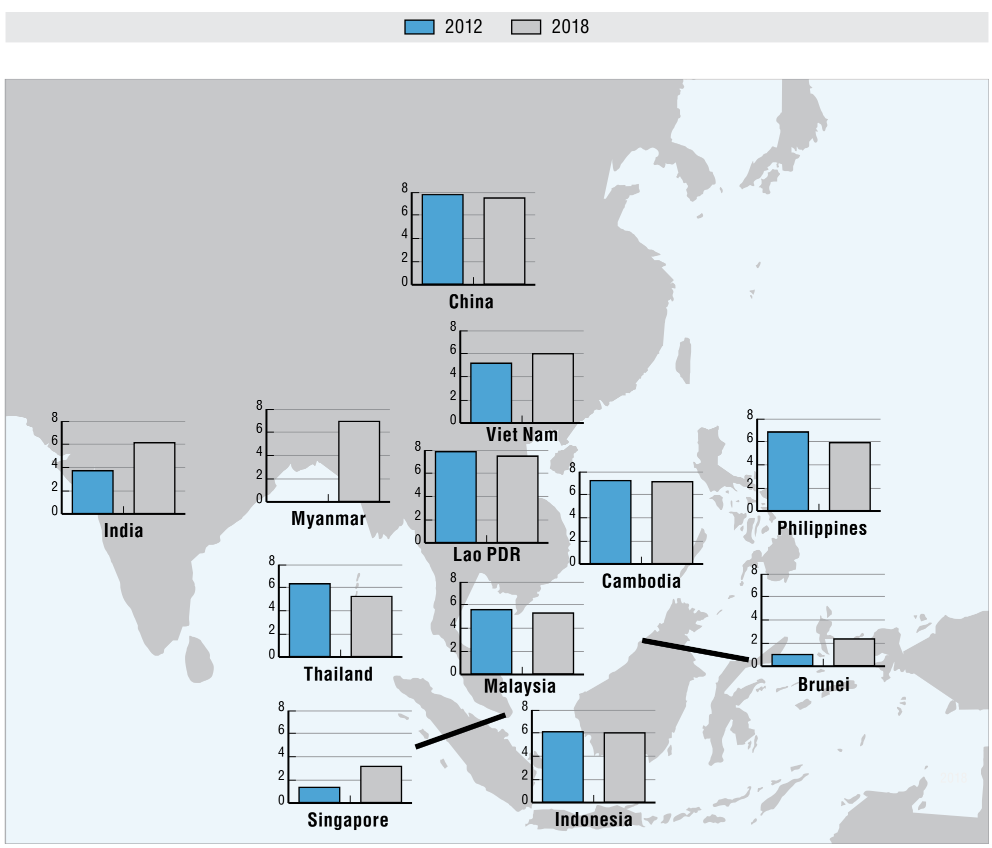
Real GDP in Malaysia and Thailand is projected to grow by 5.1% and 4.9% per annum respectively over the period 2014-18, led by stronger growth in domestic demand especially in infrastructure investment and private consumption. While the projected growth rates for Malaysia and Thailand compare favourably to the growth for other developing countries at a similar stage of economic development, stronger productivity growth is needed for Malaysia and Thailand to sustain long-term growth beyond the "middle-income trap". For Singapore, the economy is projected to grow by 3.3% over the period 2014-18, reflecting its more advanced stage of economic development and the economy's shift towards more sustainable and inclusive growth, led by productivity growth and innovation.

The CLMV countries (i.e. Cambodia, Lao PDR, Myanmar and Viet Nam) are projected to grow at a robust pace over the medium term, led by Laos at 7.7% per annum. Real GDP growth in Cambodia and Myanmar is projected to average close to 7% growth per annum during 2014-18, underscoring its significant improvement in investment appeal as the country opens up to foreign investment. For Viet Nam, while real GDP growth is projected to remain healthy at 5.4% over the medium term, growth will be slower than prior to the global financial crisis owing to slower external demand from advanced economies. Weak macroeconomic management policies could pose downside risks to growth.

As a whole, Emerging Asian countries are expected to grow by a healthy rate of 6.9% by 2018, somewhat slower than the 8.6% registered before the global financial crisis (Figure 1.1). This slower growth largely reflects the moderated pace of expansion in the two large Emerging Asian economies of China and India. Notably for China, real GDP growth is expected to moderate to 7.5% by 2018 (compared to 10.5% during 2000-07) as the country rebalances its growth model towards consumption-driven growth. Implementation of structural reforms will be a crucial factor to steer the Chinese economy towards sustainable development and to allow it to move into a higher income bracket. Similarly, India's growth is projected to moderate to 6.1% by 2018, compared to 7.1% during 2000-07.

Figure 1.1. **GDP growth in Southeast Asia, China and India: Comparison between 2012 and 2018**

Annual percentage change



Note: 2012 data for Myanmar are not included.
Source: OECD Development Centre, MPF-2014. The cut-off date for data is 6 September 2013.
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The other main results of the MPF-2014, which are discussed in detail in the remainder of this chapter, are as follows.

- While real GDP growth in Emerging Asia will moderate gradually, it remains robust over the 2014-18 period.
- Domestic demand, particularly private consumption and investment, will be the main driver of growth in most cases. Most ASEAN-6 countries remain in current account surplus, while CLMV countries will remain in deficit in the medium term.
- Fiscal deficits will narrow in most countries, leading to stable or lower public debt to GDP ratios.
- Countries will face key macroeconomic policy challenges over the medium term from fluctuations in capital flows.

Recent macroeconomic developments and near-term prospects

Amidst external headwinds, growth momentum in Emerging Asian economies eased in the first half of 2013. In the near term, while domestic demand will continue to provide growth support, alongside gradual recovery in external demand, Emerging Asia will face a challenging macro environment. These include downside risks to growth and financial stability arising from a prospective reversal of capital inflows. Nevertheless, the underlying resilience in macroeconomic fundamentals remains intact, but policy makers in Emerging Asia will need to stay focused on implementing structural reforms to ensure sustainable economic growth over the medium term while dealing with near-term challenges.

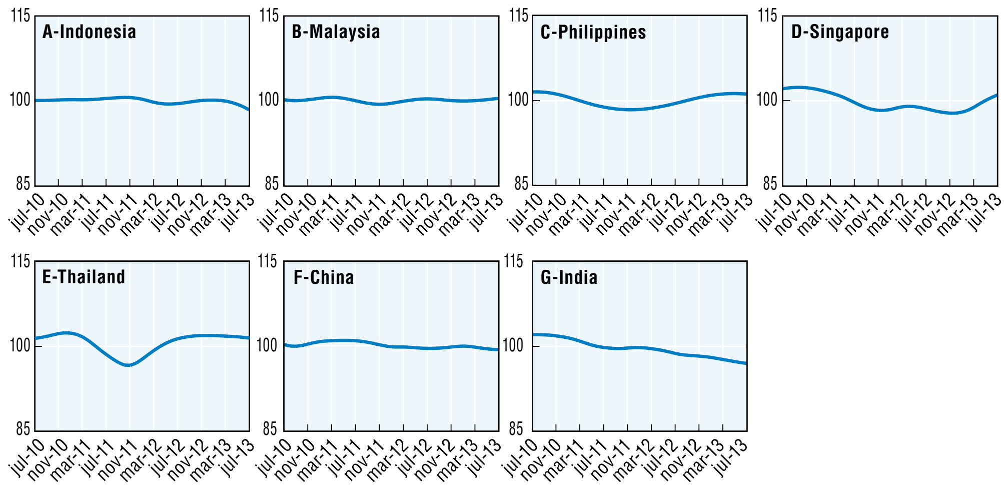
Weakness in external demand continued to weigh on economic growth in Emerging Asia

The global economy continued to experience tepid growth in the first half of 2013. In the advanced economies, US GDP growth was moderate, while economic activity remains weak in the euro area. Persistent external headwinds have weighed on growth in emerging Asia. In China, real GDP growth slowed to 7.5% on a year-on-year basis in the second quarter of 2013, down from 7.7% in the first quarter and 7.9% in the fourth quarter of 2012. While the pace of China's economic growth has slowed, the risk of a hard landing remains low given the stable growth in domestic demand. India's economy has slowed even more, as growth eased to 4.4% year-on-year in the second quarter of 2013, its slowest pace in four years, partly owing to weak external demand that slowed export growth.

The slowdown in China coupled with tepid growth in the advanced economies have weakened the growth momentum of Southeast Asian economies, given that they are becoming more dependent on China as a key trading partner. In particular, Thailand, Southeast Asia's second-biggest economy, entered a technical recession for the first time since the global financial crisis, as real GDP contracted by 0.3% on a seasonally adjusted basis in the second quarter of 2013, following a revised 1.7% decline in the first quarter. Indonesia's real GDP growth slowed to 5.8% on a year-on-year basis in the second quarter of 2013, the first time that growth has dropped below 6.0% since the third quarter of 2010. In Malaysia and Viet Nam, while real GDP improved slightly in the second quarter of 2013, underlying growth momentum was subdued. On the other hand, Singapore's GDP grew at an accelerated pace of 3.8% year-on-year in the second quarter of 2013, up from 0.2% in the previous quarter, on the back of improvements in trade-related sectors as well as resilence in domestic-oriented sectors. The Philippines economy was the strongest performer, growing by 7.5% in the second quarter and matching the pace of growth recorded in China, largely thanks to its strong domestic demand.

Figure 1.2. **Business Cycle Composite Leading Indicators**

100=threshold between expansion and contraction



Note: see www.oecd.org/dev/asiapacific/abcis for more detailed information.

Source: OECD (2013a), *This Quarter in Asia*, Vol.12 (Asian Business Cycle Indicators) and OECD Composite Leading Indicators.

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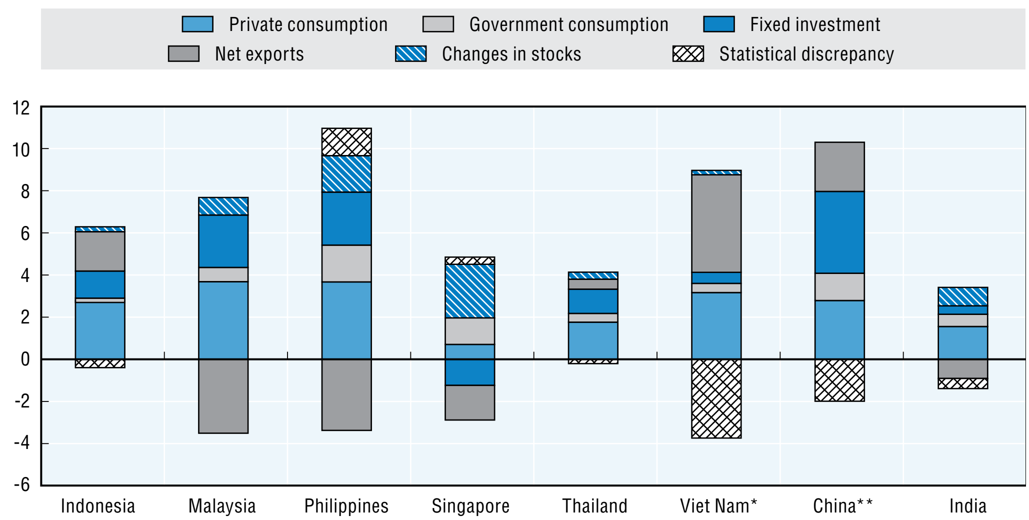
Nevertheless, external demand should pick up as the global economy improves gradually in the near term. The latest OECD Development Centre's Asian Business Cycle Indicators (ABCIs) suggest that although growth outlook is mixed across Emerging Asia, there are signs of growth stabilisation for China and a more positive outlook for the Philippines and Singapore (OECD, 2013a). However, the growth prospects for India are still weak (Figure 1.2).

While growth in domestic demand has moderated, it remains a key pillar of growth

Despite some moderation in its growth, domestic demand has remained resilient and a key pillar of growth in most Emerging Asian economies. In Indonesia and Malaysia, private consumption growth moderated slightly to 5.1% and 7.2% respectively in the second quarter of 2013, while Thailand's private consumption eased sharply to 2.4%, down from 4.4% in the first quarter. In contrast, private consumption growth accelerated in the Philippines in the second quarter of 2013 partly owing to buoyant foreign remittance inflows. Overall, private consumption continued to be a key pillar of growth, accounting for more than half of the overall real GDP growth in half of 2013 in India, Malaysia and Viet Nam and more than a third of the growth for the China, Indonesia, Philippines, Singapore and Thailand (Figure 1.3).

Figure 1.3. **Contributions to growth in Emerging Asia in the first half of 2013**

Percentage of GDP



Note: * Data for China and Viet Nam refer to 2012. ** Data for China refer to 2012, ADB estimates.

Source: CEIC.

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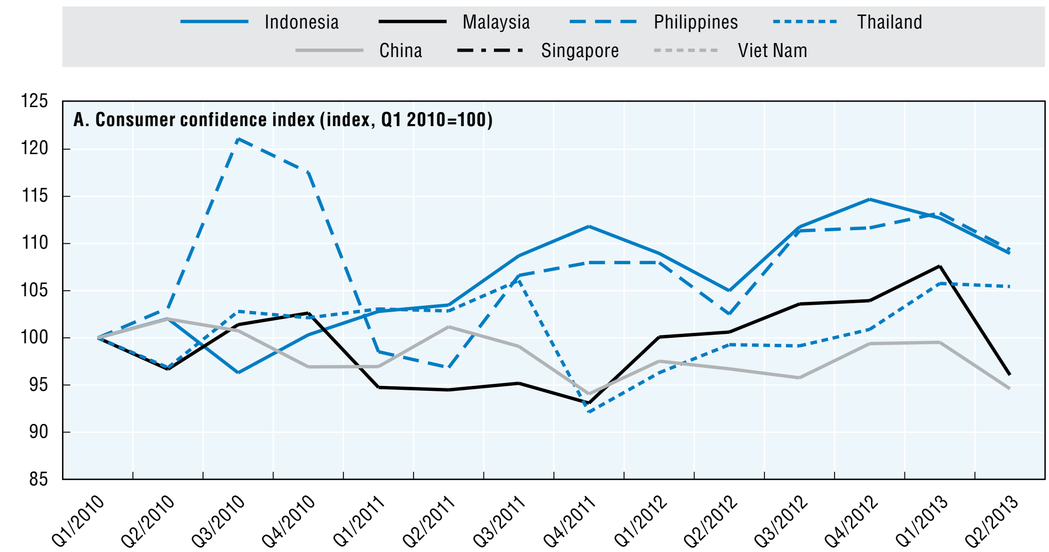
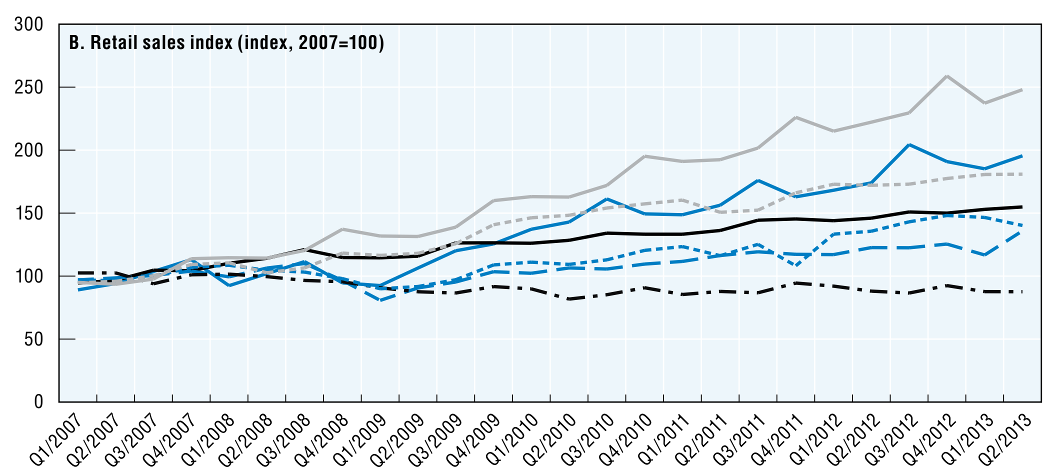
Growth in retail sales is holding up across most countries in Emerging Asia, as consumer confidence remains broadly stable. Supported by rising disposable income, retail sales of consumer goods in China and Philippines remained buoyant. By contrast, retail sales in Thailand declined in the second quarter of 2013 and are expected to remain soft in the near term as consumer confidence has weakened amidst economic concerns. The consumer confidence index showed some stabilisation in July (Figure 1.4).

Figure 1.4. **Private consumption indicators**



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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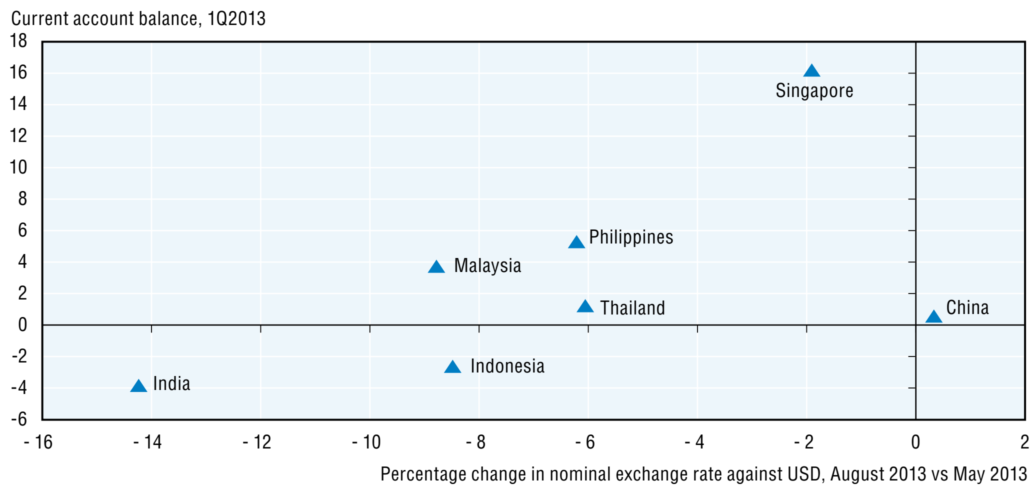
Financial market volatility and capital outflows have increased downside risks in the near term

The key near-term downside risk facing Emerging Asia is volatility in the financial markets. The rise in global bond yields since May 2013, triggered by the prospects of a tapering of quantitative easing (QE) in the US, resulted in significant regional financial market turbulence during the June-August period, along with higher financing costs, capital outflows and sharp currency depreciations. Emerging Asian economies with large current account deficits and comparative vulnerability to capital outflows, such as India and Indonesia, bore the brunt of the financial turmoil (Figure 1.5). Moreover, fears of contagion risks rose with the sell-off in equities and spikes in sovereign bond spreads and credit default swap rates during the period May-August across Emerging Asia (Figure 1.6 and 1.7).[1]

Figure 1.5. **Current account balances and changes in nominal exchange rates**



Source: OECD Development Centre calculation based on national sources.

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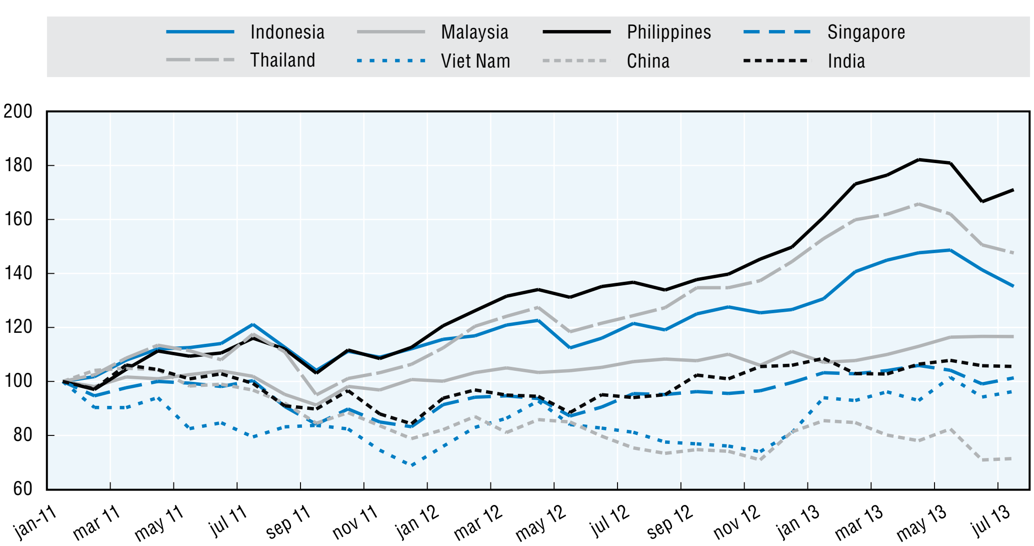
Figure 1.6. **Stock indices in Emerging Asia**

Index, January 2011=100



Source: CEIC.

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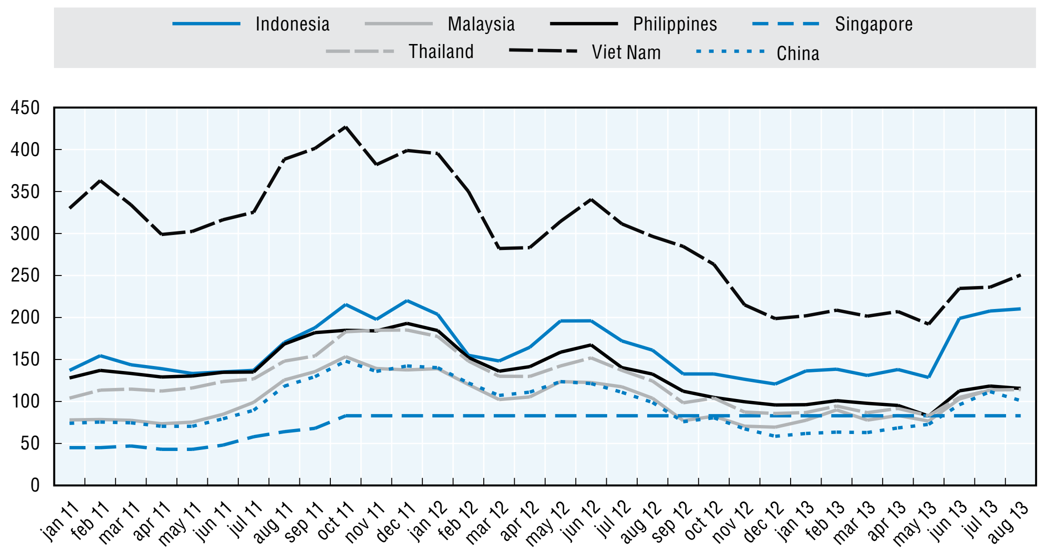
Figure 1.7. **Credit default swap premiums in Emerging Asia**

Premium mid spread



Source: Datastream.

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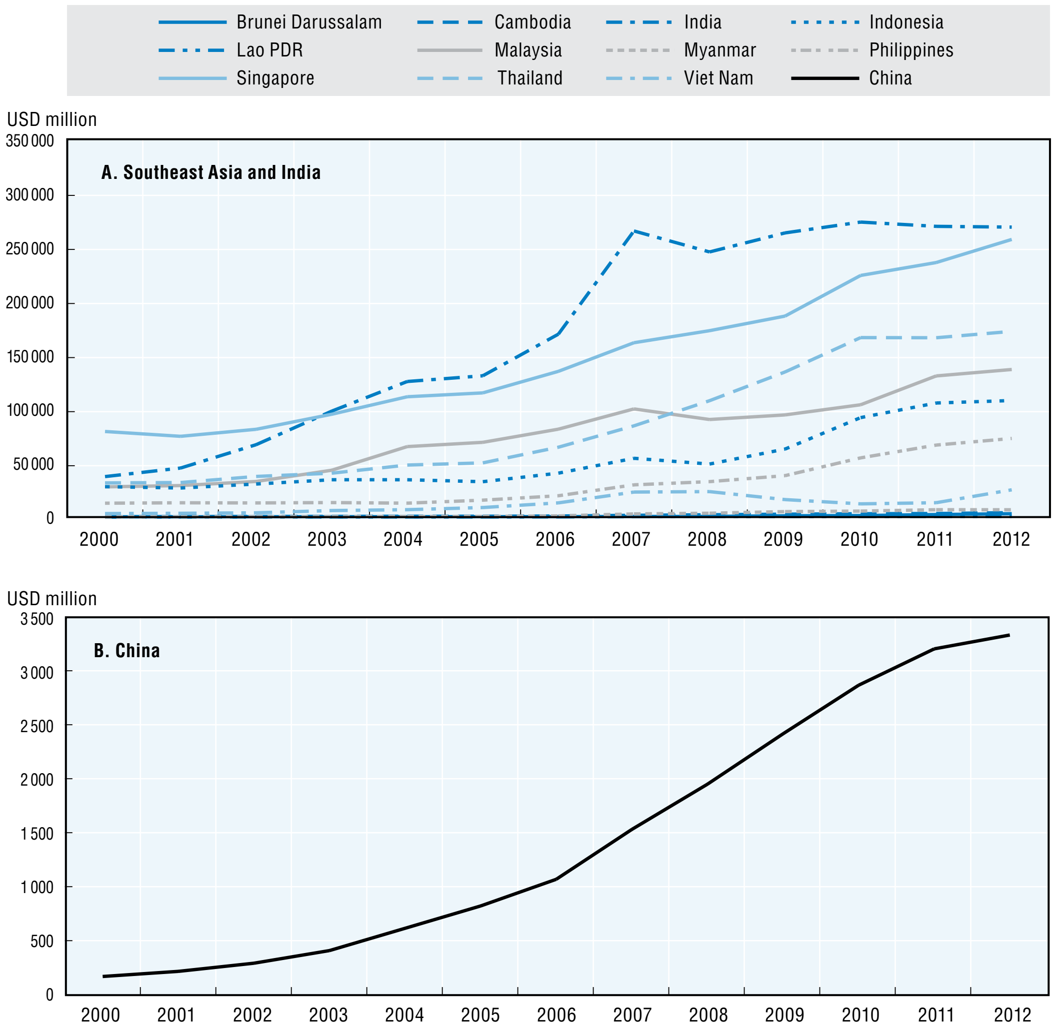
Emerging Asia should weather the turbulence, as underlying macroeconomic fundamentals remain intact

The financial turbulence buffeting Emerging Asia has heightened fears of contagion risks with concerns of impending economic crisis in the region, drawing parallels to past crises episodes such as the Asian Financial Crisis (AFC) of 1997-98 and India's balance of payment crisis in 1991. Indeed, there are some signs of macroeconomic weaknesses, particularly in India and Indonesia, where persistent current account deficits warrant concerns. Nevertheless, the overall macroeconomic fundamentals in Emerging Asia are broadly favourable and should enable the region to weather the turbulence.

International reserves across Emerging Asia economies have generally increased since 2000, which will help to provide a buffer against external shocks[2] (Figure 1.8). More importantly, unlike the fixed exchange rate regimes and currency overvaluation which led to the AFC, the greater flexibility of exchange rates currently has reduced the risk of substantial currency misalignment and the need for central banks in Emerging Asia to use reserves to defend their currencies.[3]

Figure 1.8. **International reserves position**



Note: UNCTAD estimate for LAO PDR 2012.

Source: International Financial Statistics (IFS).

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Growth stabilisation in China and recovery in advanced economies will help to bolster regional current account balances

To some extent, the prolonged weakness in external demand has weighed on the current account balance positions in Emerging Asia. In particular, given the increasing importance of China as a key trading partner, the slowdown in the Chinese economy has weighed on the export performance of Emerging Asian economies

However, incoming indicators suggest signs of growth stabilisation in the near term and have allayed concerns of an imminent hard-landing in China. Industrial production picked up to 10.4% year-on-year in August 2013, the fastest pace of growth in 17 months. Industry profits rebounded in July 2013 as net income rose 12% on a year-on-year basis after gaining 6.3% in the previous month, exports grew by 5.1% on a year-on-year basis in July 2013, while imports gained 10.9%, after contracting by 3.1% and 0.7%, respectively, in June. The official Purchasing Managers' Index (PMI) figure, published by China's National Bureau of Statistics, rose to 51.0 in August 2013 from 50.3 in July, the highest level since April 2012. This coincided with continued improvement in China's manufacturing PMI. Recent fine-tuning of government policy has begun to feed into improvement in domestic demand conditions and economic activities are likely to pick up in the near term. However the degree to which growth is becoming more balanced is not yet clear and the government is likely to focus on structural reforms to rebalance the economy (Box 1.1).

Box 1.1. **Structural slowdown in China**

China has been experiencing a growth slowdown, which saw its GDP growth moderating from 10.6% in 2010 to 7.8% last year and 7.6% in the first half of 2013. For the whole of 2013, the government's official growth target at 7.5% would represent the slowest pace of growth since 1990. While growth appears to have stabilised, the government is unlikely to use massive fiscal stimulus policies in the short term.

Indeed, China will not make any major changes in its short-term macroeconomic policies and will make greater efforts to press ahead with structural reforms and rebalance its economy, driven by consumption and more inclusive growth. At the conclusion of a meeting of the State Council (China's cabinet) In July 2013, Premier Li Keqiang announced three measures to support growth: *i)* a waiver of value-added and business taxes for select small and medium-sized enterprises (SMEs) (those with monthly sales below RMB 20 thousand (Chinese renminbi), or about USD 3.3 thousand) effective from 1 August; *ii)* support for exports through simplification of customs procedures, cuts in export taxes and fees, and maintenance of exchange rate stability; and *iii)* promotion of public-private partnerships to invest in railway and city subway systems. Separately, the State Agency for Foreign Exchange (SAFE) announced a simplification of administrative procedures for settlement of trade in services.

These measures are the latest sign of the government's shift toward growth-supportive measures to achieve the 7.5% growth target for this year. Notably, the measures aim to improve efficiency, while avoiding large-scale stimulus spending given the limited scope for such measures and the continued focus on curtailing domestic financial excesses. Indeed, one of the policy priorities stated in the 12th Five Year Plan is to improve the provision of basic public services and deepening fiscal reform through improvements to transfer payments, budget management and tax systems. As will be discussed in Chapter 2 Structural Policy Country Notes, while China has made progress in these areas, it can do more to streamline administrative efficiency and accelerate budgetary reform.

In addition, the incipient economic recovery in the advanced economies will also provide support to exports from Emerging Asian economies. The US economy expanded at a 2.5% annualised rate in the second quarter of 2013, up from 1.1% in the preceding quarter. The euro area exited its worst recession on record, with euro area GDP growing by 0.3% in the second quarter of 2013. In Japan, the economy expanded for the third consecutive quarter, with GDP growing at an annualised rate of 2.6% in the second quarter of 2012. Moreover, Japan's consumer price index increased at the fastest pace since 2008 in July 2013, adding to signs that "Abenonomics" is making progress in pulling the economy out of 15 years of deflation. Indeed, the OECD Composite Leading Indicators (CLI) point to economic growth outlook firming in the US and to growth above trend in Japan. In the euro area as a whole, the CLI continues to indicate a gain in growth momentum.[4]

Capital outflows and currency depreciation pose macroeconomic management dilemmas

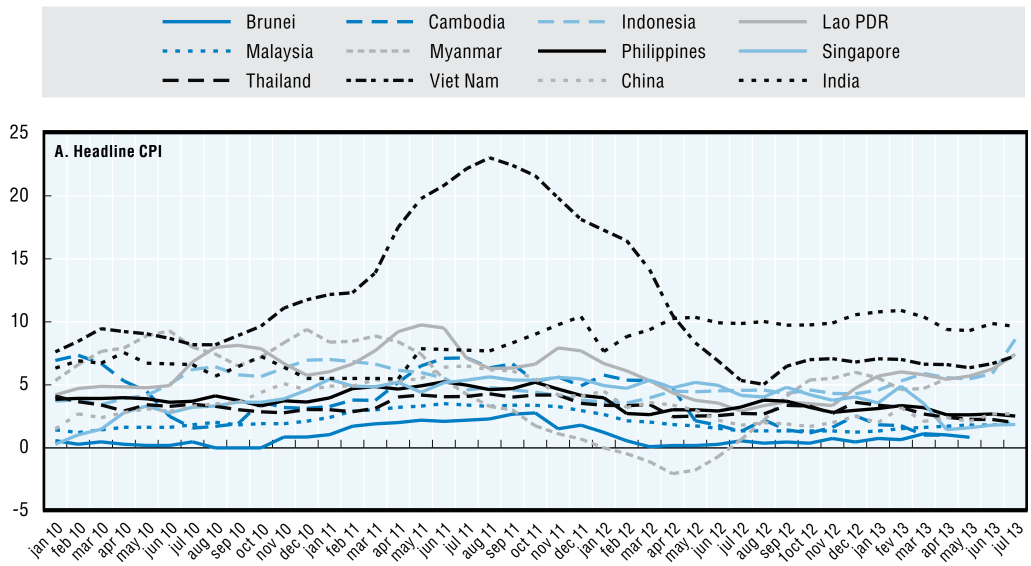
Inflationary pressures are generally modest across most countries in Emerging Asia. In Singapore, the year-on-year growth in the overall consumer price index (CPI) has been below 2% since April 2013, while CPI inflation for China, Malaysia, Thailand and Philippines is hovering around 2%. By contrast, the headline CPI inflation in India and Indonesia surged to 9.6% and 8.6% respectively in July 2013, following measures to reduce fuel subsidies in a bid to narrow their current account deficits (Figure 1.9). However, core CPI inflation in India and Indonesia is lower, at 7.7% and 4.4% respectively.

While monetary policy ideally should remain accommodative given the modest inflationary pressures in most countries and the moderation of economic growth, capital outflows and currency depreciation will constrain policy options. Indeed, rapid currency depreciation can be destabilising to the economy and create inflation pressures. In addition, global oil prices will remain volatile should there be renewed tension in the Middle East. These external events have added to uncertainty about inflation and pose policy dilemmas in the region in the near term.

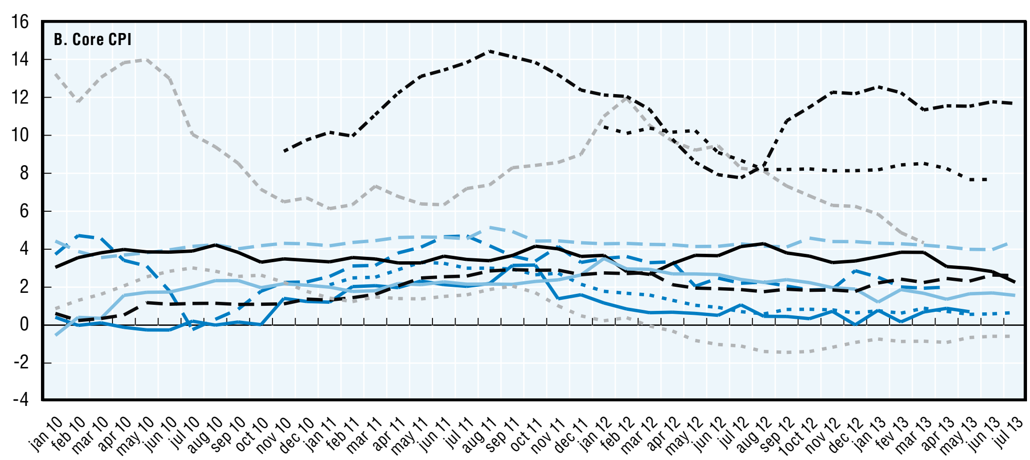
Against this backdrop, policy responses differ across countries in Emerging Asia. India and Indonesia, which are running large current account deficits and experiencing the greatest currency depreciation pressures, have tightened their monetary policies. The Reserve Bank of India (RBI) introduced measures in July to tighten liquidity in an effort to stem the rupee's decline.[5] Bank Indonesia raised its benchmark interest rate by half a percentage point to 7% in an unscheduled move on 29 August. It also raised the deposit facility rate by half a point to 5.25%. By contrast, other countries in the region have largely maintained their monetary policy stance (Figure 1.10).

Figure 1.9. **Consumer price inflation**

Year-on-year percentage change



Notes: For Cambodia data refer to inflation as registered in Phnom Penh.
Sources: CEIC and Datastream.



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 avergae 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.

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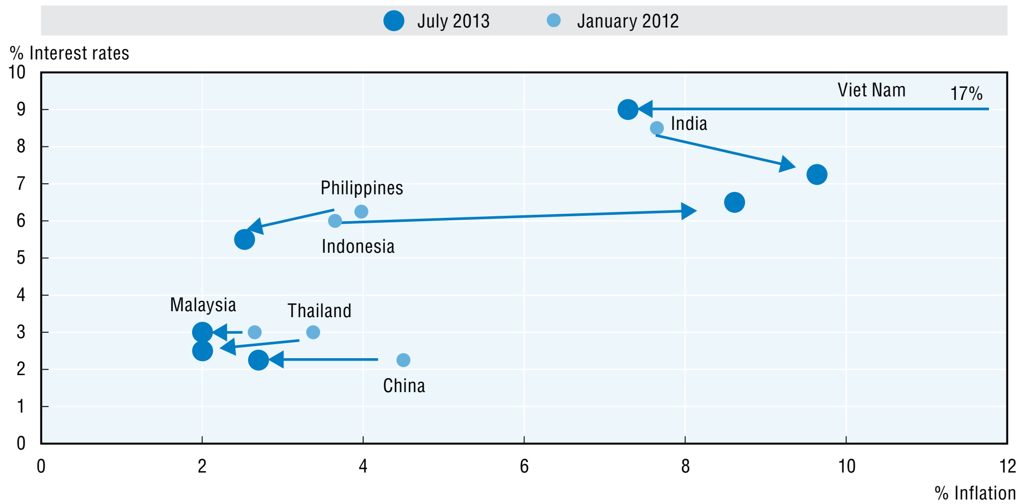
Figure 1.10. **Evolution of inflation and policy interest rates**

Annual percentage changes



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 July 2013 and January 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.

Sources: CEIC, Datastream and national sources.

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Macroeconomic management should focus on boosting medium-term growth prospects

Policy makers will face further policy conflicts in the event of a prolongation of capital outflows and/or currency depreciation pressures. Significant tightening of macroeconomic policies to stem currency depreciation will dampen economic growth. For Indonesia, although the moderation in GDP growth this year has been comparatively milder and private consumption remains robust, a sharp increase in interest rates could aggravate the weakness in investment, which has slowed for four consecutive quarters since the third quarter of 2012. India faces an even greater dilemma, as the authorities cannot afford to tighten macroeconomic policy significantly further given the already brittle economy.

Use of capital controls, such as those deployed by India in July 2013 to restrict the amount of investment which its citizens and companies can invest overseas, also poses risks. Imposition of such capital controls can damage the confidence of foreign investors and discourage foreign direct investment, which would be detrimental to medium-term growth prospects.

Hence, management of capital flows will continue to be of one the key medium-term policy challenges facing Emerging Asia. Indeed, as discussed later in this Chapter, it will be imperative for policy makers to step up efforts to implement structural reforms and to liberalise regulatory regimes to boost their medium-and long-term growth potential.

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

The results of the MPF-2014 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. The shift in the composition of growth will be accompanied by lower 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 in most cases, or fall back 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 (Box 1.2).

Box 1.2. **Key assumptions of the medium-term outlook until 2018**

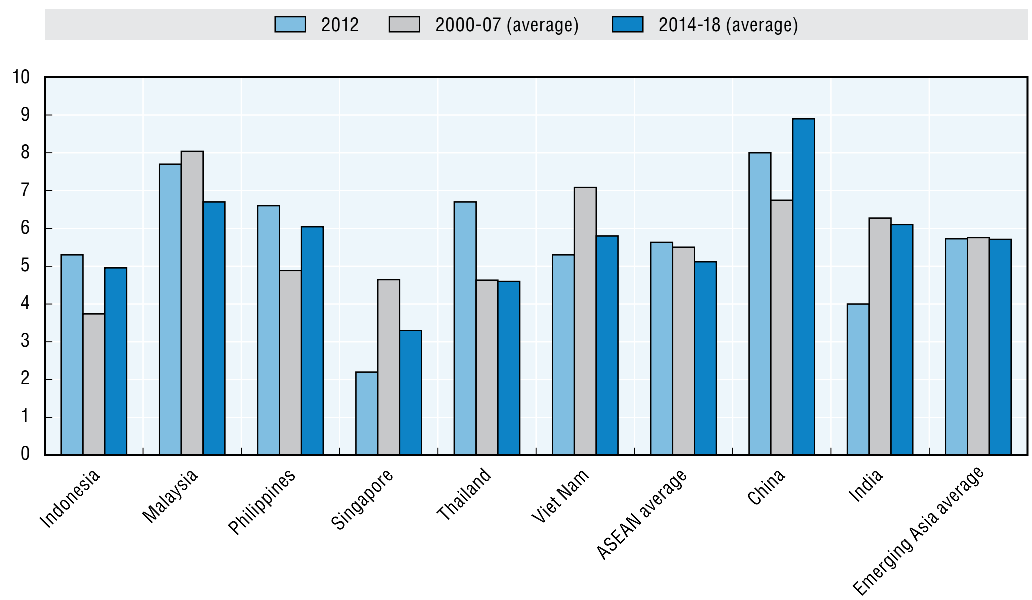
- Output gaps – the gap between actual and potential GDP – will converge to zero by 2018.
- Exchange rates of most Emerging Asian economies will gradually appreciate (against the USD) through 2018.
- Inflation-targeting countries will continue to pursue price stability and adjust monetary policies to support their target.
- Regional economic integration initiatives and projects remain on track.
- The various five-year plans of Emerging Asian countries will largely be implemented, where feasible, subject to budgetary and other policy considerations (see Chapter 2 Structural Country Notes for reference).
- The cut-off date of data for MPF-2014 is 6 September 2013. For more detailed information on MPF, see www.oecd.org/dev/asiapacific/mpf.

Private consumption will provide a key support for domestic demand

Growth of private consumption will continue to be robust and a key contributor to overall GDP growth over the medium term across most countries in Emerging Asia. China is projected to post the fastest growth in private consumption, at 8.9% annually over the period 2014-18, as the economy continues to rebalance its growth model towards consumption-driven growth. This growth is substantially faster than 6.7% per annum registered prior to the global financial crisis during 2000-07. Private consumption growth in India is also projected to be strong, averaging 6.3% during 2014-18, the same pace of growth as recorded prior to the global financial crisis (Figure 1.11).

Figure 1.11. **Private consumption of Southeast Asia, China and India**

Percentage change



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

Source: OECD Development Centre, MPF-2014.

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Within the Southeast Asian economies, private consumption growth is projected to remain buoyant at 5.1% per annum during 2014-18. Malaysia and the Philippines are projected to post the fastest rate of private consumption growth at 6.7% and 6.0% respectively, followed by Viet Nam at 5.8%. Elsewhere, private consumption growth will also remain robust in Indonesia and Thailand at 5.0% and 4.6% respectively during 2014-18. In particular, private consumption in Indonesia and the Philippines will grow at a faster clip compared to before the global financial crisis.

Labour markets in Emerging Asia are expected to remain relatively tight and this will help to continue to support growth in wages and private consumption. Macroeconomic policies have also helped to support private consumption growth by providing price stability over the medium term. Moreover, reinforcing structural factors are becoming important drivers of private consumption growth. Indeed, as noted in the 2013 edition of the *Outlook* (OECD, 2013b), the rise of the middle class, especially in China and India but also broadly across Southeast Asian countries, will help to boost spending on household durables and automobiles as well as education and health services.

More importantly, government policies will play an increasingly critical role in driving sustainable growth in private consumption over the medium term. The rise of the middle class will be intertwined with the continued shift of the industry structure in Emerging Asia towards services sectors. Recognising this, policy makers across Emerging Asia have taken steps to liberalise the services sectors, but there is still scope for further regulatory reforms.

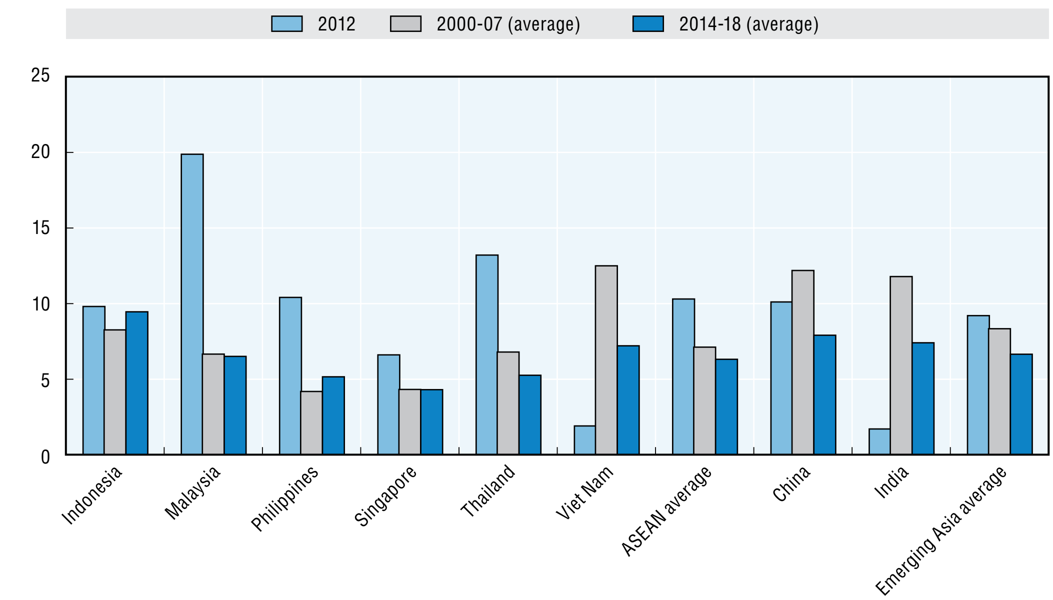
Fiscal reforms to enhance transfer payments, budget management, and tax systems can also help to support consumption. As noted in the Structural Policy Country Note in Chapter 2, the Chinese government has planned several fiscal reforms in the areas of tax, budget and transfer payments as a key priority area under the 12th Five Year Plan. Such fiscal reforms will help to make government more efficient in providing adequate public services. Government redirection of resources to social welfare programmes can increase late household consumption by reducing discretionary level of precautionary savings (HSBC, 2013). Similarly, across Southeast Asian countries, increasing government spending on health and social safety-net programmes will continue to encourage consumption spending by freeing up household resources and by reducing their need for precautionary saving (OECD, 2011).

Government policies to narrow income gaps and promote more inclusive growth can also help to support sustainable growth in private consumption. For example, in India consumption growth in rural areas has grown at a faster pace than in urban areas. Rural consumption has been underpinned by strong increases in rural incomes owing to rising non-farm employment opportunities and the government's focus on employment generation schemes such as the Mahatma Gandhi National Rural Employment Scheme. Cash payments and/or subsidies to poorer households have also been increased in the Philippines and Malaysia, while Singapore has increased its "in-work" income supplement for low wage workers as well as support for those who are unable to work. Private consumption in Malaysia and Thailand will also be supported by increases in wages of public workers and in statutory minimum wage rates for the private sector.

Investment growth will remain robust

Investment is projected to remain robust in Emerging Asia over the period 2014-18 at 6.6% per annum. In the Southeast Asian region, investment growth is projected to be healthy in the next five years at 6.3% per annum, with Indonesia and Philippines growing at faster pace compared to the pre-global financial crisis (Figure 1.12). However investment growth in China is projected to moderate during 2014-18, as structural policies and other factors favouring greater dependence on consumption take hold. Investment growth in India is also projected to be slower over 2014-18 than during 2000-07, partly reflecting government budgetary constraints and uncertainties over prospects for further reforms.

Figure 1.12. **Gross fixed capital formation of Southeast Asia, China and India**
Percentage change



Note: ASEAN average includes Indonesia, Malaysia, Philippines, Singapore, Thailand, Viet Nam. Emerging Asia average includes six countries of ASEAN, China and India.
Source: OECD Development Centre, MPF-2014.
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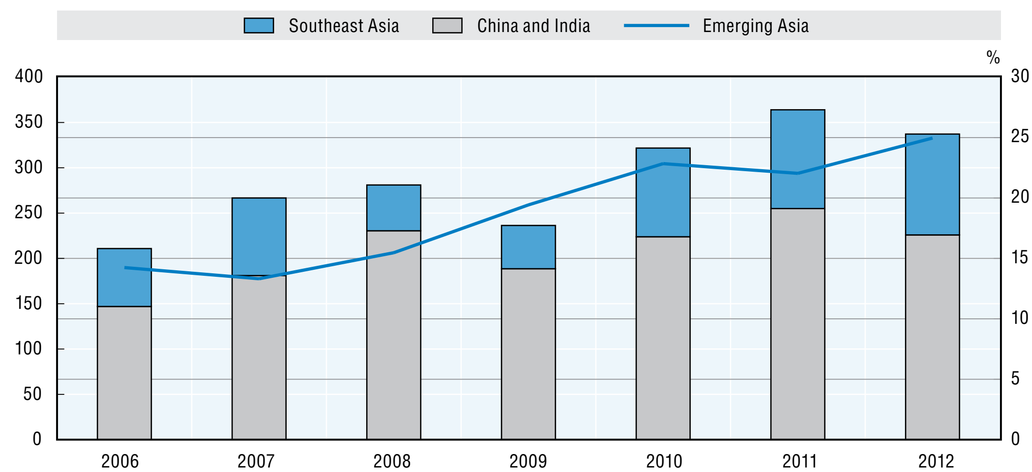
Government infrastructure spending continues to contribute considerably to overall investment growth across the Southeast Asia countries. In Indonesia, infrastructure remains a top priority under the Master Plan for Acceleration and Expansion of Indonesia's Economic Development (MP3EI), which calls for investment in infrastructure projects in six economic corridors.[6] In Malaysia, the government's Economic Transformation Programme (ETP) to develop higher value-added industries and infrastructure will continue to support infrastructure spending. Under the Philippine Development Plan, the government plan to increase infrastructure spending to around 5% of GDP by 2016, as it allocates more funds to build roads, railways, airports and bridges to support its goal of inclusive and sustainable growth.[7] Thailand is also aggressively pursuing infrastructure improvements, and has recently rolled out ambitious development plans to invest THB 5.5 trillion (Thai baht) (USD 179 billion) – 20% of Thailand's GDP – on new roads, rail networks and other projects over the next seven years (Credit Suisse, 2013).

More importantly, private investment will be the key to sustained growth in overall investment. Private-public partnership (PPP) programmes will play an increasingly critical role in infrastructure projects across the Emerging Asian economies. In Indonesia, 32 out of 79 infrastructure projects in the MP3EI are listed as PPP and this form of infrastructure programme will be increasingly prominent along the Economic Corridors of the MP3EI (Strategic Asia, 2012). Similarly, the Malaysian government has introduced several strategies to accelerate investment including enhancing private-public sector collaboration to increase the inflow of investments over the medium term. In the Philippines, the government has prioritised PPP projects, including the construction of medical, power, education and transport infrastructure, to complement the current construction projects in road and schools and provide support for growth in private investment (Standard Chartered, 2013).

The Emerging Asian region's resilient macroeconomic fundamentals are an important competitive advantage in attracting Foreign Direct Investment (FDI). Over the medium term, this competitive advantage will help to sustain strong FDI inflows into the region and to support growth in domestic investment. FDI inflows into Emerging Asia as a share of global FDI inflows have increased steadily in the past five years, from 13.3% in 2007 to 25.0% in 2012 (Figure 1.13). China and Singapore were the second and eighth largest FDI recipients globally in 2012, while India and Indonesia were also among the top 20. Driven by continued intra-regional restructuring in manufacturing, lower-income countries such as Cambodia, Myanmar, the Philippines and Viet Nam were attractive FDI locations for labour-intensive manufacturing (UNCTAD, 2013).

Figure 1.13. **FDI inflows in Emerging Asia**

USD billion



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

Source: UNCTAD (2013), *World Investment Report 2013 - Global Value Chains: Investment and Trade for Development*, June.

StatLink http://dx.doi.org/10.1787/888932937396

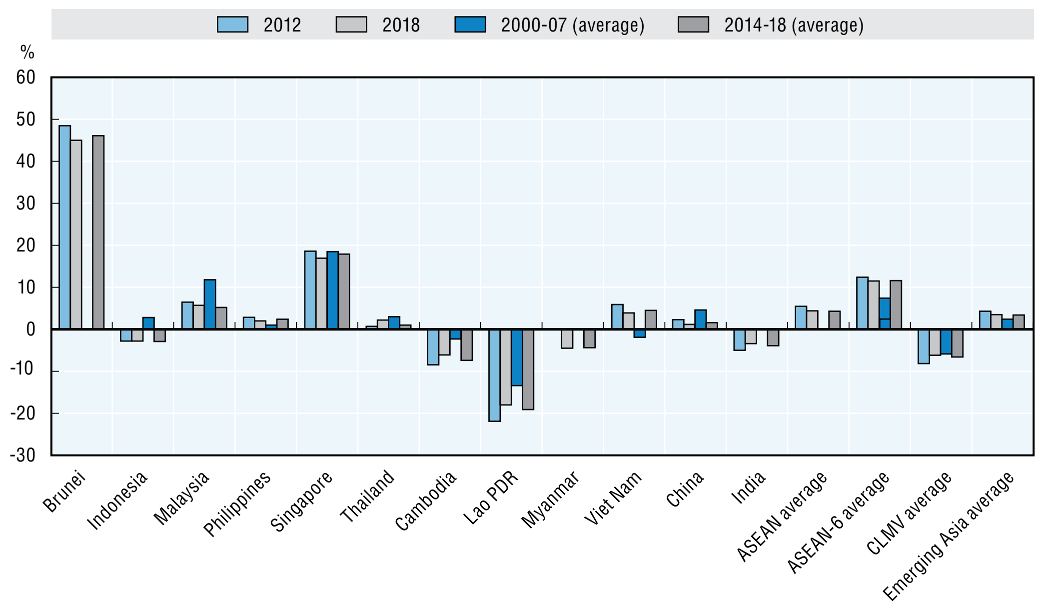
Current account surpluses will narrow while net capital inflows remain strong

The current account surpluses in most of the Emerging Asian economies are projected to remain broadly stable or to decline over the next five years as domestic demand becomes the key driver of overall growth. The current account surplus in China is projected to nearly halve from 2.3% of GDP in 2012 to 1.2% of GDP by 2018, as the country rebalance its growth towards consumption-led growth. India's current account deficit is projected to decline moderately from 5.0% of GDP in 2012 to 3.4% of GDP in 2018 (Figure 1.14).

In Southeast Asia, the overall current account surplus is projected to lower from 5.5% of GDP in 2012 to 4.4% of GDP by 2018. This largely reflects the projected lower current account surplus for Brunei Darussalam, Malaysia, Singapore and the Philippines. For Indonesia, the current account deficit is projected to remain stable at 2.8% of GDP in 2018. The CLMV countries, particularly Cambodia, Lao PDR and Myanmar are projected to continue to run current account deficits through 2018, although they should narrow.

Figure 1.14. **Current account balance of Southeast Asia, China and India**

Percentage of GDP



Notes: ASEAN-6 average includes Brunei, Indonesia, Malaysia, the Philippines, Singapore, Thailand. CLMV average includes Cambodia, Lao PDR, Myanmar, 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-2014.

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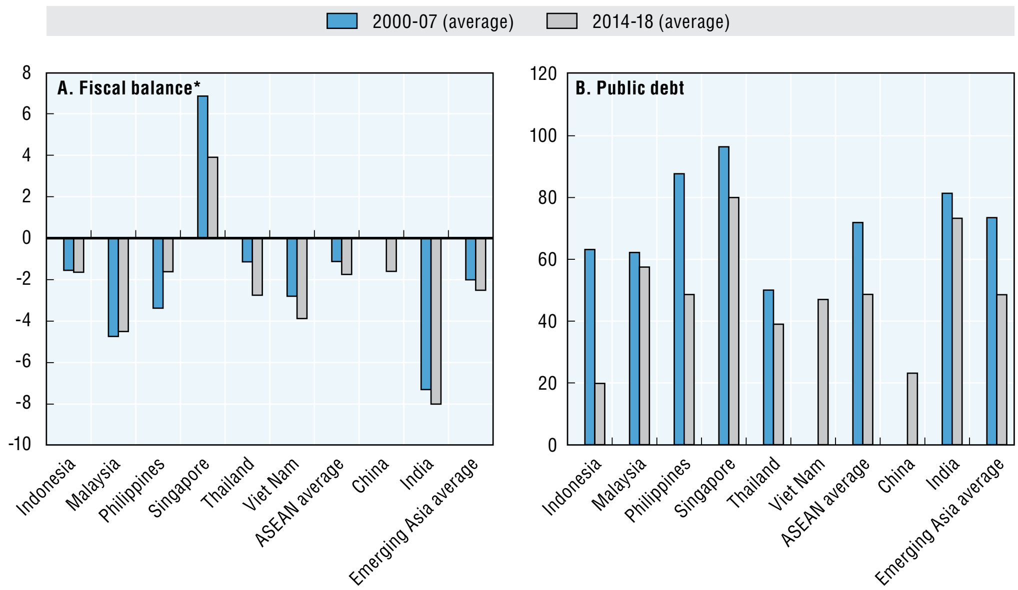
Macroeconomic policies will support robust growth

The favourable economic growth outlook assumes that macroeconomic policies will continue to be effective. In particular, the projection framework assumes that monetary policies will continue to help to sustain price stability consistent with central bank targets in across most Southeast Asian economies as well as China, and to progressively reduce inflation rates in India, Indonesia and Viet Nam, where they have been comparatively high.

On the fiscal front, according to officially announced budget plans, some countries in the region will continue to reduce their fiscal deficits, although at a somewhat more moderate pace than recently (Figure 1.15). Singapore is the only country projected to continue to run a fiscal surplus. Malaysia, which suffered a downgrade in its international credit rating in 2013 owing to a surge in its budget deficit, is projected to reduce the deficit to 4.5% of GDP during 2014-18, compared to about 4.7% during 2000-07.[8] However, the fiscal deficit in India is projected to remain considerable at 8.0% of GDP.

Figure 1.15. **Public finances of Southeast Asia, China and India**

Percentage of GDP



Notes: * Fiscal balance of general government. ASEAN average includes Indonesia, Malaysia, Philippines, Singapore, Thailand, Viet Nam. Emerging Asia average includes six countries of ASEAN, China and India. Owing to data availability Emerging Asia average 2000-07 does not include China.

Source: OECD Development Centre, MPF-2014.

StatLink http://dx.doi.org/10.1787/888932937434

Notes : ASEAN average includes Indonesia, Malaysia, Philippines, Singapore, Thailand, Viet Nam. Emerging Asia average includes six countries of ASEAN, China and India. Owing to data availability country averages for 2000-07 do not include Viet Nam and China.

Source: OECD Development Centre, MPF-2014.

Budget consolidation in most of the Emerging Asian countries is thus projected to be gradual and relatively limited. Consolidation via containing increases in budget expenditure remains a challenge for the region given their ambitious infrastructure development plans. Greater PPP financing of infrastructure spending will help to alleviate the burden on government financing. Hence, as will be discussed later in this chapter, it is imperative for governments to focus on implementing structural policies to enhance FDI and to reap the benefits of capital inflows.

The medium-term economic outlook is subject to both upside and downside risks

The medium-term economic projection for Emerging Asia is subject to developments on both external and domestic fronts.

- More prolonged economic weakness in the euro area and the United States would moderate the projected robust real growth in Emerging Asia to some extent.
- Renewed inflationary pressures from food, oil and other commodity prices could re-emerge as a result of the severe droughts in major farming regions and geopolitical tensions surrounding Middle East oil producers. Rising commodity prices could add to inflationary pressures in Emerging Asia and constrain the space for monetary easing to cushion weakness in external demand. Surges in commodity prices could also complicate budget consolidation efforts in those countries where commodity subsidies are now comparatively large.

- Severe financial volatility could arise if there is a disorderly exit from QE in the advanced economies. This could raise macroeconomic risks and aggravate volatility in capital flows and currency depreciation pressures and pose challenging policy dilemmas.
- On the domestic front, slower or ineffective implementation of economic reforms and projects would moderate the projected strong medium-term growth. For example, widespread delays in infrastructure projects, particularly in Indonesia, the Philippines and India, would lead to lower than projected growth, while a slower pace in economic reforms will limit investment growth and productivity gains. On the other hand, should the implementation of such reforms and projects surprise on the upside, the benefits to productivity and growth would be greater than now projected.

Key policy challenges to sustaining healthy growth in the medium term

The success of Emerging Asian countries in realising their favourable medium-term growth and development prospects will hinge on the management of several key challenges. To harness their growth potential, it is critical for policy makers to implement structural policies, liberalise regulatory regimes, particularly in the services sectors, and foster greater economic co-operation and integration.

- Managing the spillover effects of capital flows will continue to be an important policy challenge. Governments should focus on implementing structural policies to reap the benefits of capital inflows and greater regional co-ordination to deal with capital flows.
- Governments in ASEAN need to step up efforts to ensure that economic integration remains on track.

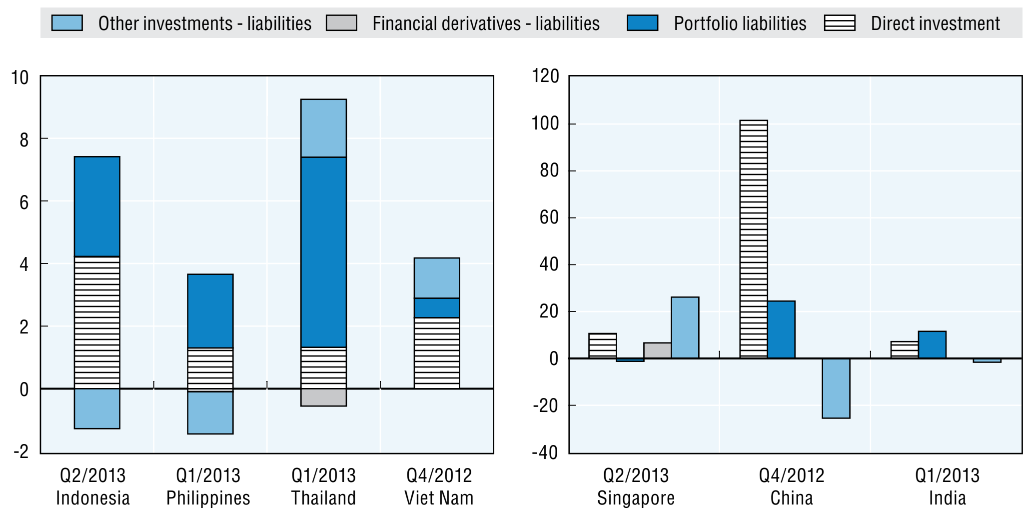
The spillover impacts of quantitative easing on capital flows will need to be managed

Capital mobility is a key component of international finance. Capital flows allow for savings to be channelled from surplus countries to deficit countries, thus supporting long-term economic growth through better allocation of saving and investment. However, if not managed properly, large international capital flows can make the receiving countries vulnerable to various types of financial risks and pose several important policy challenges.

Since the aftermath of the global financial crisis, the advanced economies have pursued large scale expansionary policies to help stablise financial markets and promote growth. In particular, the United States Federal Reserve has launched three rounds of unprecedented large-scale quantitative easing policies resulting in a huge expansion of its balance sheet.

Some have argued that these large scale quantitative easing policies were primarily responsible for large flows of capital to the Emerging Asian economies that followed. These inflows have led to problematic spillover effects on export competitiveness on these countries and posed financial risks. However, in the early part of the third quarter of 2013, the landscape has changed swiftly. Capital outflows have increased across emerging Asian economies amidst signs of slower growth in the region and rising expectations over the impending exit from quantitative easing in the United States.

Figure 1.16. **Breakdown of capital inflows to Emerging Asia**
USD billion



Source: CEIC.
StatLink http://dx.doi.org/10.1787/888932937453

Against this backdrop, management of international capital flows while ensuring sustainable economic growth will continue to be a key medium-term macroeconomic policy challenge facing Emerging Asian economies. Sharp reversals or "sudden stops" in capital inflows also present danger to the macroeconomy. These risks have sparked renewed policy interest and debate on the use of capital controls.

The ebb and flows of capital movements will pose important policy challenges over the medium term

Capital inflows into the Emerging Asian economies can be viewed as driven by factors which are internal to the economies receiving the flows ("pull" factors) and external to those economies ("push" factors) (Figure 1.16). Pull factors are the conditions which help determine the attractiveness to international investors of directing capital inflows towards Emerging Asia. These include domestic monetary and financial conditions, steps towards financial liberalisation and political stability.

However, the recent drivers of capital inflows have mostly been characterised by push factors. Monetary policy since the global financial crisis has remained unusually expansionary in the advanced economies and interest rates are at historically low levels. Furthermore, central banks in the advanced economies have flooded markets with liquidity. These conditions have pushed investors to seek more profitable investment opportunities in emerging markets, particularly in periods when investors overall tolerance for risk is relatively high. Overall, differentials in real growth and interest rates between emerging and advanced economies along with the global risk appetite of investors have been statistically and economically important determinants of net private capital inflows into emerging economies, including Emerging Asian economies (Ahmed and Zlate, 2013).

Large capital inflows can have several problematic spillover effects on the receiving countries. First, they tend to exert upward pressure on real exchange rates which, if it persists, can undermine export competitiveness. Second, as highlighted in the 2013 edition of the *Outlook*, capital inflow surges ("capital bonanzas") can be an important driver of domestic credit booms (OECD, 2013b). The evidence discussed there indicates that surges in cross-border lending by foreigners tend to increase the probability of an onset of a credit boom. Countries which have less developed financial markets as well as limited competition in the domestic banking sector tend to be most prone to credit booms from capital inflow surges.

Third, persistent capital inflows can trigger and prolong asset price bubbles and amplify financial risks. Recent housing price increases in emerging Asian economies are partly attributable to the large capital inflows that have accompanied the prolonged quantitative easing policies in advanced economies. In addition, the danger of a sudden stop of capital inflows and a retrenchment of investors threatens not only growth prospects, but could lead to banking sector distress (Gerlach and Tillmann, 2011).

In essence, the ebb and flows of capital movements posed important policy challenges over the medium term. Conventional macroeconomic tools seem to offer limited effectiveness in managing large capital inflows. In particular, it is becoming increasingly difficult to prevent movement in capital flows from fluactuation in the exchange rate while maintaining domestic monetary policy control, as capital accounts have become more liberalised[9] (Box 1.3). Allowing the exchange rate to fluctuate is often the best way to cope with large capital flows (this is the usual response of most developed countries), but Emerging Asian economies are typically reluctant to allow a significant real appreciation of their currencies for fear of adverse consequences on their export competitiveness; conversely sharp currency depreciation can destabilise financial markets and add to inflationary pressure. In view of this limited policy space, some Emerging Asian economies have introduced macroprudential and other regulatory measures to influence capital inflows and foreign exchange positions in the post-global financial crisis era.

Macroprudential measures can be useful but the scope for capital controls is declining

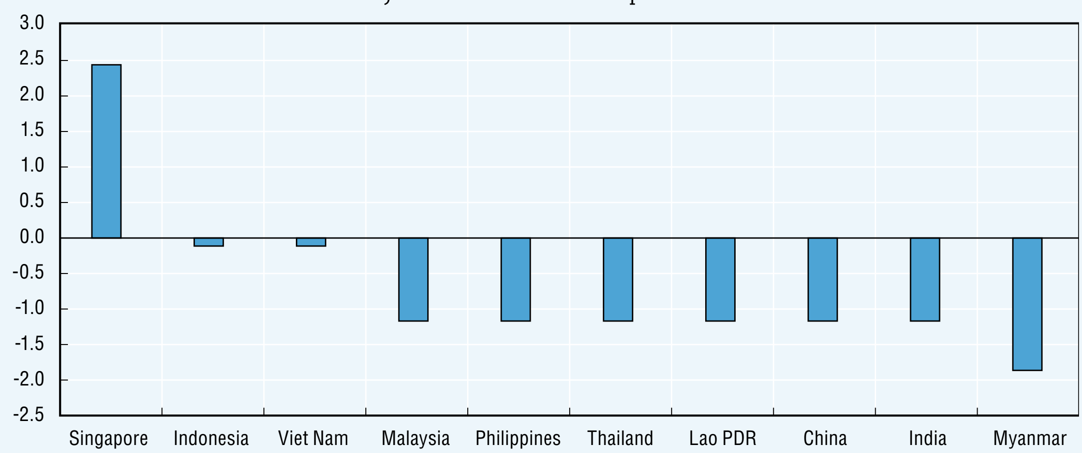
Policy responses to capital flows undertaken by Emerging Asian economies largely aim to safeguard macroeconomic and financial stability by managing large capital inflows and pre-empting the build-up of financial vulnerabilities in specific sectors. These involve the use of: *i)* macroeconomic measures (such as greater exchange rate flexibility); and *ii)* other macroprudential and capital flow management measures (CFMs). The CFMs can be system-wide (such as limits on foreign currency lending and net open currency positions) or sector-specific measures (such as caps on Loan-to-Value (LTV) ratios and Debt-to-Income (DTI) ratio).

Box 1.3. **Capital account openness across Emerging Asian economies**

Capital account openness varies across emerging Asian economies. This variation is illustrated by the (*de jure*) index of financial openness constructed by Chinn and Ito (2008) based on the International Monetary Fund (IMF)'s *Annual Report on Exchange Arrangements and Exchange Restrictions*, where a higher index value indicates greater openness (see figure below). Except for Singapore, most Emerging Asian economies maintain various controls on cross-border capital flows, though many are substantially open with respect to foreign direct investment inflows and to portfolio inflows through purchases by non-residents of domestic securities.

Degree of capital account openness

De jure index of financial openness



Source: Chinn-Ito Index based on the IMF's Annual Report on Exchange Arrangements and Exchange Restrictions, where a higher index value indicates greater openness.

StatLink http://dx.doi.org/10.1787/888932937472

Other, *de facto,* measures of capital account openness are broadly consistent with the de jure indices. Lane and Milesi-Ferretti (2006) developed a volume-based measure of international financial integration, defined as the ratio of the stock of assets and liabilities to GDP. Kawai and Lamberte (2012) updated data for 2005 and 2009 by using the IMF's *International Financial Statistics* stock data, where available, or capital flow data, where stock data are not available. For Asia, the ratio generally rose for all economies from 1990 to 2009.

The use of macroprudential and other regulatory measures to manage the effects of capital flows is fairly recent, although most of the specific instruments have long been used to address other domestic financial risk factors. As discussed further in Chapter 3, Emerging Asian countries have greatly strengthened their frameworks for macroprudential oversight since 1997. Three main categories of instruments are usually distinguished based on the source of the risks they are intended to address, namely credit, liquidity and capital-related measures. The distinctions may be somewhat more ambiguous in practice (see for example IMF, 2012a).

Thus far, Emerging Asian economies have largely pursued macroeconomic measures (such as greater exchange rate flexibility) and macroprudential measures and other CFM measures to deal with the effects of capital inflows. Against the backdrop of rising housing prices and the associated prudential concerns, credit-related measures (LTV and DTI caps), property-related taxes and capital-related measures have been commonly used across emerging Asian economies (Table 1.2). While administrative measures such as the imposition of minimum holding periods have been adopted (for example in Indonesia), these economies have not deployed market-based measures such as a Tobin tax.

Table 1.2. **Macroprudential and other CFM measures undertaken by selected Emerging Asian economies**

		Indonesia	Malaysia	Singapore	Thailand	Viet Nam	China	India
Credit-related	LTV cap	√	√	√	√		√	√
	DTI cap		√	√	√			
	Credit growth cap	√				√	√	
	Caps on foreign currency lending							
Liquidity-related	Maturity mismatch limits/ Net open position limits							
	Min. liquidity ratio							
Capital-related	Capital requirements/ Risk weights		√		√		√	√
	Provisioning requirements							√
	Reserve requirements	√					√	√
	Risk weight restrictions							√
	Restrictions on profit distribution							
Others	Property-related tax		√	√			√	
	Withholding tax				√			
	Min. holding period of bonds/ bills	√						

Source: OECD Development Centre compilation based on Lim et al. (2011), "Macroprudential policy: What instruments and how to use them? Lessons from Country Experiences", IMF Working Paper, Monetary and Capital Markets Department, October; Kawai and Lamberte (2012), "Managing capital flows: Emerging Asia's experiences, policy issues and challenges", updated version of Chapter 1 in *Managing Capital Flows: The Search for a Framework*, ADB and Edward Elgar Publishing.; IMF (2012a), "The Interaction of Monetary and Macroprudential Policies", *IMF Policy Paper*, December.; and AMRO (2013), "Global liquidity, capital flows, asset price movements and macro-prudential measures in ASEAN+3 Region", Second OECD-AMRO Joint Asian Regional Roundtable, July.

In assessing the prospective usefulness of regulatory measures aim at limiting capital inflows or what the IMF (2011) calls capital flow management measures, it is important to bear in mind the following considerations for Emerging Asian economies (see Kawai and Lamberte, 2012).

First, ASEAN member states are committed to creating an ASEAN Economic Community (AEC) by 2015, which is defined to be a region characterised by free movement of goods, services, and investment and freer movement of capital. It is difficult for any of these countries to reverse the process of capital account liberalisation by introducing new barriers to capital mobility except during an emergency on a temporary basis. Indeed, the low degree of capital account openness in some ASEAN countries implies that they may have to undertake substantial capital account liberalisation relatively quickly and must do in a manner consistent with the ultimate requirements of AEC.

Second, Singapore, as a major international financial centre, cannot afford to take measures to restrict the freedom of international investors to move funds across borders. Given the depth of its financial market and the robust regulatory regime in place, the use of CFMs is probably not necessary except during a crisis. The other Emerging Asian economies have maintained some restrictions on capital inflows, with tighter controls on outflows. Even Indonesia, arguably the most financially open economy in the rest of the region, is known to subject banking flows to tight control.

Third, China and India still maintain extensive restrictions on capital inflows (as well as on capital outflows). For these countries, use of capital controls only represents a reversal of the gradual capital account liberalisation process. For the CLMV countries, Viet Nam, to some extent, still maintains restrictions on capital flows; Cambodia and the Lao PDR have virtually no domestic financial markets, while Myanmar's capital account is closed.

These considerations suggest that: *i)* use of outright capital controls (or what the IMF (2011) calls residency-based CFMs) is feasible for only for a handful of emerging Asian economies (e.g. Indonesia, Malaysia, the Philippines and Thailand); *ii)* purchases by non-residents of domestic securities are the main (or the only) target of any potential CFMs; and *iii)* the use of outright capital controls (that explicitly discriminate against foreign investors) is increasingly ruled out as a feasible policy option, especially if it is pursued by individual countries. This last point is highlighted by the types of measures that have been introduced by some of these countries recently to limit capital inflows or inflow volatility. Except for the Indian measure, the other measures (introduced by Indonesia and Thailand) are carefully designed not to discriminate against foreign investors. The pressing question for Emerging Asia's policy makers is not when or in what sequence to employ CFMs. It is rather what non-residency-based CFMs are effective in mitigating the risk of capital inflows (if not directly reducing the purchases by non-residents of domestic securities) as they preserve their commitment to an open capital account regime (Kawai and Lamberte, 2012).

Moreover, the empirical literature generally tends to find that capital controls have only weak effects on capital flows (BIS, 2012). Evidence is mixed as to whether capital controls can appreciably limit the overall size of capital flows. For example, Forbes and Warnock (2011) examined a large cross-country panel of data and found no evidence that the stringency of capital controls has any influence on the size of flows during extreme episodes – either episodes of capital surges (when foreigners bring large amounts of money into a country) or episodes of stops (when they take large amounts of money out). On the other hand, a recent study by Ahmed and Zlate (2013) found that the new capital control measures introduced since 2009 have exerted a significant dampening effect on inflows for emerging market economies. Specifically, the number of capital control measures in place has a negative and statistically significant effect on both total flows and portfolio inflows.

There is some evidence that controls can change the composition of flows. De Gregorio, Edwards and Valdes (2000) find that Chilean controls changed the composition of flows toward longer maturities. This finding is confirmed in the recent study by IMF researchers Ostry et al. (2011) The meta-study of Magud, Reinhart and Rogoff (2011) finds this to be a robust outcome over many empirical studies. Ostry et al. (2011) also find that the currency composition of flows can be effectively altered by policies that discourage borrowing in foreign currencies. Evidence is mixed on the question of whether capital controls actually allow countries to control real exchange rates and have more independent monetary policy, though the meta-study of Magud et al. tends to favour this conclusion.

Regional co-operation will help in managing capital flows

There is a geographical component to the pattern and size of large net capital inflows, which Schadler (2010) calls the "neighbourhood" effect. Conversely, when sudden outflows cause a currency crisis, contagion often has a regional focus, as was the case during the Asian financial crisis in 1997-98 and in Europe at the height of the 2008 global financial crisis. These patterns must be related to the interconnectedness among the neighbouring economies of a region (Park and Takagi, 2012). This tendency suggests that collective action at the regional level will be important for Emerging Asian economies to manage the spillover effects of quantitative easing in the advanced economies.

There are two areas of co-operation amongst Emerging Asian economies for managing capital flows. First, these countries can co-ordinate the introduction of prudential and other regulatory measures, given the recognition that individual countries are finding it increasingly difficult to do so alone (Kawai and Lamberte, 2012). In this aspect, collective action can be helpful in two ways. First, if these measures are either introduced as part of regional efforts or sanctioned by a regional decision, there could be less negative reaction from international investors. Second, these measures, if effective in one country, would divert more capital inflows to its regional neighbours. Without a regional framework, use of prudential and other regulatory measures to limit capital inflows could turn into a tool of beggar-thy-neighbour policies. Indeed, the IMF (2012b) found that controls on capital inflows can have significant direct portfolio effects not only on the country instituting the controls but also externality effects on other countries.

Second, there is also greater scope to tap the Chiang Mai Initiative Multilateralization (CMIM) for monitoring capital flow movements and improving crisis prevention and management capacity in the region.[10] In early May 2013, the meeting of the Finance Ministers and Central Bank Governors of ASEAN+3 reached a consensus to transform the ASEAN+3 Macroeconomic Research Office (AMRO) – an independent regional surveillance unit supporting the CMIM – into an international organisation. Moreover, it was agreed in May 2013 to amend the CMIM Agreement to reflect the following measures: doubling the size of the CMIM from USD 120 billion to USD 240 billion; introducing a crisis prevention facility (the Precautionary Line); and minimising the IMF-linked portion from 80% to 70% (and further to 60% in 2014). These regional co-operation efforts could help to prevent the occurrence of financial crises and foster the capacity to manage crises effectively if they occur (Bank of Japan, 2013).

More importantly, structural policy reforms will be critical to reap the benefits of capital flows

Structural policy reforms can maximise the long-term gains from international capital movements in support of stronger, more balanced and sustainable growth. Structural policy, including financial and product market regulation, have a large impact on net foreign capital positions. An OECD (2012) analysis of a large sample of mature and emerging-market economies shows that countries with more open financial markets, better institutional quality and more competitive product and labour markets appear to be more able to attract and absorb foreign and domestic capital flows.

In addition, structural policy can help to minimise the short-term risks associated with capital flows. While improved structural policy settings are likely to increase the overall scale of capital flows, this may heighten short-term risks. On the other hand, better structural policies (more competition-friendly product market regulation, more adaptable labour markets, higher institutional quality and greater capital account openness) are associated with a composition of capital inflows – principally more FDI and less debt – which is more stable and less prone to risk. The net effect of capital flows on short-term risks will depend not only on the particular form of structural reforms enacted, but also on how they are reinforced by progress in financial reforms to strengthen the prudential and macroprudential framework in both emerging and advanced economies (OECD, 2011).

Efforts to pursue ASEAN economic integration should be stepped up

The ASEAN region has vast strengths to play an increasingly important role on the global economic stage. With a population of over 600 million, it is the third largest market in the world, larger than the European Union. With a combined GDP of over USD 2.2 trillion, its ten member states make up the fifth largest economy in the world.

As integration with the world economy intensifies, the ASEAN region finds itself facing important opportunities and challenges including the need to better integrate the newer members into the regional and global economy. Hence, to harness its medium-term economic growth potential, ASEAN needs to capitalise on its strengths while overcoming a number of distinct challenges to attain the medium-term goal of a common market within the ASEAN community by 2015 (Box 1.4).

Box 1.4. **Recent progress in implementing the Roadmap for the ASEAN Community**

The Roadmap for the ASEAN Community (2009-2015) was developed to put the objective of regional integration at the centre of ASEAN's co-operation and to provide a framework for more coherent implementation of the regional integration programmes. The various actions under the Roadmap are intended to ensure that the benefits of integration are spread across all ten countries.

Recent progress in implementing the ASEAN Community Roadmap includes the following:

- **Trade and Investment:** Implementation of the ASEAN free trade agreements (FTA) with other countries (dubbed as "ASEAN plus one" agreements) and the other mandates that arise from the various consultations with major trading partners; launch of formal negotiations for the regional comprehensive economic partnership (RCEP) agreement between ASEAN and its six FTA partners: Australia, China, India, Japan, Korea and New Zealand, which aims to consolidate the plus one agreements; the coming into force of the ASEAN Comprehensive Investment Agreement in 2012 which covers investment liberalisation, promotion, facilitation and protection; and trade facilitation and enhancement initiatives in the region through the ASEAN Single Window.

Box 1.4. (contd.)

- **Infrastructure:** The ASEAN Plan of Action for Energy Cooperation 2010-2015; establishment of the ASEAN Energy Management System to enhance energy efficiency; ASEAN ICT Master plan; work towards establishing an ASEAN Broadband Corridor to increase availability of broadband services, provide universal access, and boost broadband utilisation; work towards an ASEAN Single Aviation Market which envisages ASEAN airspace as a seamless block; implementation of the ASEAN Framework Agreement on Cross Border Transport of Passengers; conducting studies on enhancing regional maritime transport, such as creation of a single shipping market and a ASEAN roll on-roll off shipping network.
- **Tourism:** ASEAN Tourism Strategic Plan; implementation of an ASEAN-wide mutual recognition arrangement for its tourism professionals and work towards the establishment of a regional secretariat for ASEAN tourism professionals; ASEAN Tourism Resource Management and Development Network; implementation of capacity building programmes; implementation of the ASEAN Tourism Marketing Strategy.
- **Education:** Implementation of the ASEAN Five-Year Work Plan on Education; co-operating through various regional initiatives such as the ASEAN University Network (AUN), Southeast Asian Ministers of Education Organization. ASEAN Curriculum Sourcebook, ASEAN Studies Course for undergraduate students, and online AUN ASEAN Credit Transfer System; development of projects to support developing regional higher education frameworks of quality assurance, qualification frameworks and credit transfer; mutual recognition and increased regional competitiveness of higher education institutions.
- **Health:** ASEAN Declaration of Commitment (Getting to Zeros) for HIV and AIDS; initiatives to address issues on malaria, universal health coverage, multi-sector (non-health) impacts of pandemics, migrants' health and nutrition.

While development gaps have narrowed, they remain significant in some areas

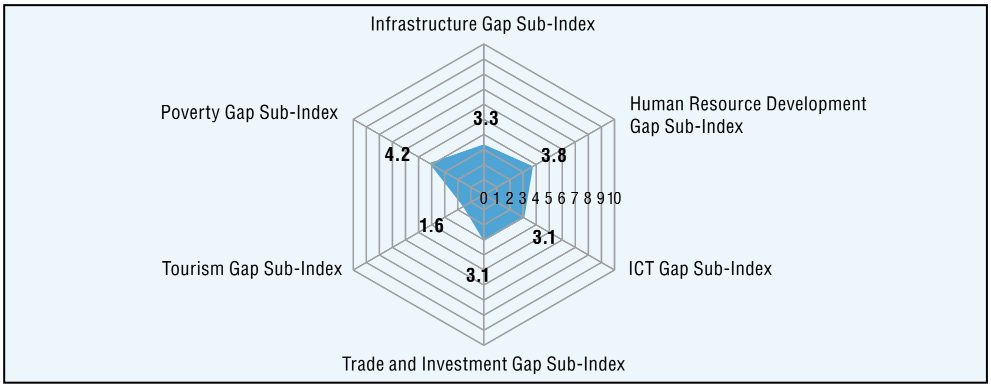
One of the key medium-term policy challenges lies in narrowing the social and economic development gaps among the ASEAN members. Indeed, the journey to build an ASEAN Community by 2015 requires member countries, including the newer members, to not only stay on the same track but to keep pace.

To monitor the progress of efforts to narrow the disparities in socio-economic development, the Narrowing Development Gap Indicators (NDGIs), first released by the OECD Development Centre and the ASEAN Secretariat in 2013, provide important comparative information on various socio-economic development indicators among ASEAN countries.

The NDGIs measure the gap between the averages of two country-groups in ASEAN: Cambodia, Lao PDR, Myanmar and Viet Nam (CLMV) and the more highly developed and prosperous ASEAN-6 countries (Brunei Darussalam, Indonesia, Malaysia, the Philippines, Singapore and Thailand). Each gap indicator and its sub-indicators is measured on a scale with 11 steps, where 0 denotes no gap and 10 is the widest gap. The 2013 *Outlook* reported that for the period 2005 to 2011, of the six policy area indicators, development gaps were widest in the areas of Poverty and Human Resource Development.

The Outlook 2014 paints a broadly similar picture. The NDGIs and their sub-indicators for 2012 show that the gap between CLMV and ASEAN-6, remained widest for Poverty and human Resource Development Gap at 4.2 and 3.8 respectively, although these two indicators have improved slightly compared to 2011. The Infrastructure Gap was 3.3, followed by the Information Communication Technology (ICT) and Trade and Investment Gaps both at 3.1, while the Tourism Gap was the smallest at 1.6 (Figure 1.17).

Figure 1.17. **Narrowing Development Gap Indicators (NDGIs): Disparities between CLMV and ASEAN-6, 2012**



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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Implementation of the IAI Work Plan will be key to narrowing development gaps

The implementation of the Initiative for ASEAN Integration (IAI) Work Plan will be the main driver for efforts to narrow the development gaps in ASEAN and to support the three ASEAN Community Blueprints (Political-Security Community, Economic Community and Socio-Cultural Community).

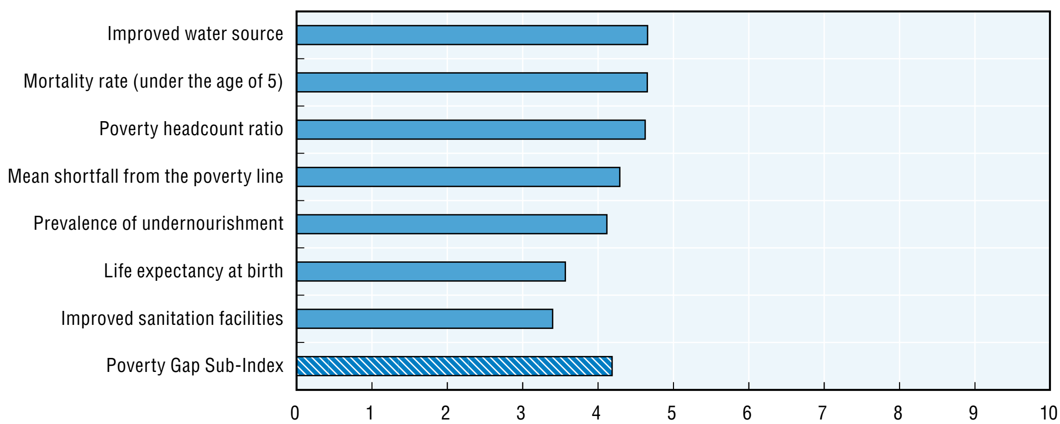
The Work Plan is currently in phase two (IAI Work Plan II) which covers the period 2009-15. The Work Plans have mainly focused on soft infrastructure. However given the current state of development in the CLMV, emphasis is now being placed on infrastructure facilities (e.g. airports, seaports, roads, bridges, and other facilities). Particularly in the Master Plan for ASEAN Connectivity, support for developing and improving physical connectivity has become an important priority area that can potentially accelerate economic integration. Prioritising infrastructure development will benefit the region in the medium to long term.

Along with four general enabling actions, the IAI Work Plan II is composed of 182 prescribed actions that will support CLMV countries to better participate in the integration process. Out of the 182 actions, 19 are studies, 78 are policy and implementation support, and 85 are training programmes, apprenticeships and other capacity building activities.

The following discussion highlights the components of the NDGIs where gaps are largest and provides a concise description of ASEAN's prescribed initiatives to support the CLMV, mainly through the IAI Work Plan II.

The three largest gaps between CLMV and ASEAN-6 under the **Poverty Gap** sub-indices can be found in the mortality rate for children under the age of five years, the percentage of the population with access to improved drinking-water source and the poverty headcount ratio (Figure 1.18).

Figure 1.18. **Poverty Gap Sub-Indices between CLMV and ASEAN-6, 2012**



Source: OECD Development Centre calculations based on World Bank's *World Development Indicators* (WDI).
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Table 1.3. **IAI Work Plan II Action to Narrow the Poverty Gap Sub-Indices**

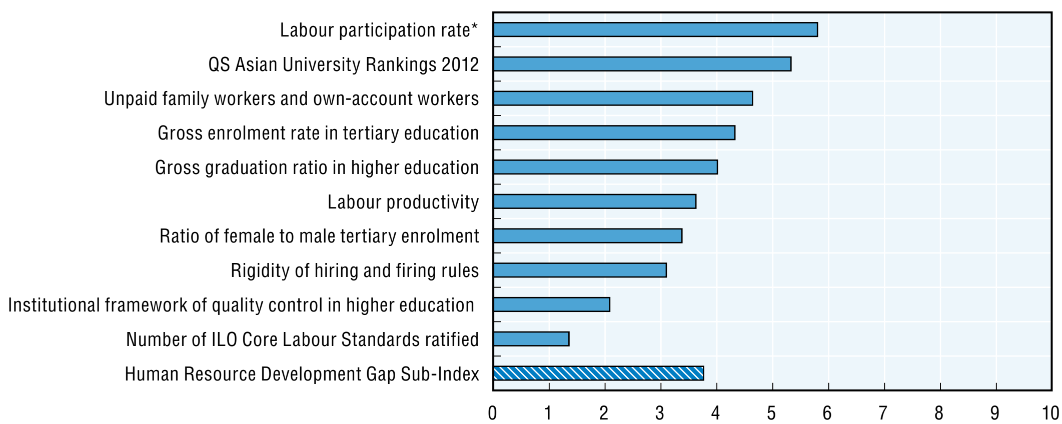
Key programme	IAI Work Plan II Action
Poverty alleviation	Implement projects related to poverty alleviation in CLMV with due attention to female households in rural areas.
	Conduct workshops for CLMV to review and assess the impact of numerous internationally funded poverty-reduction programmes and to adopt best practices.
	Conduct workshops on economic development at grassroots level and in rural areas.
Access to health care and promotion of healthy lifestyle	Enhance quality of herbal medicine and prevent illegal importation.
	Develop and implement action plan under the new ASEAN-WHO Memorandum of Understanding (2009-2013) to include capacity building activities on Healthy Lifestyles for CLMV.
Improving capability to control communicable diseases	Integrate responses to HIV epidemic under the Third ASEAN Work Programme on HIV and AIDS, 2006-2013.
	Employ existing mechanisms to control other Emerging Infectious Diseases (EID) including TB and malaria.
	Integrate HIV and AIDS impact assessment into the feasibility study phase for development projects with due attention to gender-responsive aspects.
Ensuring a drug-free ASEAN	Provide support through exchange of experiences, best practices and technical assistance to develop patterns for drug-replacement crops/alternative crops as substitute in the areas previously used for illicit drug crops.
	Enhance capabilities and provide technical assistance for the treatment and rehabilitation of addicted persons including synthetic drugs users.
	Provide advisory assistance to create linkages between government, non-governmental organisations and civil society to establish comprehensive system which can provide treatment, rehabilitation and aftercare services.
	Develop national public awareness strategy and implementation plan against the threat of illicit drugs.

Source: ASEAN Secretariat.

The IAI Work Plan Actions related to these sub-indices address the areas of poverty alleviation, access to health care and promotion of healthy lifestyles, improving capabilities to control communicable diseases, and ensuring a drug-free ASEAN (Table 1.3).

The three largest gaps between CLMV and ASEAN-6 under the **Human Resource Development** Gap sub-index are in the labour participation rate, the competitiveness of higher education institutions based on global rankings of universities, and the number of unpaid family and own-account workers (Figure 1.19).

Figure 1.19. **Human Resource Development Gap Sub-Index between ASEAN-6 and CLMV, 2012**



Note: An asterisk (*) indicates a larger value for CLMV countries ASEAN-6 and thus denotes a change in the direction of the gap between the two country groups.

Source: OECD Development Centre 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 (KLIM), UNESCO UIS database and QS University Ranking.

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The IAI Work Plan Actions related to this sub-index mainly focus on advancing and prioritising education, investing in human resource development and promoting decent work (Table 1.4 and Box 1.5).

Table 1.4. **IAI Work Plan II Action to Narrow the Human Resource Development Gap Sub-Index**

Key programme	IAI Work Plan II Action
Advancing and prioritising education	Conduct a programme for training in the management of higher education for CLMV countries.
Investing in HRD	Conduct a seminar on strategic planning for skills development. Study the possibility of establishing vocational/university exchange programmes or temporary training programmes for certain skills sets that are needed for CLMV.
Promotion of decent work	Implement a programme to promote safety in the workplace in CLMV countries. Provide advisory assistance to CLMV in the development of the informal sector, including policy measures and training programmes.

Source: ASEAN Secretariat.

Box 1.5. **Education plays a significant role in narrowing the development gap in ASEAN**

The role of education in narrowing the development gap in ASEAN is particularly evident in the IAI Work Plan where capacity building and human resource development are key elements to ASEAN integration efforts.

Of the 182 actions in the IAI Work Plan, 47% come in the form of capacity-building activities such as training courses, workshops, attachment programmes, language training, academic scholarships and the like. These capacity-building efforts under the IAI span across all three pillars of the ASEAN Community and general enabling actions such as English proficiency training and trainers' training on project management.

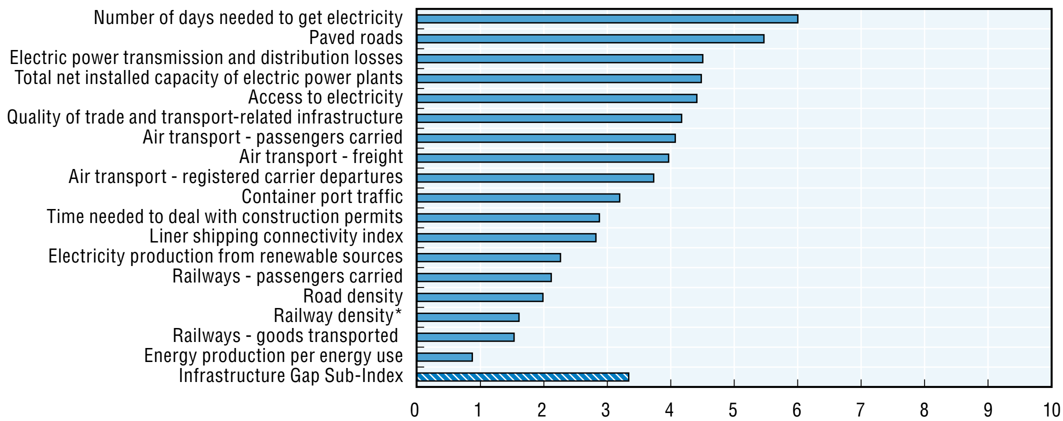
The Work Plan also prescribes actions on training managers and administrators of higher education institutions; establishing vocational or university-based exchange programmes, and training programmes for specific skills sets needed by CLMV; and providing support in the implementation of ASEAN's Mutual Recognition Agreements.

Projects have been implemented to support these prescribed actions. A flagship project is the Attachment Officers' Programmes for CLMV diplomats and officials that are being supported by Japan and Brunei Darussalam. Through Japan's assistance 11 batches of CLMV officials have been attached at the ASEAN Secretariat for between six months and one year to help them learn more about the work of ASEAN and to help them bring back home the skills and lessons they have learned from the programme. Most graduates of the Programme return to their home countries or get posted abroad taking on more senior roles in their respective ministries. Two batches are currently posted at the Secretariat.

Other on-going and up-coming IAI projects include support from various ASEAN Dialogue Partners on establishing or refining policies for National Qualifications Framework to harmonise recognition of qualifications across ASEAN countries, giving particular attention to supporting CLMV countries. The US, through the Lower Mekong Initiative, will pursue a comprehensive programme supportive of education and IAI, covering programmes such as increasing technical English skills, policy formulation and information sharing on accreditation and equivalencies benchmarks, exploring emerging technologies such as massive open online courses, Internet-based distance learning, and implementing programmes geared towards youth, young professionals and women.

The three largest gaps between CLMV and ASEAN-6 under the **Infrastructure Gap** sub-index can be found in the number of days to get an electricity connection, the percentage of paved roads, and access to electricity (Figure 1.20).

Figure 1.20. **Infrastructure Gap Sub-Index between CLMV and ASEAN-6, 2012**



Note: An asterisk (*) indicates a larger value for CLMV countries ASEAN-6 and thus denotes a change in the direction of the gap between the two country groups.

Source: OECD Development Centre calculations based on UNESCAP Asia-Pacific database, World Bank's World Development Indicators (WDI), World Bank's Doing Business database and UN Energy Statistics database.

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The IAI Work Plan Actions related to this sub-index focus more on providing technical assistance for planning and operating road, multimodal transport, railway and maritime projects, as well as training programmes on the use of energy sources, power distribution and regulation, and energy conservation (Table 1.5 and Box 1.6).

Box 1.6. **Implementation of the IAI Work Plan will require more targeted resources**

Capacity-building is important for the CLMV countries' ability to implement regional integration projects but having adequate resources to carry the projects out is also essential. Easing the resource constraint particularly of capacity building reflects the commitment of ASEAN to ensure that the community is not two-tiered.

ASEAN has a number of Co-operation Programmes to support and carry out regional activities in the various sectors. To address the more complex regional undertakings, the ASEAN Infrastructure Fund (AIF) has been set up as a limited company incorporated in Malaysia. The Asian Development Bank provides the administrative services to the AIF and co-finances the loans to infrastructure projects that are expected to contribute to the ASEAN Master Plan on Connectivity.

Box 1.6. (contd.)

Similarly, China has set up a USD 15 billion credit facility and a USD 10 billion China-ASEAN Investment Cooperation Fund with a focus on infrastructure and connectivity. China's support of the Master Plan on ASEAN Connectivity also paves the way for a more active role and enhanced co-operation with ASEAN in infrastructure development, transport, energy and resources, ICT, and trade and investment facilitation.

An equally important external source of funds is the private sector. Meeting financing requirements for accelerating infrastructure development will require greater co-ordination between the public and private sectors. The use of Public-Private Partnership (PPP) in infrastructure development will have to be enhanced. The ASEAN Economic Community Symposium and ASEAN Connectivity Symposium are examples of regional events designed to involve private sector actors in the economic integration and connectivity process through identification of infrastructure investment projects.

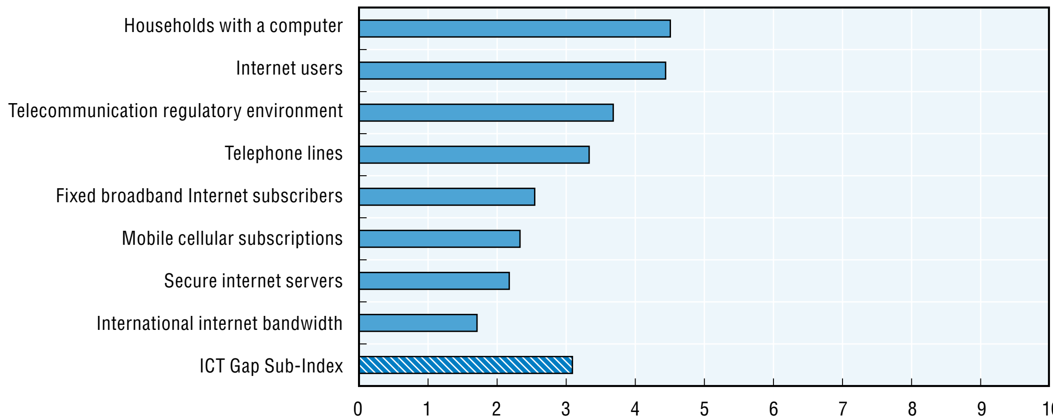
Table 1.5. **IAI Work Plan II action to narrow the Infrastructure Development Gap Sub-Index**

Key programme	IAI Work Plan II Action
Infrastructure Development	Continuation, intensification and expansion of training in multimodal transport.
	Provide training on multimodal transport, logistics and supply chain management.
	Provide technical assistance and training for CLMV in establishing and operating their segments of the Singapore-Kunming Rail Link.
	Conduct a feasibility study on the upgrading of secondary roads in each of the CLMV countries for connecting to the ASEAN Highway Network.
	Undertake activities on the application of ICT to transportation.
	Conduct training projects for container transport, urban transport planning, traffic management and transport engineering.
	Conduct a capacity-building project on traffic safety in inland waterways.
	Consider implementation of Viet Nam's proposal to convert the Inland Waterways College in Ho Chi Minh City into a regional training centre for inland waterways.
	Provide support to amend the road transport law and road traffic law for CLMV to comply with regional obligations.
	Provide training on railway operation for CLMV.
	Implement projects to build CLMV capacity to participate in ASEAN energy schemes, primarily the ASEAN Power Grid.
	Provide training in high-voltage inter-connection and in power-systems planning.
	Provide training in fuel quality testing, fuel transport safety, power trading and negotiations on transboundary power tariffs.
	Develop a programme on fuel conservation and renewable energy, with a training component.

Source: ASEAN Secretariat.

The three largest gaps between CLMV and ASEAN-6 in the **ICT sub-index** are in the percentage of people that own computers, the number of Internet users, and the degree to which the regulatory framework is favourable to the sectors (Figure 1.21).

Figure 1.21. **ICT Gap Sub-Index between CLMV and ASEAN-6, 2012**



Source: OECD Development Centre 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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The IAI Work Plan's prescribed actions on ICT include both the provision of technical assistance for planning and the implementation of national ICT infrastructure that will help connect ASEAN countries to each other and to the rest of the world on the economic front; and the promotion and provision of training programs to maximise and increase the utilisation of ICT throughout the region (Table 1.6).

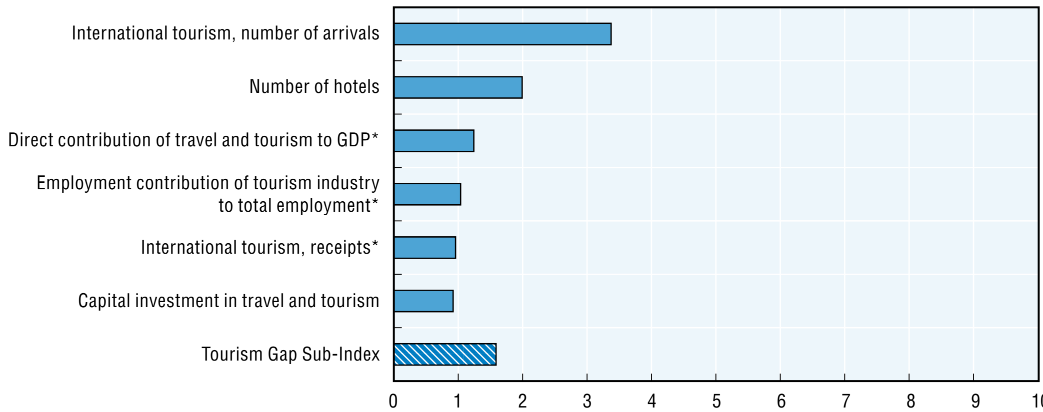
Table 1.6. **IAI Work Plan II action to narrow the ICT Sub-Index Gap**

Key programme	IAI Work Plan II Action
Infrastructure development	Provide support for formulation of national ICT master plans.
	Provide support for formulation of e-government master plans.
	Provide support for formulation of national action plans for human resource development in ICT.
	Provide support to review telecommunications regulations to support liberalisation (and development) of the telecom sector with an integrated approach on regulation and policy reform (on competition policy, foreign investment, licensing, allocation of resources such as frequencies and access facilities).
	Provide support to complete the GMS Information Superhighway to provide the telecom backbone network and connectivity to all parts of CLMV.
	Conduct a study and implement measures to implement CLMV ICT manufacturing bases/clusters (and to be connected to other IT parks in ASEAN).
	Conduct training programmes on the basis of a coherent programme for the ICT focal points of CLMV.
Promoting ICT	Provide expertise training in the management of large-scale ICT projects in CLMV countries.
	Provide support in building up and developing a group of CEOs for ICT.
	Provide support for CLMV countries in studying and building of structures and information standards serving e-government.
	Develop a standard ICT infrastructure of CLMV for their people, especially women, youth, elderly and disabled persons, to easily access ICT.
	Provide ICT training for people in each CLMV country including women, youth, elderly and disabled persons.
	Provide support to implement capacity building programmes to increase ICT literacy in ASEAN, including women, children, elderly and disabled people.

Source: ASEAN Secretariat.

The three largest gaps between CLMV and ASEAN-6 under the **Tourism Gap** sub-index are in the number of international tourist arrivals, the number of hotels, and the amount of the direct contribution of travel and tourism to countries' GDP (Figure 1.22).

Figure 1.22. **Tourism Gap Sub-Index between CLMV and ASEAN-6, 2012**



Note: An asterisk (*) indicates a larger value for CLMV countries ASEAN-6 and thus denotes a change in the direction of the gap between the two country groups.

Source: OECD Development Centre calculations based on UN World Tourism Database, World Bank's *World Development Indicators* (WDI), World Travel & Tourism Council (WTTC) and national sources.

StatLink http://dx.doi.org/10.1787/888932937586

CLMV countries have fared well in tourism in the last few years, with most of the countries opening up to the global market. In 2012, CLMV countries registered a 19.7% growth in visitor arrivals and remain committed to achieve the target of 25 million arrivals by 2015. The CLMV countries will co-operate on the development of tourism products and infrastructure, and jointly promote the "Four Countries, One Destination" campaign.

The IAI Work Plan, following the ASEAN Economic Community Blueprint, considers tourism as a key services sector, and suggests capacity-building initiatives for tourism professionals. The signing of the mutual recognition agreement for tourism professionals in ASEAN is a milestone for the sector and is one area where CLMV countries may be able to catch up most easily (Table 1.7).

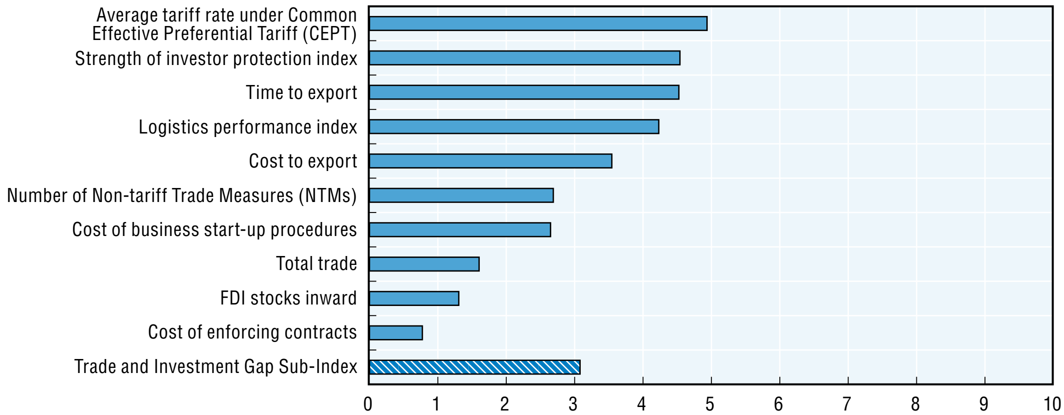
Table 1.7. **IAI Work Plan II action to narrow the Tourism Gap Sub-Index**

Key programme	IAI Work Plan II Action
Free flow of services - tourism	Provide technical assistance in formulating services-related policy measures in tourism sector including air transport services, liberalisation of tourism services and the use of tourism professionals.
	Provide joint training in tourism services sector to strengthen the capacity of government officials and private sectors in charge of services in CLMV countries.

Source: ASEAN Secretariat.

The three largest gaps between CLMV and ASEAN-6 under the **Trade and Investment Gap** sub-index are in average tariff rates, the ease of exporting measured by the number of days to export, and the intensity of investor protection (transparency and access to and disclosure of information) (Figure 1.23).

Figure 1.23. **Trade and Investment Gap Sub-Index between CLMV and ASEAN-6, 2012**



Source: 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.

StatLink http://dx.doi.org/10.1787/888932937605

Gaps between CLMV and ASEAN-6 countries in trade liberalisation and participation in the global market are evident in ASEAN trade and tariff statistics. More than 80% of the total trade in ASEAN is accounted for by the ASEAN-6 countries. While the average tariff on imports in the ASEAN-6 was 0.05% in 2012, it was 1.69% in the CLMV. To narrow the trade and investment gap, the Work Plan focuses on key areas such as the aspirations for free flow of goods, services, and investment; enhancing external economic relations through free trade agreements, and increasing participation in global supply chains (Table 1.8).

Table 1.8. **IAI Work Plan II Action to Narrow the Trade and Investment Gap Sub-Index**

Key programme	IAI Work Plan II Action
Free flow of goods	Conduct a study to analyse the state, in each of the CLMV countries, of each of the relevant priority sectors and how the sector would benefit from or be affected by more rapid regional integration within ASEAN, proposing measures to undertake adjustments to reap the benefits and mitigate the costs. Implement the agreed measures.
	Conduct a study to identify obstacles encountered by CLMV exporters to or through ASEAN-6 countries and vice versa.
	Conduct a review with a view to implement effectively the ASEAN Integration System of Preferences.
	Conduct a study on ways by which the ASEAN-6 can help strengthen the export competitiveness of the CLMV countries.
	Implement the agreed recommendations of the study on managing the revenue losses and adjustment costs arising from CLMV participation in AFTA.
	Assist CLMV in capacity building to ensure the implementation of National Single Window.
	Conduct attachment programmes and other methods of improving the familiarity of the customs and other agencies of the CLMV countries with the CEPT scheme and other integration measures and strengthening their capacity to implement them.
	Conduct programmes to familiarise the private sector in the CLMV countries with ASEAN Trade in Goods Agreement (ATIGA) and other integration measures.
	Continue implementation of the IAI training and institution-building programmes in customs administration and operations.
	Continue implementation of additional programmes on the basis of a coherent capacity building programme adopted by the ASEAN customs authorities, including training in the application of rules of origin, risk assessment and enforcement of agreements related to customs.
	Provide assistance to those CLMV countries that need assistance in drafting or amending customs related legislation.
	Implement programmes on customs-related information on transparency, appeal mechanism and access to information.
	Implement programmes on customs automation.
Free flow of services	Conduct a study to analyse the state and impact of free flow of services in each of the CLMV countries in the global and regional contexts, including the five priority sectors for the integration of trade in services. Implement the agreed measures.
Free flow of investment	Conduct a research study to identify the difficulties encountered by investors in their operations in CLMV countries.
	Undertake a review of possible strategies to attract investment, improve the investment climate, build capacities and maximise the benefits of FDI for development.
	Conduct capacity building programmes to review, streamline and simplify procedures for investment applications and approvals.
	Provide technical assistance in strengthening databases, such as on rules and regulations and incentives, for investments covering goods and services to facilitate policy formulation, and dissemination of investment information.
	Conduct a study of the human resource requirements of the sectors to which the CLMV countries seek to draw investments, including reforms in the educational system and short-term vocational training.
	Conduct programmes to familiarise the private sector in the CLMV countries with ASEAN Comprehensive Investment Agreement (ACIA) and other integration measures.
External economic relations (FTAs)	Conduct training programmes for the CLMV countries in the application of the rules of origin of trade agreements concluded or being negotiated by ASEAN.
	Conduct capacity-building programmes to provide policy advice to CLMV governments in the negotiation of free trade agreements in accordance with their respective needs and interest.
	Provide assistance to the CLMV governments in ensuring that their specific requirements are taken into account in the study on the investment elements of FTAs being negotiated between ASEAN and Dialogue Partners.
Enhanced participation in global supply chains	Provide training in the assessment of overseas markets.
	Conduct studies of the major markets for actual or potential CLMV exports.
	Support CLMV countries in conducting studies on impact of integration in agricultural sector.

Source: ASEAN Secretariat.

Box 1.7. Trans-Pacific Partnership (TPP) and Regional Comprehensive Economic Partnership (RCEP)

The **Trans-Pacific Partnership (TPP)** is a proposed free trade agreement under negotiation by 12 countries: Australia, Brunei Darussalam, Chile, Canada, Japan, Malaysia, Mexico, New Zealand, Peru, Singapore, the United States and Viet Nam. The TPP is an expansion of the Trans Pacific Strategic Economic Partnership Agreement (P4) that is a Free Trade Agreement (FTA) between Brunei Darussalam, Chile, Singapore and New Zealand signed in 2005. As the P4 evolves into the TPP, new countries have the opportunity to join through a process of consultation, assessment and consensus building among current members.

The P4 resulted in removing most tariffs on goods traded between the four countries. It also included further pledges to open government procurement contracts to businesses operating in any of the four countries as well as to co-operate on issues such as customs procedures, labour practices, intellectual property and competition policies. It is planned to be a broad-based agreement on all sorts of horizontal issues other than trade with the objective of generating growth in the countries involved. The negotiations include such topics as environmental safeguards, small and medium-sized enterprises (SMEs), government procurement and the treatment of state-owned enterprises (SOEs), innovation and competitiveness, intellectual property rights, as well as regulatory coherence and co-operation. Furthermore, in principle under the TPP there will be no exemptions.

However, the TPP negotiations have also raised concerns and criticism because of the TPP's potential negative impact on certain sectors, products and services in certain member countries and the effect of its expansive scope on intellectual property laws and patent enforcement (for example, on the. distribution of generic drugs).

The **Regional Comprehensive Economic Partnership (RCEP)**, which was launched by the leaders of the ASEAN in November 2011, aims to build a FTA between the ten ASEAN nations and the six countries with which ASEAN has existing FTAs – Australia, China, India, Japan, Korea, and New Zealand – and which are also known as the ASEAN Free Trade Partners (AFPs) in relation to the RCEP. The RCEP is expected to lead to greater economic integration within the ASEAN as well as to broaden and deepen the engagements already achieved through the existing ASEAN+1 FTAs.

Similarly to the TPP, the RCEP is expected to be broad in the sense that the negotiations not only cover trade in goods and services but also issues related to investment, economic and technical co-operation, intellectual property, competition, and dispute settlement. Regarding the negotiations on trade in goods and services, however, the possibility of exemptions has not yet been ruled out. The ultimate aim is to progressively eliminate all tariff and non-tariff barriers as well as to eliminate the majority of restrictions and discriminatory measures with respect to trade in services in order to establish a free trade area among the participating countries. Furthermore, the RCEP also has the objective of narrowing development gaps with the less developed ASEAN countries through early elimination of tariffs on specific products and provision of development assistance. The target year to sign the final RCEP agreement is 2015, in line with the proposed date for creation of the ASEAN Economic Community.

Box 1.7. (contd.)

In terms of country coverage, there is an overlap between the TPP and the RCEP negotiations as several countries, including Australia, Brunei Darussalam, Malaysia, New Zealand, Singapore and Viet Nam, are taking part in both negotiations. Whereas both the TPP and the RCEP would create an economic zone currently unmatched by size, the two initiatives differ in some attributes. While the trade share of the two agreements to the total world trade would be similar, just below 30%, the TPP would account for a larger share of global GDP of around 38% with a substantially higher average per capita income of above USD 33 000. On the other hand, the RCEP would have a total population more than eight times of that of TPP (see Table below).

Comparison of the Trans-Pacific Partnership (TPP) and the Regional Comprehensive Economic Partnership (RCEP)

	Countries involved	Population (million)		GDP		GDP per capita (PPP USD)	Total trade (import and export of goods and services)	FDI inflow	FDI outflow
		Billion	% of world total	USD trillion	% of world total		% of world total	% of world total	% of world total
TPP	12 (i.e. Australia, Brunei Darussalam, Chile, Canada, Japan, Malaysia, Mexico, New Zealand, Peru, Singapore, the United States and Viet Nam)	0.8	11%	28	38%	33 000	26%	30%	44%
RCEP	16 (i.e. ASEAN countries, Australia, China, India, Japan, Korea and New Zealand)	3.4	48%	21	30%	20 000	27%	24%	23%

Note: Figures refer to 2012 or latest year available. GDP per capita (PPP USD) is calculated as a simple average.

Sources: IMF World Economic Outlook Database, World Bank World Development Indicators, and United Nations Conference on Trade and Development (UNCTAD), (all accessed 29 August 2013).

Both the TPP and the RCEP have similar broad objectives such as increased market access for goods, services, skills and technology, large markets offering economies of scale and scope for specialisation, and insurance against protectionist measures (Wignaraja, 2013).

Recent analyses by Petri, Plummer and Zhai (2012 and 2013) point to considerable potential welfare gains from the two integration projects. They simulate different scenarios using a computable general equilibrium model to see the income gains (including both trade and FDI effects) of the potential trade agreements as compared to a baseline projection. The result of simulations suggest that the agreements would bring economic benefits to the global economy by 2025, although there are considerable differences in income gains both at a country level and among the different scenarios.

Narrowing socio-economic development gaps remains a key medium-term policy challenge

Narrowing socio-economic development gaps continues to be a critical medium-term policy challenge to enhance ASEAN's growth potential as well as its integration process. However as the above analysis has shown, despite some narrowing of development gaps, the poverty and human resource development gaps remain significant and wide disparities persist in the areas of infrastructure, and trade and investment and ICT.

While the IAI Workplan II is a useful driver for efforts to narrow the development gaps in ASEAN, there should be greater efforts in the push for greater social and economic integration, particularly in infrastructure and trade and investment. For example, the infrastructure development can be sped up with better allocation of resources and consensus in implementation. There could also be greater regional co-operation to attract investment and liberalise trade to harness the growth potential of the ASEAN region.

As disparities in poverty also remain wide, more vigorous policies are needed to speed up poverty alleviation. For human resource development, there should be greater focus to enhance labour productivity and reduce skills mismatches. More importantly, the inequitable access to higher education and its uneven quality are important areas for policy reforms. Chapter 2 discusses in greater detail such policy reforms, particularly as they relate to CLMV countries.

In essence, while closing development gaps will necessarily involve implementation of structural policies which are longer-term in nature, it will require continued efforts and commitment from ASEAN member countries to bridge development gaps. These efforts will provide a solid foundation for the integration process as it strives towards the goals of the ASEAN Community by 2015 and beyond.

Conclusion

Recent economic developments have highlighted both the strengths of the Emerging Asian economies and their vulnerabilities. The countries' comparative success in sustaining robust growth in the face of major external shocks highlights their strong economic fundamentals and their considerable improvement since the 1997-98 Asian financial crisis. However the slowdown in growth in 2013, although modest, and the strains arising from fluctuating capital flows into the region underscore the continued sensitivity of the region to external real and financial shocks.

The region has demonstrated strengths which indicate favourable prospects for continued robust growth in the medium term but the vulnerabilities underscore that further structural reforms are not only necessary over the long term but in some cases increasingly urgent. Effective management of fluctuations in capital flows, which pose one of the key downside risks in the medium term, will ultimately require better development of capital markets and strengthened capabilities for macroprudential oversight and regulation. Achievement of a more stable and productive composition of capital inflows will depend on structural reforms to broaden the range of investment outlets for foreign as well as domestic residents. Further development of regional co-operation on common financial issues could also help greatly in managing the effects of capital flows and in avoiding conflicts.

Regional efforts to achieve greater integration and freer trade with other countries have become increasingly intense and progressively more ambitious in recent years. In principle, these efforts aim to establish a free flow of goods, services and investments, and freer flow of capital among the ASEAN countries and, to a lesser extent with China and other Asian countries, within the medium term. Even if these agreements are not fully implemented within the official timelines, they are likely to bring significant direct benefits to the participants. The increasing economic integration within the region will also boost structural reforms at the national level by enhancing their potential benefits and improving incentives for national governments to carry out reforms to keep up with their neighbours.

Notes

1. The US Federal Reserve announced on 18 September 2013 that it will continue its current pace of bond-buying programme. In its Federal Open Market Committee (FOMC) statement, the Fed said that while the economy and labour market continue to improve, the central bank decided to await more evidence that progress will be sustained before adjusting the pace of its purchases. The postponement of QE tapering has brought some temporary reprieve for Emerging Asia and helped to ease financial market conditions in India and Indonesia.

2. In September, India and Japan agreed to more than triple their bilateral currency swap arrangement to USD 50 billion, a development that is likely to bring stability in financial markets in the country. This followed from an earlier announcement in late August by Bank Indonesia to extend a bilateral swap deal with the Bank of Japan valued at USD 12 billion that will allow the two to borrow from each other's foreign-exchange reserves.

3. A recent empirical study by Frankel and Saravelos (2012) found that international reserves and real exchange rate overvaluation stood out as useful leading indicators of the recent global financial crisis. They were also the top two indicators identified in their extensive literature review.

4. OECD's CLI was released in September 2013. www.oecd.org/std/leading-indicators/PR_Eng_Sept13.pdf.

5. Specifically, the total amount of funds that the RBI will lend to banks through its overnight Liquidity Adjustment Facility (LAF) at the repo rate was lowered to around INR 750 billion (Indian rupee). Banks needing funds above what they can access from the LAF have to turn to the Marginal Standing Facility (MSF), for which the RBI has raised the borrowing rate by 200bp to 10.25%. The RBI describes its liquidity tightening measures as temporary, but it will want to see a period of sustained currency stability before it reverses them. Indeed, in September 2013, the RBI Reserve Bank hiked the repo rate by 25 basis points but unwound some of the exceptional measures taken earlier to defend the rupee: *i)* the marginal standing facility rate, which has become the effective policy rate during periods of acute liquidity shortages, was reduced by 75 basis points from 10.25% to 9.5%; and *ii)* the cash reserve ratio (CRR) was kept constant at 4% but the daily CRR balance requirement for banks was lowered from 99% to 95%.

6. The six economic corridors and respective key focus areas are: Sumatera (production centre of natural resource and national energy source); Kalimantan (production centre of mining and national energy source); Sulawesi (production centre of agriculture, plantation and fisheries); Jawa (industrial and services); Bali-Nusa Tenggara (tourism and livestock); and KE. Papau – KEP. Maluku (natural resources).

7. "PH increasing infrastructure budget to P400b in 2014", *Manila Standard Today*, 18 July 2013, http://manilastandardtoday.com/2013/07/18/ph-increasing-infrastructure-budget-to-p400b-in-2014

8. In July 2013, global ratings agency, Fitch, downgraded its credit outlook on Malaysia to negative from stable, saying in a statement that Malaysia's public finances were its key rating weakness and warned of future negative shocks should no reforms and measures be taken by the federal government to remedy the country's financial standing. Since then, the government has raised fuel prices for the first time since 2010, to curb subsidies that have stretched government budgets and threatened investor confidence. The fuel price increases will help the government save about MYR 1.1 billion (Malaysian ringgit) in 2013 and MYR 3.3 billion annually in future by reducing state subsidies.

9. It is well known that a fixed exchange rate regime, an open capital account and domestic monetary policy autonomy are conceptually incompatible – that is an "impossible trinity" or "trilemma". Specifically, a fixed exchange rate regime with an open capital account implies that the central bank cannot independently control domestic interest rates, which will fluctuate with foreign interest rates. The only way to retain complete monetary independence with an open capital account is to allow the exchange rate to vary with fluctuations in capital flows. An empircial study by Aizenman et al. (2008) also suggests that countries do face the binding trilemma.

10. The Chiang Mai Initiatives, later renamed the Chiang Mai Initiative Multilateralization (CMIM), was established in 2000 as a framework for crisis prevention and management among the Association of Southeast Asian Nations Plus Three (ASEAN+3) countries.

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CHAPTER TWO

Structural policy country notes for Emerging Asia

Abstract

While the Emerging Asian region has positioned itself well to weather short-term economic volatility, it is imperative to ensure that the new growth and development strategies of countries in the region do lead to sustainable growth over the longer term. To this end, there must be structural policy reforms to ensure sustained and robust productivity growth, the cornerstone of every nation's economic growth and competitiveness. The reforms should also target upgrading of economic activities to ensure that the region's economies can remain competitive participants in global value chains in the face of changing domestic and external conditions.

Reflecting growing importance and policy interests, for the first time, coverage of the Structural Policy Country Notes has been expanded to cover all ten ASEAN economies – including Brunei Darussalam, Myanmar and Lao PDR – as well as the two large emerging economies, China and India. Each note discusses important priorities specified in the country's medium-term development plan. The notes also discuss relevant experiences in OECD countries, providing useful insights and suggestions of "best practices" that may be valuable to policy makers in the Emerging Asian region. While each country's policy objectives may focus on quality sustainable growth, the policy challenges they face will largely depend on their unique development situation. For China and India, they are facing challenges of strengthening government institutional capacities to support development and to maintain macroeconomic stability. On the other hand, for the Southeast Asian economies, there has been a broadening in the development strategies, with increasing focus on quality of growth.

Synopsis of structural policy challenges in Emerging Asia

The Emerging Asia region has positioned itself well to weather short-term economic volatility, but this success only underscores the need to focus on how to realise the region's long-term potential. On-going economic uncertainties in the advanced economies have continued to drive home the point that steadily increasing capabilities and sustained economic growth for the region cannot be taken for granted and will require considerable skill and effort by policy makers if they are to be achieved.

Further structural reforms are the key to the realisation of Emerging Asia's long-term potential

There is thus a need to ensure that the new growth and development strategies of the Emerging Asian countries do lead to sustainable growth. To succeed in that goal, there must be structural policy reforms to ensure that, among other things, there is sustained and robust productivity growth, the cornerstone of every nation's economic growth and competitiveness. The reforms should also target economic upgrading to ensure that the region's economies can remain competitive participants in global value chains in the face of changing conditions domestically and in the international environment. Failure to undertake the necessary reforms could put countries at risk of being caught in a "middle-income trap".

There has been a broadening in the development strategies of Southeast Asian economies, with increasing focus on the quality of growth (Table 2.0.1). For example, there has been a significant shift in Thailand's five-year development planning to a new model of holistic people-oriented development. The Philippine Development Plan has more or less the same objectives, adopting a framework for growth that is both sustainable and inclusive, in the sense of generating widespread employment and reducing poverty. Indonesia's vision is towards the "realisation of an Indonesia that is prosperous, democratic and just" while that of Cambodia is focused on realising "growth, employment, equity and efficiency".

This *Outlook* includes Structural Policy Country Notes on the ten ASEAN member countries as well as China and India, the two large emerging economies in the region. Each Note discusses the most important priorities specified in the country's medium-term development plan. The notes also discuss relevant experiences in OECD countries, providing useful insights and suggestions of "best practices" that may be useful to policy makers in the Emerging Asian region.

While each country's policy objectives may focus on quality sustainable growth, the policy challenges they face will largely depend on their unique situation. And policy challenges facing each country depend on their level of development (Table 2.0.2).

The six most advanced ASEAN economies face common challenges of improving capacities to provide the education and job skills that will be needed for the development of higher productivity and technology intensive industries. The fostering of more inclusive growth and of greater resilience to natural disasters and climate change are also becoming increasingly important priorities.

Table 2.0.1. **Medium-term development plans of Southeast Asia, China and India**

Country	Period	Theme/Vision
ASEAN 10 countries		
Brunei Darussalam	2012-17	Knowledge and innovation to enhance productivity and economic growth
Cambodia	2009-13	Growth, employment, equity and efficiency
Indonesia	2010-14	Realisation of an Indonesia that is prosperous, democratic and just
Lao PDR	2011-15	Socio-economic development, industrialisation and modernisation towards the year 2020
Malaysia	2011-15	Charting development towards a high-income nation
Myanmar	2012-15	Development of industry, balanced development, improvements in education, health and living standards and improved statistical capacities.
Philippines	2011-16	Pursuit of inclusive growth
Singapore	2010-20	Highly skilled people, innovative economy, distinctive global city
Thailand	2012-16	A happy society with equity, fairness and resilience under the philosophy of a sufficiency economy
Viet Nam	2011-20	A modern, industrialised country by 2020
2 large economies in Emerging Asia		
China	2011-15	Rebalancing the economy, ameliorating social inequality and protecting the environment
India	2012-17	Faster, more inclusive and sustainable growth

Source: OECD Development Centre based on national sources.

Brunei's economy needs to become less reliant on the oil and gas sectors, which accounted for more than 60% of GDP and 95% of total exports in 2010. The development of other high-value-added manufacturing and services sectors is a key priority. The Tenth National Development Plan is based on six strategic development thrusts. Three of these are particularly important to the goal of creating a more diversified economy: an environment conducive to business; an educated and highly skilled population; and a progressive, productive economy based on knowledge and innovation.

Indonesia particularly needs to focus on reforms to make education more widely accessible, to strengthen its ability to deal with natural disasters and to accelerate reforms to social protection, particularly the pension system. The environment for business also needs to be improved.

Improvements to government policies, through reforms to make the current scholarship and conditional cash transfer (CCT) programmes more efficient and other measures, will be key to achieving wider access to education. Indonesia is highly exposed to natural disasters that have claimed lives and wreaked financial and economic damage, with the poor disproportionately affected. Given this exposure, which may well increase with climate change, the country's natural disaster management system, particularly with regard to flooding, urgently needs to be strengthened. The country's pension system, one of the pillars of its social protection system, is currently ill-suited for providing secure income for the majority of the retired population. Reforms to the system need to be accelerated. Indonesia also needs to improve its business climate to ensure that its economic growth can be maintained. A key priority is to build on and reinforce the recent progress made in improving the investment climate by moving to simplify business procedures.

The **Malaysian** economy has proved to be resilient at a time of global uncertainty in the OECD area. Over the medium term, however, there are important long-standing structural issues that may affect its march towards developed country status by 2020.

Structural problems affecting the education system continue to be a stumbling block in efforts to improve productivity and to attract the value-adding high-tech industries that require skilled labour. Small and medium-sized enterprises (SMEs), which contribute so heavily to employment, are especially hard hit by difficulties in finding skilled labour. While the fiscal balance continues to improve, uncertainties in the external environment, coupled with the failure so far of fiscal reforms to rein in spending on subsidies or to implement a goods and services tax (GST), raise questions as to whether the improvement in public finances can be sustained.

Singapore's priorities going towards 2020 are to boost skill levels across job categories, to deepen corporate capabilities to seize business opportunities in Asia, and to make Singapore a distinctive global city and endearing home.

To boost job skills in the face of an ageing population, the Singapore government has strengthened its adult learning policies. The Singapore government recognises the key role that SMEs play in the economy and has put in place policies to enhance their productivity. SME support is provided through a multi-agency assistance framework that offers SMEs a variety of schemes, ranging from tax cuts to loans and grants to help defray the costs of productivity improvements in areas such as R&D, automation and business capacity building. Land scarcity is a key challenge facing Singapore in its efforts to make the city state a distinctive global city and an endearing home. Policies need to manage the competition for space among demands for housing and industrial and commercial uses while ensuring a liveable environment for all.

Key priorities in the **Philippines** are to improve job creation, to strengthen resilience to natural disasters and climate change, and to promote development of the poorest regions. A weak job-creating capacity that has led to chronically high unemployment and, even more significantly, under-employment has been a key contributor to the persistent poverty and inequality. Job creation also needs to be bolstered through reforms to foster a more favourable business and investment climate, particularly for the small and medium-sized enterprises which contribute so much to employment. The Philippines' poorest island grouping, Mindanao, has been largely overlooked by rural development policies. To help Mindanao capitalise on its natural assets, invigorate its economy and lift its people out of poverty, rural development needs to focus on improving agricultural productivity and the island's woeful transport infrastructure.

The Philippines is one of the countries most prone to natural disasters in the world. It is exposed to multiple natural hazards from typhoons, earthquakes, volcanic eruptions, and especially flooding. Serious aggravating factors are environmental degradation, climate change and uncontrolled urbanisation. Reforms to improve disaster management and to foster environmentally sustainable growth will be essential to improving and sustaining the country's development.

Although **Thailand** has carried out some reforms in the two years since the latest medium-term development plan was initiated, it needs to do more – specifically to upgrade educational quality, to strengthen the agriculture sector, and to restructure the economy with an emphasis on green growth.

In education, there needs to be a co-ordinated effort to elevate the quality of learning and teaching if outcomes are to be improved. In agriculture, meeting the challenge of greater productivity and income and employment security requires further efforts to modernise the sector and to educate farmers in the use of technology. As regards green growth, Thailand can make its national strategy more effective by strengthening institutional co-ordination and by raising levels of public awareness of the benefits of a green lifestyle.

Sustainable development of natural resources and agriculture are key priorities for the CLMV countries. A number of these countries also need to focus on strengthening institutional capacities for preserving macroeconomic and financial stability.

Cambodia's economic development has been fast paced. To keep growth sustainable and strong, there are three priority areas on which the government should focus in the medium term. First, agriculture, and rice production in particular, need to be further developed. The government has introduced a new system of rice intensification (SRI) to improve the productivity of rice-field irrigation and has taken measures to diversify the agricultural sector. The second priority is to further develop the prudential and supervisory framework of the financial sector to ensure financial stability in a context of fast credit growth. Finally, development of the tourism sector needs to be strengthened by increasing the number of destinations available to tourists and by improving transport and other key infrastructure.

The Lao PDR's resource-based economy – driven by forestry, agriculture, hydropower, and minerals – is on a robust and impressive growth path. However, development has been uneven and poverty remains widespread. The government needs to adopt a sustainable, inclusive growth model so as to reduce poverty while implementing sound strategies for natural resource management to ensure that the country's economic growth is environmentally sustainable. It is essential that Infrastructure development keep pace with the country's fast economic growth and rapid urbanisation. This will ensure sustainable growth and improvements in the overall welfare of the people.

Fortunate to be endowed with a wealth of natural assets, **Myanmar** is well positioned to engage a multi-pronged development strategy that draws on agriculture, mining and extraction, manufacturing and services. For the strategy to be a success, the internal peace process and renewed relations with major bilateral and multi-lateral partners will be important. Myanmar can also benefit from its advantageous location between major growth poles and markets, such as China and India, and its proximity to the ASEAN tigers to regain – or even exceed – the importance it once enjoyed as a regional hub.

Myanmar has already undertaken some major reforms and the political will to take them even further appears strong. Myanmar will need to address important, long-standing issues related to the economy that include an environment that is still not very conducive to business, the lack of skilled labour and under-developed infrastructure.

Since **Viet Nam** initiated its Doi Moi Policy of economic reform in 1986, it has made considerable progress in modernising its economy and has produced impressive growth and poverty reduction. However, growth has slowed in the last five years. Sustained economic development will require increasingly sophisticated labour skills to allow industry to shift toward higher productivity and technology intensive activities. Viet Nam urgently needs to improve schooling and technical and vocational education and training (TVET) if it is to rectify the mismatch between skills supply and demand.

Viet Nam needs to foster an equitable, stable business environment and to ensure a level playing field for non-state versus state enterprises. Only then will it be able to fully harness the essential and growing economic contributions of Viet Nam's SMEs. Viet Nam also urgently needs to reform its monetary policy framework so that monetary policy can more effectively sustain macroeconomic stability. In the medium and long term, the monetary policy framework needs to be focused on controlling inflation and reducing macroeconomic fluctuations.

The two largest economies in the region are facing challenges of strengthening government institutional capacities to support development and to maintain macroeconomic stability.

China has made significant progress in the last decade in sustaining and broadening its economic development, in continuing to raise living standards, and in enhancing its status in the international community. Improvement in the institutional capacities of government to further promote these goals has become a key priority. One important policy direction laid out in the 12th FYP (Fiscal Year Plan) is to improve the provision of basic public services – notably public education, health care and social security – by undertaking more effective institutional reforms and defining more clearly the responsibilities of different levels of government. The FYP goes on to state the government's intention of deepening fiscal reform through improvements to transfer payments, budget management and tax systems. While China has made progress in these areas, it can do more to streamline administrative efficiency and to accelerate budgetary reforms.

India's economy has developed quickly in the last decade, improving living standards and experiencing strong growth in key sectors of the economy such as information and communication technology (ICT). In recent years, however, circumstances have become less conducive to growth: macroeconomic conditions in the developed economies point to a prolonged external slowdown, while domestic constraints such as high inflationary pressures and rising fiscal and current account deficits have emerged.

The 2013-14 budget focuses on the poor as part of the overarching goal of creating opportunities for young people to acquire the education and skills that will enable them to get decent jobs or become self-employed. Similarly, the educational focus of the 12th FYP is on teacher training, evaluation and accountability. It also stresses the need for higher quality in research, infrastructure, teachers and curriculum content.

Table 2.0.2. **Summary of medium-term policy challenges and responses**

ASEAN-6

Country	Policy focus	
Brunei Darussalam	Human capital development	Improve private sector development to diversify beyond the hydrocarbon economy
	Private sector development	Legislate and implement competition policy
	Innovation	Improve tertiary education attainment
Indonesia	Education	Widen access to education, in particular for low-income households
	Disaster management	Strengthen natural disaster management and protection infrastructure
	Social security reform	Accelerate reform of the pension system to improve transparency and quality
Malaysia	Education	Improve the quality of education
	SME development	Improve the productivity of SMEs
	Taxation	Widen the tax base and improve tax administration and compliance
Philippines	Poverty	Create more jobs for sustainable poverty reduction
	Human capital development	Build holistic disaster risk reduction and management capacities to reduce vulnerability to natural hazards
	Governance	Improve agricultural productivity and transport infrastructure in Mindanao
Singapore	Land use	Optimise land use and allocation by incorporating a green growth strategy
	SME development	Raise SME productivity through well co-ordinated assistance programmes
	Education	Strengthen life-long learning to increase labour market flexibility
Thailand	Education	Upgrade human capital by improving the national curriculum and teaching standards
	Agriculture	Improve agricultural productivity through modernisation and education
	Green growth	Improve institutional co-ordination to achieve green growth

CLMV

Country	Policy focus	
Cambodia	Agriculture	Improve productivity of agriculture, in particular rice production
	Financial sector	Improve the prudential and supervisory framework for the financial sector
	Tourism	Develop tourism-specific infrastructure
Lao PDR	Poverty	Reduce poverty through inclusive growth
	Natural resource management	Improve national resource management, in particular mining, to ensure environmental sustainability
	Infrastructure	Develop transport infrastructure to speed up rural development
Myanmar	Private sector development	Create a business-enabling environment
	Human resource development	Upgrade education and anticipate future demands for skilled labour
	Financial sector development	Create a stable and efficient financial system
Viet Nam	Human capital development	Increase access to education and strengthen TVET to improve the quality of human capital
	Private sector development	Ease access to credit and lower transport costs to develop the private sector
	Financial sector development	Restructure the financial system to enhance the effectiveness of monetary policy

Two large Emerging Asian economies

Country	Policy focus	
China	Fiscal policy	Improve fiscal efficiency through institutional reform
India	Education	Improve teaching and national assessment systems to raise education standards

Source: OECD Development Centre.

Brunei Darussalam

A. Medium-term economic outlook (Forecast, 2014-18 average)

GDP growth (percentage change):	2.3
Current account balance (% of GDP):	46.1

B. Medium-term plan

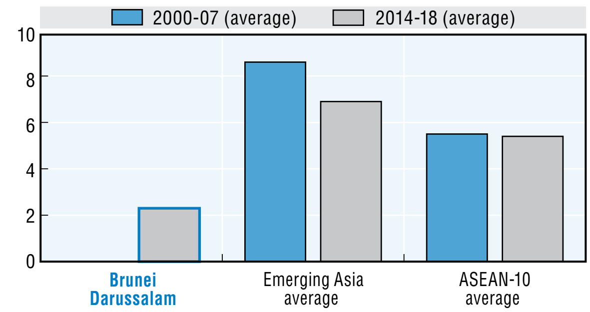
Period:	2012-17
Theme:	Knowledge and innovation to enhance productivity and economic growth

C. Basic data (in 2012)

Total population:	0.4 million*
Population of Bandar Seri Begawan	0.2 million (in 2010)
GDP per capita at PPP:	54 388 (current USD)**

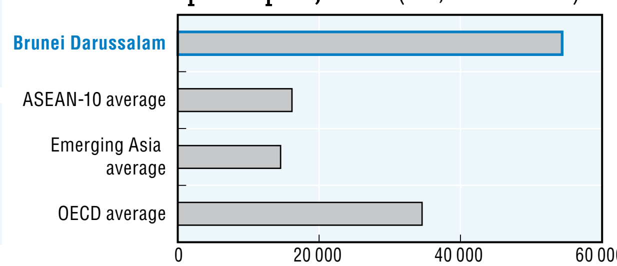
Note: * Total population data for 2012 are estimates.
** IMF estimate
Sources: OECD Development Centre, national sources and IMF.

GDP growth rates (Percentage change)



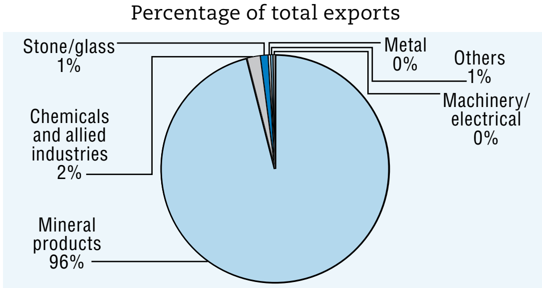
Source: OECD Development Centre, MPF-2014.

GDP per capita, 2012 (PPP, current USD)



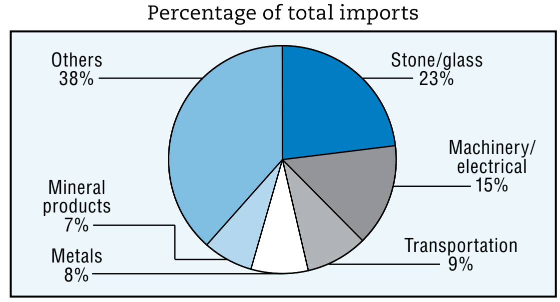
Source: IMF and national sources.

Composition of exports, 2012
Percentage of total exports



Source: Trademap.

Composition of imports, 2012
Percentage of total imports



Source: Trademap.

With abundant natural resources and a small population, Brunei Darussalam has one of the highest levels of GDP per capita in Southeast Asia. However, over the last decade its gross domestic product (GDP) per capita growth rate has been the lowest in the region. Structural reforms to depart from the hydrocarbon-dependent development are critical to enhance productivity and to sustain economic growth.

The Tenth National Development Plan 2012-17 (NDP10) is the second medium-term development plan under the national long-term development vision, known as Wawasan Brunei 2035, or Vision Brunei 2035. It puts the emphasis firmly on "accelerating economic growth" through high productivity to achieve the target of 6% average annual economic growth.

To realise that goal, Brunei's economy needs to be less reliant on the oil and gas sectors, which accounted for more than 60% of GDP and over 90% of total exports. It is urgent to foster the development of other high-value-added manufacturing and services sectors. In line with NDP10, the government has set out six strategic development thrusts. Three are particularly significant: an environment conducive to business; an educated and highly skilled population and a progressive, productive economy based on knowledge and innovation.

Brunei Darussalam's medium-term policy challenges

- Improve private sector development to diversify beyond the hydrocarbon economy
- Legislate and implement competition policy
- Improve tertiary education attainment

POLICY FOCUS

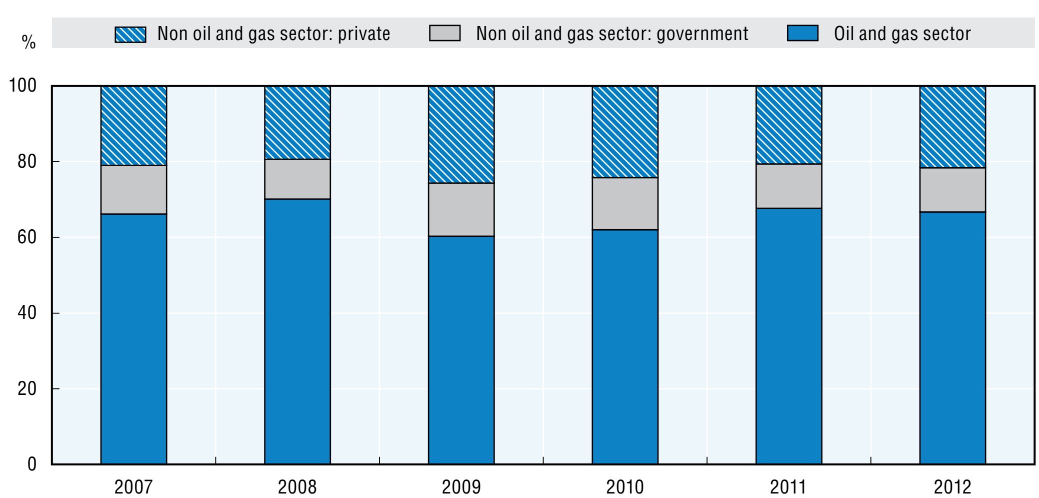
Improve private sector development to diversify beyond the hydrocarbon economy

There is great scope to improve the private sector and diversify the economy

Owing to the country's reliance on the hydrocarbon sector, there has been relatively moderate development in the private sector in Brunei Darussalam. The oil and gas industry has dominated the economy for the past 80 years. Hydrocarbon resources account for over 90% of Brunei Darussalam's exports and more than 50% of its gross domestic product (Brunei Economic Development Board). The private sector outside the oil and gas industry has contributed steadily around 20% to GDP in recent years (Figure 2.1.1). In terms of employment, while the number of employees in the private sector fell from some 125 000 in 2007 to around 117 000 in 2010, they account for a significant share of total employment. On the other hand, the public sector employment level grew slightly but steadily (Figure 2.1.2).

Figure 2.1.1. **GDP in Brunei Darussalam, by sector, 2007-12**

Percentage of total GDP



Source: CEIC.

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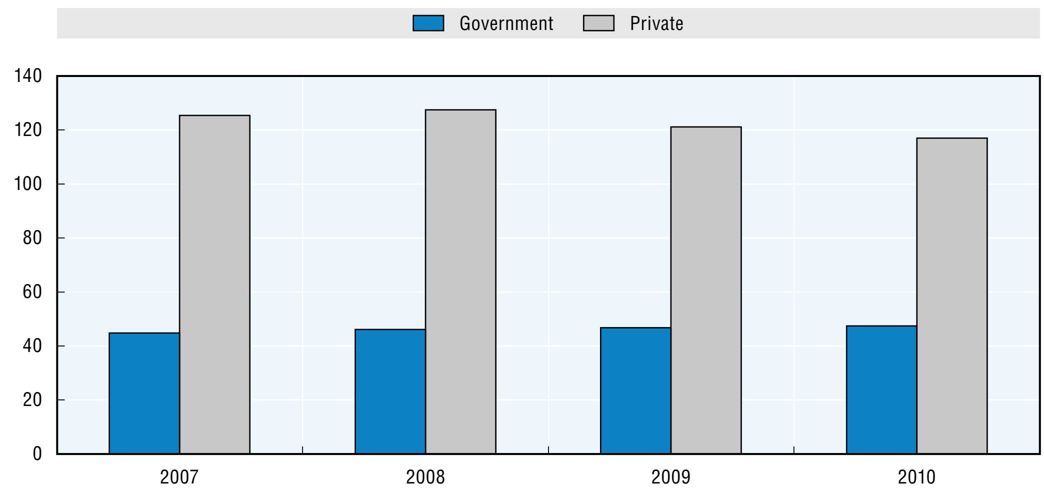
Figure 2.1.2. **Total employment in Brunei Darussalam, by sector, 2007-10**

Thousand people



Source: CEIC.

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The dependence of the Brunei economy on oil and gas resources has led to a larger government sector, which limited the role of the private sector. The dominance of the public sector and the hydrocarbon industry is further strengthened by the combination of high wages and low productivity that makes much of the private sector internationally uncompetitive (Lawrey, 2010). To bring about a more diversified economy with less reliance on the hydrocarbon sector, the public and private sectors need to be rebalanced so that the former no longer crowds out the potential of the latter.

While the government's role in the economy needs to be more balanced in the long run, the lack of critical mass in private sector activity means that the public sector will need to be involved in diversifying and rebalancing the Brunei economy. The government could promote diversification and private sector development through measures such as public-private partnerships (PPPs) and more effective co-ordination and implementation of policies across its own departments and agencies.

Avenues to explore in rebalancing the economy

PPPs could be an appropriate rebalancing tool. The private partner in such an arrangement supplies expertise and productivity, whereas the public side provides financing and is able to skirt the pitfalls raised by bureaucracy. Similarly, a co-ordinating body that represents different government departments or agencies and has the mandate and authority to streamline regulatory procedures, assist implementation and utilise potential synergies across government departments would substantially benefit the development of the private sector.

Brunei Darussalam also needs to improve research and development in a wide range of industries if it is to diversify the economy through internal and external resources other than oil and gas. These would be priority sectors identified by the Brunei Economic Development Board (BEDB) as attractive to foreign direct investment (FDI).

Brunei Darussalam is endowed with raw materials other than oil and gas and is located close to some very large markets within the region which will continue to expand as populations increase. Another potential advantage is that Brunei Darussalam's Islamic culture has established high standards for the production of halal products, which would enable it to take market shares in Muslim markets all over the world.

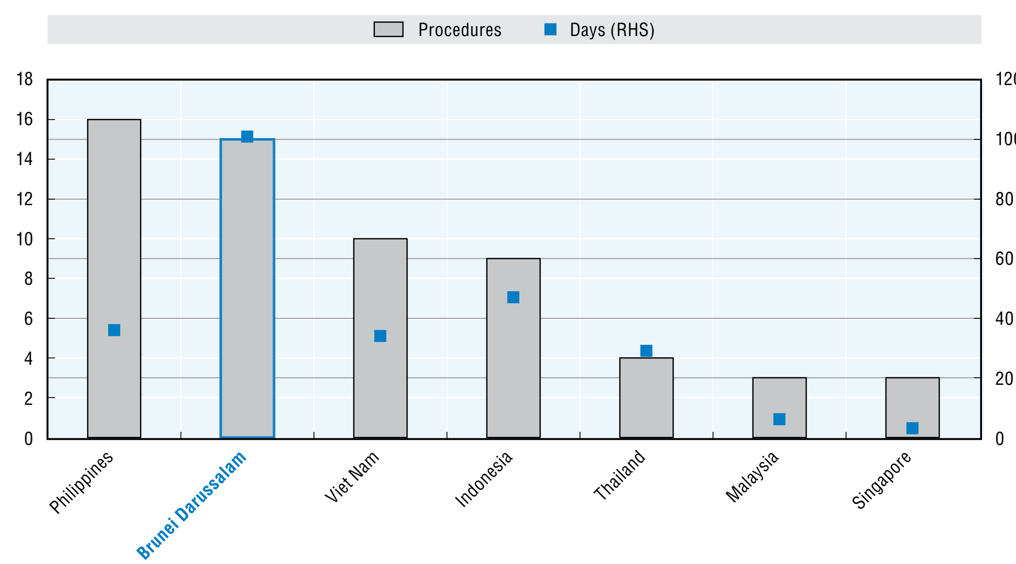
While the business environment has improved, there is room to make it more conducive

A prerequisite condition for private sector development is to promote SMEs through an improved business environment. The World Bank (2013a) ranks Brunei Darussalam 79th out of 185 economies for ease of doing business, while regional peers such as Singapore, Malaysia, and Thailand are ranked far better – 1st, 12th and 18th, respectively.

Nevertheless, Brunei Darussalam has made improvements to its business environment in recent years. These include more efficient company registration procedures, an electronic system for name searches, an electronic customs system, shorter waiting times for excavation permits, a one-stop shop for preconstruction approvals, and reduced corporate income and profit tax rates (World Bank; 2010a, 2012a, and 2013a).

However, Brunei Darussalam still needs to improve performance, particularly when it comes to starting a business and registering property. Both procedures are cumbersome. Starting a business involves 15 different procedures and takes 101 days, while property registration takes 7 procedures and 298 days (Figures 2.1.3 and 2.1.4). Furthermore, even established enterprises find it difficult to expand their operations.

Figure 2.1.3. **Number of procedures and days needed to start a business in Brunei Darussalam and other Southeast Asian countries**



Source: World Bank (2013a) *Doing Business 2013: Smarter Regulations for Small and Medium-Size Enterprises*, World Bank, Washington, DC.

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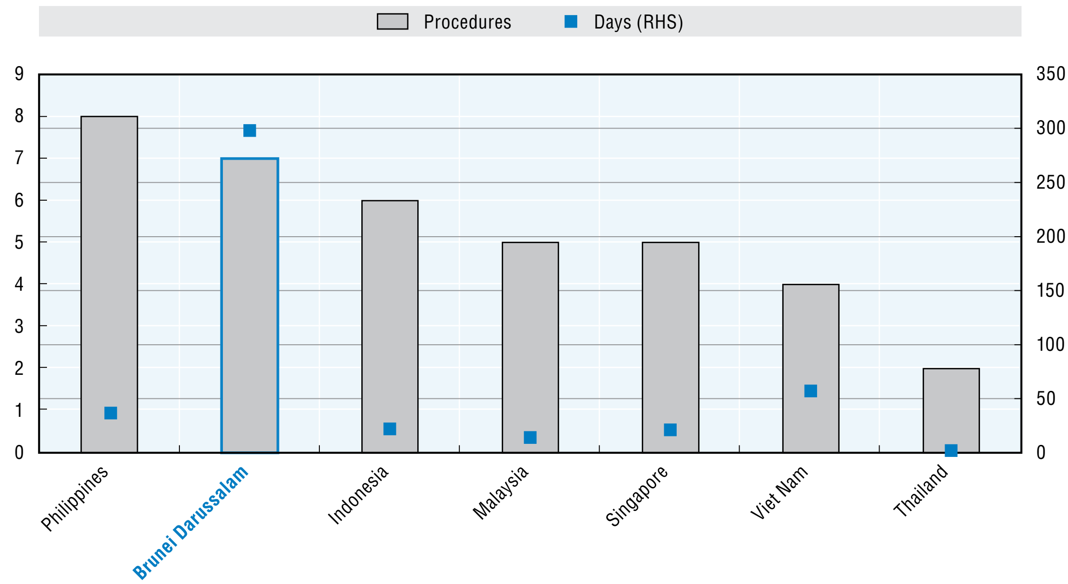
Figure 2.1.4. **Number of procedures and days needed to register a property in Brunei Darussalam and other Southeast Asian countries**



Source: World Bank (2013a) *Doing Business 2013: Smarter Regulations for Small and Medium-Size Enterprises*, World Bank, Washington, DC.

StatLink http://dx.doi.org/10.1787/888932937681

In line with the policy directions outlined in Brunei's long-term development plan, Wawasan Brunei 2035, the country's local business development strategy aims to strengthen the private sector and promote a business-friendly environment. It seeks to improve financing, provide assistance in the form of training to local enterprises and SMEs, and reduce the cost of doing business. The initiatives undertaken by the BEDB and other government ministries and agencies to promote local business development include various grant, subsidy and loan schemes; investment funds; training programmes, and advice and information services (Table 2.1.1).

Despite the various initiatives already in place that are designed to improve financing and provide assistance in the form of training and capacity building, the government needs to step up regulatory reform, particularly to make it easier to set up new businesses. The procedure could be made faster and smoother through online services – e.g. an online one-stop shop for starting up new companies or standard online registration procedures.

Property registration procedures could be improved and made substantially shorter by implementing a more efficient caseload management system for land registries, employing an electronic information management system that would allow different branches of departments to share information, and increasing the number of operating hours or hiring more personnel.

The establishment of a supportive institutional infrastructure in the form of an agency dedicated specifically to the SME sector – such as the SME Corporation in Malaysia and the Office of SME Promotion in Thailand – would boost SME development.

Table 2.1.1. **Local business development initiatives in Brunei Darussalam**

Youth Skills Development Programme (YSDP)	Aims to help young people to start their own micro businesses as well as to increase the pool of young entrepreneurs. Besides a micro grant, the programme also includes motivational seminars, business/job mentoring programmes, and business/job skills enhancement workshops. So far YSDP has helped to start 38 new businesses.
Village Enterprise Financial Grant – "*One Village, One Product"*	A grant scheme to assist in the development and commercialisation of village products to support the 'One Village, One Product' initiative under the Ministry of Home Affairs. The maximum amount of grant that can be allocated is BND 50 000 per recipient village.
Promising Local Enterprise Development Scheme (PLEDS)	Provides support to promising local companies to enhance their competitiveness and expand overseas. This scheme is targeted for established enterprises in a broad range of industries, including oil and gas, transportation and logistics, construction, ICT as well as food manufacturing and processing, through various activities such as financial assistance, competency programmes and market access.
Enterprise Technical Assistance Scheme (ETAS)	A grant scheme to help established local companies that intend to internationalise, strengthen their competencies as well as overcome common market entry cost barriers. It is offered on a cost-sharing principle, where up to 50% of the approved project cost will be funded by the government. The grant is capped at BND 300 000 per recipient company.
Enterprise Expansion Programme (EEP)	Aims to assist SMEs to expand their businesses through increasing their productivity and to groom future promising local enterprises to export and expand overseas. The maximum amount of loan per business that can be allocated under the EEP is BND 15 000.
Loan schemes by the Ministry of Industry and Primary Resources (MIPR)	The Microcredit Financing Scheme (MFS) assists local entrepreneurs to start and expand small scale business activities. The maximum loan amount per company or enterprise is BND 50 000. The Enterprise Facilitation Scheme (EFS) aims to help SMEs to expand and develop their business activities and build their capacity to export. The maximum amount allocated per recipient company is BND 5 million. The Export Refinancing Scheme (ERS) provides registered and certified exporters with short-term financing. The maximum amount allocated per recipient company is within the range of BND 50 000 and 500 000.
Standards and Quality Certification Programme	The programme is administered by the National Standard Centre under the Ministry of Industry and Primary Resources (MIPR) and aims to ensure that products manufactured comply with required standards needed for export and are safe for use or consumption.
Promotion and marketing services	Under the guidance of the MIPR, local products are promoted both domestically and in overseas markets through the participation of SMEs in various exhibitions, seminars or trade missions, with a view to support the development of exportable local products.
ICT Competency Programme	Administered by the Authority for Info-Communications Technology Industry of Brunei Darussalam (AITI), the programme offers subsidised training courses to train local citizens in relevant ICT skills and knowledge, with the objective of empowering the non-ICT job seekers with basic IT literacy and upgrading SMEs' employees' qualifications with professional ICT certifications.
Training and Employment Scheme (SLP)	Administered by the Jabatan Perancangan dan Kemajuan Ekonomi (JPKE) (Department of Economic Planning and Development of the Prime Minister's Office), the SLP is a grant scheme that helps companies defray the training costs of employees that have limited skills and experience as well as to help them to retain workers.
Opportunity Centre	Planned to be a one-stop business concierge service located in the third phase of the Anggerek Desa Technology Park with the objective of assisting SMEs in the business start up processes, providing legal advise and business information. The aim is to help improve the ease of doing business in Brunei through the provision of business-related services and the improvement of the regulatory environment for businesses in collaboration with relevant government agencies and stakeholders.

Source: Brunei Economic Development Board (BEDB), www.bedb.com.bn/bisop_devlocalbusiness.html and www.bedb.com.bn/documents/sme/BEDB.SME.Guide.Book(2012).pdf.

POLICY FOCUS

Legislate and implement competition policy

Brunei should also foster greater business competition

A condition that is essential to developing the private sector and improving productivity is increased competition. That requires sound and comprehensive competition policy and law. Stronger competition in Brunei Darussalam would lead to productivity gains and help in diversifying the hydrocarbon-dependent economy.

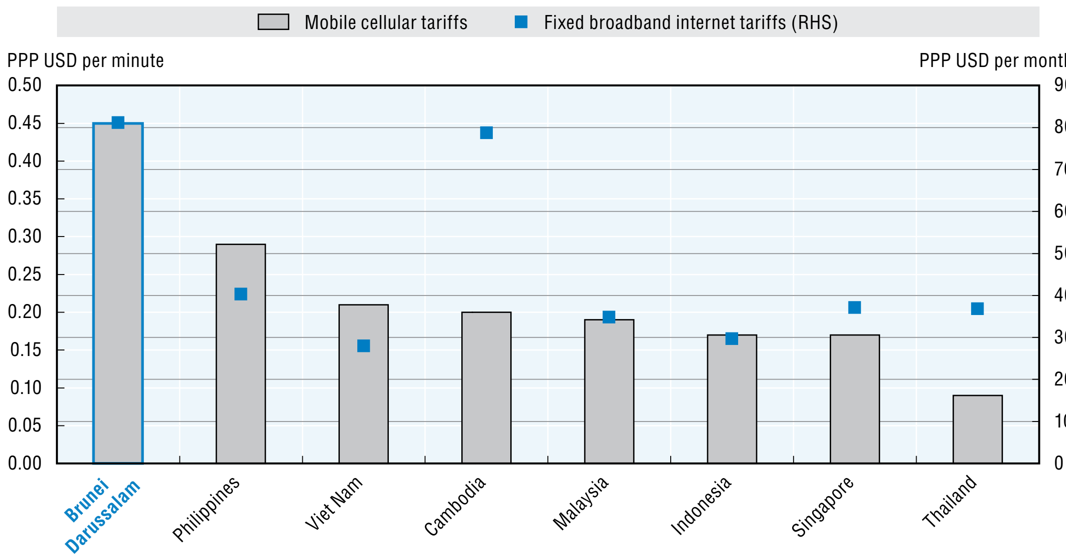
Furthermore, as a member of ASEAN, Brunei needs to further foster competition, as the ASEAN Economic Community (AEC) Blueprint stipulates the creation of a national competition policy and law by 2015.

The current level of business competition in Brunei Darussalam needs to be improved – compared to other Southeast Asian countries. According to the World Economic Forum's *Global Competitiveness Report 2012-2013* (WEF 2012a), it is weaker than in Malaysia, Singapore, the Philippines, Thailand and Viet Nam.

Notably, Brunei should foster greater competition in key sectors, including banking and telecommunications. According to the World Bank's Global Financial Development database, competition in the banking sector has been less vigorous in Brunei than in the more developed Southeast Asian countries.

Brunei also lags behind in the telecommunications sector. Its tariff rates for telecommunications services are the highest in Southeast Asia. According to the *Global Information Technology Report 2013*, mobile cellular and fixed broadband internet tariffs are particularly expensive in Brunei at around USD 0.45 a minute for mobile cellular calls and USD 81.2 per month for wired broadband Internet services. By contrast, the rates in Thailand are respectively just USD 0.09 and USD 36.8 (Figure 2.1.5) (INSEAD/WEF 2013).

Figure 2.1.5. **Competition in the ICT sector in Brunei Darussalam and other Southeast Asian countries**



Notes: Mobile cellular tariffs are measured as the average per-minute cost of different types of mobile cellular calls in PPP USD. Fixed broadband internet tariffs are measured as the monthly subscription charge for fixed (wired) broadband internet service in PPP USD.

Source: INSEAD and WEF (2013), *The Global Information Technology Report 2013 – Growth and Jobs in a Hyperconnected World*, Edited by Beñat Bilbao-Osorio, Soumitra Dutta and Bruno Lanvin, World Economic Forum, Geneva.

StatLink http://dx.doi.org/10.1787/888932937700

Brunei needs an economy-wide competition policy

A comprehensive and economy-wide competition policy and law has not yet been implemented in Brunei Darussalam. While most Southeast Asian countries – including Indonesia, Malaysia, Singapore, Thailand and Viet Nam – already have extensive competition laws and authorities in place, Brunei is still at an early stage. The only competition-related law it has is the Monopolies Act (Chapter 73 of the Laws of Brunei) which has not been amended since it was passed in 1932 and is too outdated for effective use.

With no effective competition-related law, Brunei Darussalam implements its competition policy objectives by regularly reviewing the regulatory framework of each sector with the aim of boosting competition. At present, Brunei's most advanced competition-related regulatory framework is in the telecommunications sector and comes under the mandate of the Authority for Info-communications Technology Industry (AITI).

The AITI, which was established in 2003 and given regulatory authority in 2006, is responsible for regulating the ICT industry, managing the national radio-frequency spectrum, and developing the ICT industry. Prior to 2006, the Telecommunications Department of the Ministry of Communications performed the dual functions of regulator and service provider. The AITI's authority applies to all commercial entities with a licence to operate as a service or infrastructure provider in the telecommunications industry. It is also mandated to promote competitiveness in the telecommunications and broadcasting industries. It plans, for example, to address the issue of high tariffs by introducing a tariff regulation framework by the third quarter of 2013.

Competition and consumer protection policies can be better co-ordinated

Consumer protection, which complements competition policy, received a boost from the Consumer Protection (Fair Trading) Order 2011 that came into effect in 2012. The Order is implemented by the Department of Economic Planning and Development of the Prime Minister's Office and is intended to protect consumer interests against any unfair practices by suppliers. Although it applies to all consumers or suppliers residing or conducting transactions in the country, its reach and efficiency are limited by the lack of public awareness that it actually exists.

It is important that consumer protection policy should be properly incorporated into Brunei's future competition policy and co-ordinated with it. In terms of institutional design, competition and consumer policies could be entrusted to a single agency or kept separate. Either arrangement could work, but proper co-ordination between the two policies would be needed. One way to ensure efficient co-ordination could be a central commission within government which would have advisory powers and be made up of representatives of each responsible agency. Alternatively, a co-operation agreement between competition authorities and consumer agencies ensuring that they consult each other and share information could fit the bill (Box 2.1.1.).

As Brunei is currently only at the stage of designing its competition policy and law, it may be correctly inferred that competition culture is not fully developed in the country. A strong culture of competition is an important factor, for it affects the degree of compliance with competition laws. Companies and individuals that operate in environments where the value of competition is widely understood and appreciated are more likely to comply. One way to foster a culture of competition would be to promote and introduce effective compliance programmes in companies with the aim of ensuring ethical conduct and a commitment to compliance. Such programmes should incorporate monitoring, audits and mechanisms for anonymous and/or confidential reporting of violations (OECD, 2011a).

Brunei's future competition policy needs to be shaped in such a way that the competition authority has adequate resources, political support and independence to act effectively. It is also important that the authority deals with incumbent firms, including state-owned enterprises, with the same rigour as it would with any other company that hindered competition. Close co-operation between the competition authority and other domestic agencies and international bodies is crucial to evaluating the impact of competition policies and to addressing the fairness of international trading issues such as cross-border mergers and acquisitions (OECD, 2006a).

As it designs the competition law, Brunei should take care not to place an excessive regulatory burden on businesses. And while the authorities' main objective should be to create and implement a comprehensive policy and law, they should also continue to review, and if necessary amend, current sector-based regulations until the new law has been enacted.

Box 2.1.1. **Integrating competition and consumer policy: Examples from OECD countries**

Both competition and consumer policies aim to enhance consumer welfare. As such they are highly complementary and, if well designed, integrated and co-ordinated, they reinforce one another. However, the differences between them – such as the more diverse nature and dispersed enforcement of consumer policy or the blunter tools used in competition policy – can make co-ordination and integration difficult to achieve.

In terms of institutional design, there are examples from OECD countries of a single agency directing both policies (e.g. **Australia** and **Poland**) and of a separate authority for each one (e.g. **Chile** and the **Slovak Republic**).

Housing competition and consumer policies under the same roof offers several advantages, including more centralised control, operational efficiencies and cross-fertilisation. However, there can also be drawbacks, such as potential competition for resources and the issue of effective communication with the public. Irrespective of institutional design, there is always room for proper co-ordination, as in the example (suggested above) of a single central commission made up of competition policy and consumer protection officers.

In **Australia**, while a single government body deals with competition and consumer policy arrangements, development and enforcement are separated. National policy development is steered by the Minister for Competition Policy and Consumer Affairs and the Department of the Treasury (Treasury), while enforcement is the responsibility of the Australian Competition and Consumer Commission (ACCC). The policy-making capability of the Minister for Competition Policy and Consumer Affairs, which operates within the Treasury, is split into three streams: competition policy, economic regulation of infrastructure and consumer policy. The ACCC is an independent statutory commission responsible to Parliament and, has the mandate to enforce competition and consumer law, while also advising ministers on enforcement issues. There are also agencies that regulate sectors, like the Australian Securities and Investments Commission, the Australian Communications and Media Authority, and the Australian Energy Regulator. All work closely with the ACCC.

Box 2.1.1. (contd.)

In **Poland**, antitrust and consumer protection policies come together in the Office of Competition and Consumer Protection (OCCP). The largely positive experience of the OCCP shows that single-agency management of competition and consumer policies brings numerous benefits. These include highly co-ordinated enforcement activities, synergy in policies' wider impacts, substantial reduction of costs generated through joint administration, and the mutual transfer of proven solutions.

Chile has two separate agencies for competition and consumer policies. The Fiscalía Nacional Económica (FNE) enforces competition law, while the Servicio Nacional del Consumidor (SERNAC) is in charge of consumer protection. As the FNE and the SERNAC are aware of the synergies that they can generate, they aim to harmonise their strategies in cases where both are involved. They also work to develop good communication practices – by carrying out joint initiatives, for instance. Overall, the experience of Chile is a good example of a strong relationship between competition and consumer policies.

The experience of **Slovakia**, where competition and consumer protection are the jobs of two separate authorities, illustrates what happens when they fail to co-operate closely. Competition and consumer protection policies are separated institutionally and legislatively in the Slovak Republic. The Antimonopoly Office enforces competition law, whereas the direction and enforcement of consumer policy is fragmented through many independent legislations and institutions. Although the main competencies in the area of consumer protection lie with the Ministry of Economy (which co-ordinates the activities of all institutions in this area), policy implementation is scattered across many agencies, of which the Slovak Trade Inspection is just one.

Source: OECD (2010a), "The Interface between Competition and Consumer Policies", *OECD Journal: Competition Law and Policy*, Vol. 11/1., OECD Publishing, Paris.

POLICY FOCUS

Improve tertiary education attainment

The education system has been reformed steadily in recent years

The long-term development vision for Brunei, set out in Wawasan Brunei 2035, makes education and human capital development key priorities. To date, thanks to revenue from its abundant mineral wealth, the government has provided generous education services to all. The literacy rate, for instance, is over 95%, and the gross enrolment rates both at primary and secondary levels are over 100% (Figure 2.1.6).

The education system has been reformed steadily in recent years in line with the National Education System for the 21st Century (SPN21). SPN21 aims to foster the ability of students to meet the social and economic needs and challenges of the 21st century and to think for themselves as part of a student-oriented syllabus. Since the introduction of SPN21 in 2009, mathematics, science and English have been targeted as the key subjects in the primary and secondary school curricula. The scheme also promotes the use of ICT in schools through one-to-one computing in model schools, for example. initiatives implemented as part of SPN21 include new monitoring systems and teaching methods, literacy and numeracy programmes, teacher training and education infrastructure development programmes (Table 2.1.2.)

Table 2.1.2. **Initiatives under the National Education System for the 21st Century (SPN21) in Brunei Darussalam**

Lesson Study	A Teacher Professional Development Model adopted based on the example of Japan, where groups of teachers work collaboratively and continuously in preparing, implementing, monitoring and reporting the outcome of learning based on selected themes.
Literacy Programme for Primary Schools (Malay and English)	A systematic literacy programme for primary schools focusing on the four literacy skills – listening, speaking, reading and writing – as major components to be taught in a systematic way starting from the preschool level.
Inquiry-Based Science Education (IBSE)	A teaching tool adopted from France whereby students are exposed to an inquisitive teaching and learning environment with the purpose of cultivating curiosity, stimulating creativity and critical thinking. Among other features, the approach involves trial scientific studies that give students the opportunity to have a discussion and at the same time allows them to improve their language skills.
Numeracy programmes	Includes two programmes, Active Mathematics in Classroom (AMIC) and Primary Numeracy Initiatives In-Service Training (PNI-INSET). Theset focus on providing professional development courses to teachers to help them to develop mathematical skills necessary for teaching and learning mathematics in school.
School Based Assessment for Learning (SBAfL)	An assessment tool for obtaining feedback on individual student's development and performance in the four important domains highlighted in SPN21 – Knowledge through Understanding, Skills, Values and Attitude. The feedbacks are gathered through teacher, peer and self-assessment.
Edexcel BTEC Programme	Aims to provide opportunities for students who show more interest in hands-on and concrete learning.
Teacher training programmes	The Teacher Service Scheme (Skim Perkhidmatan Guru) and the School Leadership Programme (SLP) are aimed at expanding the capacity of teachers and school leaders, respectively.
Building Improvement of Schools and Infrastructures (BISAI)	This initiative focuses on strengthening the quality of education services through improving and maintaining school infrastructure.

Source: Ministry of Education, *Strategic Plan 2012-2017.*

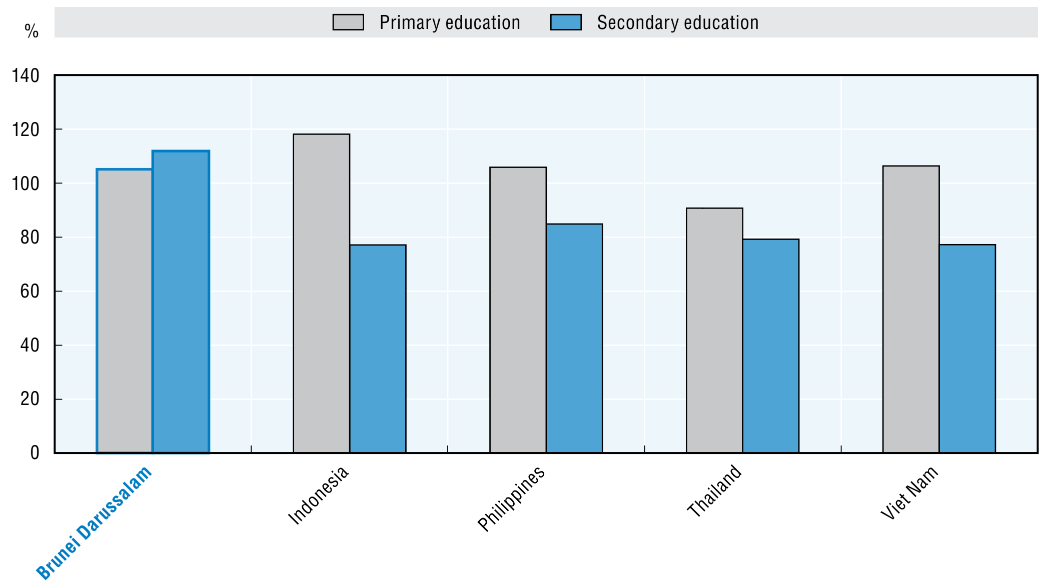
Addressing economic imbalances could also help to enhance the tertiary education level

However, despite the achievements of basic education in Brunei, the tertiary education attainment level is very low. As Figure 2.1.7 shows, the gross enrolment rate is only 19.6%, considerably below those in other Southeast Asian countries, such as Malaysia (42%) and Thailand (48%). Male enrolment, in particular, is among the lowest in the region – even lower than Cambodia and Lao PDR. There is thus a widening gender gap, to compound the poor overall enrolment rate.

The low tertiary enrolment rates stem from the imbalances of the economy and their effects on the labour market. On the demand side, there are not enough jobs on offer owing to the dominance of the two major employers, namely the public sector and the oil and gas sector. While the private sector cannot attract skilled labour because it cannot compete with the high wages offered by the big players, the public sector and the oil and gas industry do not create enough jobs. Hence, diversifying the economy and further development of the private sector could help to improve the tertiary education attainment level.

Figure 2.1.6. **Gross school enrolment rates at primary and secondary levels in Brunei Darussalam and other Southeast Asian countries**

2011 or latest year available

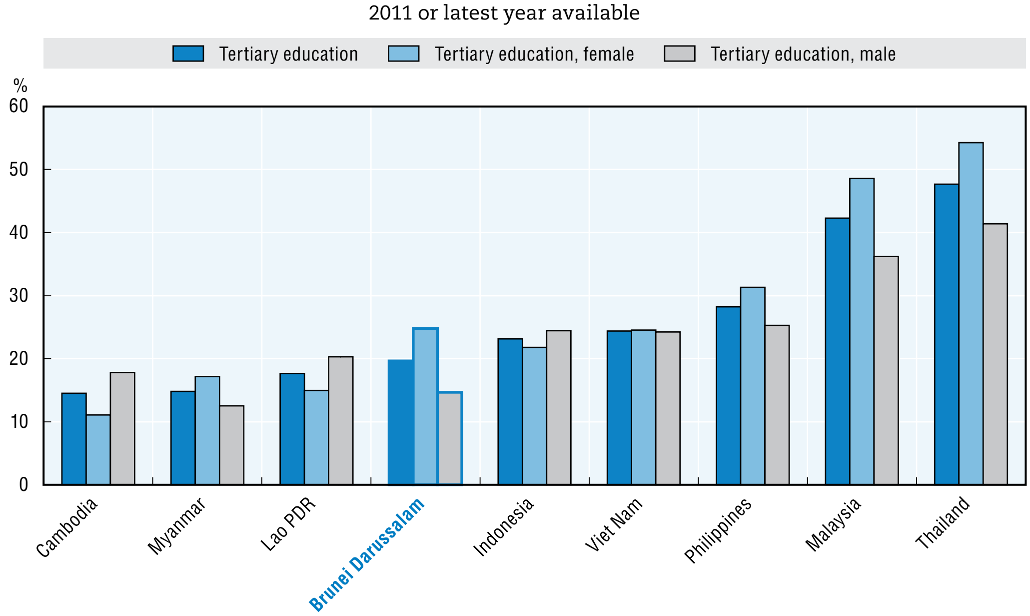


Source: UNESCO (2013), *UNESCO Institute for Statistics Data Centre* (database), United Nations Educational, Scientifi and Cultural Organization, http://stats.uis.unesco.org.

StatLink http://dx.doi.org/10.1787/888932937719

Figure 2.1.7. **Gross school enrolment rates at tertiary level in Brunei Darussalam and other Southeast Asian countries, by gender**

2011 or latest year available

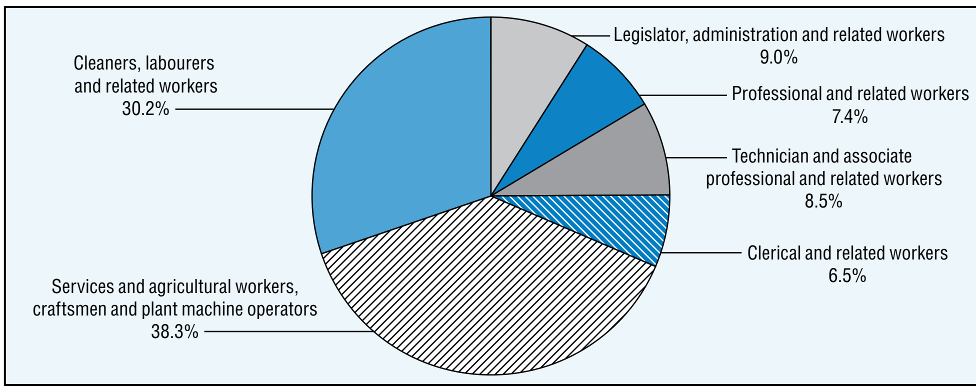


Source: UNESCO (2013), *UNESCO Institute for Statistics Data Centre* (database), United Nations Educational, Scientific and Cultural Organization, http://stats.uis.unesco.org.

StatLink http://dx.doi.org/10.1787/888932937738

As mentioned in Wawasan Brunei 2035, the country's main employer – the public sector – can no longer absorb the growing labour force and the hydrocarbon sector employs less than 3% of the workforce, anyway. And, since the private sector is limited, it is difficult to create sufficient employment opportunities that require university education. Workers at those levels – namely legislators, professionals and administrative workers – account for only around 16% of total private sector employment (Figure 2.1.8), which is well below the levels observed in Malaysia, Singapore or the Philippines.

Figure 2.1.8. **Employment in the private sector in Brunei Darussalam, by type of occupation, 2009**



Source: CEIC.

StatLink http://dx.doi.org/10.1787/888932937757

Could private sector development spark interest in higher education?

On the supply side of the labour market, the same economic imbalances lead to the prevalence of safe government jobs with high wages and generous subsidies. The existence of such jobs blunts the incentive for students to make the effort to go on to tertiary education. Despite the growing number of scholarships available, the percentage of students who pass the final exam at secondary level remains relatively low, which points to a lack of interest in moving on to university. Similarly, evidence that the reservation wage of local job seekers is above the market salary for the jobs for which they are qualified is a further indication that the existence of government jobs robs them of incentive (Razak, 2010).

Tertiary enrolment rates could also be improved by making higher education more appealing. There could be a wider choice of courses and a part-time learning provision with people of all ages in mind. Furthermore, the expansion of vocational and technical schools would be a welcome step as it would provide an alternative to academic paths.

Public spending on university education should be also increased as part of the effort to improve enrolment rates in tertiary education. Public expenditure on education was only 3.3% of GDP in 2012, well below the ratios of 5% and over in Malaysia, Thailand and Viet Nam. Although public expenditure as a percentage of overall government expenditure has been rising, it also remains low at 16.9% when compared to Malaysia, Thailand and Viet Nam. Clearly, there is room to increase overall spending on education and to reallocate resources to tertiary education.

Cambodia

A. Medium-term economic outlook (Forecast, 2014-18 average)

GDP growth (percentage change):	6.8
Current account balance (% of GDP):	-7.4

B. Medium-term plan

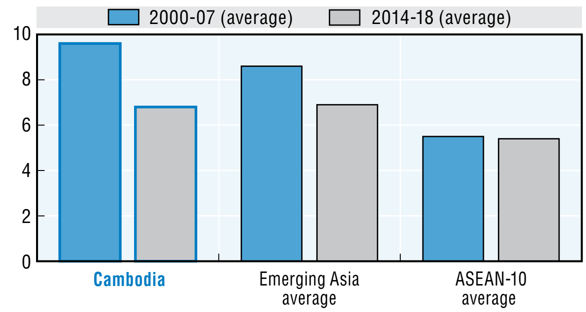
Period:	2009-13
Theme:	Growth, employment, equity and efficiency

C. Basic data (in 2012)

Total population:	15 million*
Population of Phnom Penh	1.3 million (in 2008)
GDP per capita at PPP:	2 402 (current USD)**

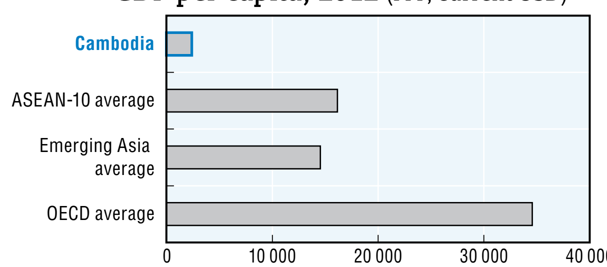
Note: * Total population data for 2012 are estimates.
** IMF estimate
Sources: OECD Development Centre, national sources and IMF.

GDP growth rates (Percentage change)



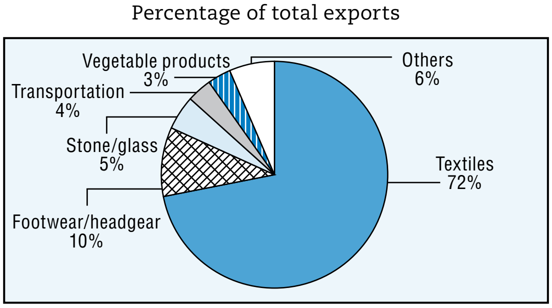
Source: OECD Development Centre, MPF-2014.

GDP per capita, 2012 (PPP, current USD)



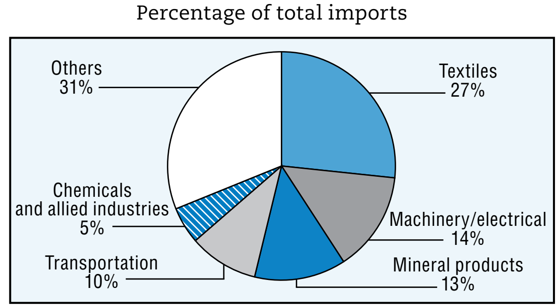
Source: IMF and national sources.

Composition of exports, 2012
Percentage of total exports



Source: Trademap.

Composition of imports, 2012
Percentage of total imports



Source: Trademap.

Over the past decade, Cambodia's economic development has been fast paced. To keep growth sustainable and strong, there are three priority areas on which the government should focus in the medium term.

First, it needs to further promote agricultural and rice production. In fact, it has introduced a new system of rice intensification (SRI) to improve the productivity of ricefield irrigation and taken measures to diversify the agricultural sector. The second priority is to further develop the prudential and supervisory framework of the financial sector to ensure financial stability in a context of fast credit growth. Finally, it must further promote the tourism sector by increasing the number of destinations it offers and improve infrastructure to ensure sustainable growth in the sector.

Cambodia's medium-term policy challenges and responses

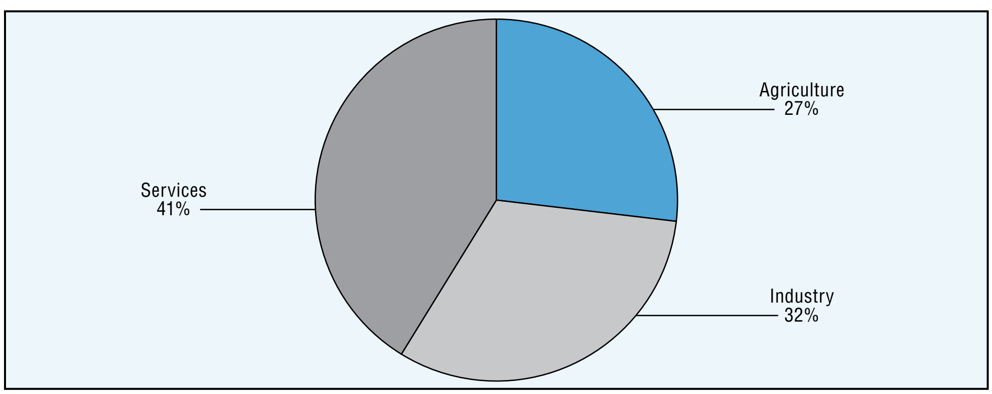
- Improve productivity of agriculture, in particular rice production
- Improve the prudential and supervisory framework for the financial sector
- Develop tourism-specific infrastructure

POLICY FOCUS

Improve productivity of agriculture, in particular rice production

The Cambodian economy performed well in 2012 and the outlook continues to be positive in 2013. The economy grew 7.3% against a backdrop of low inflation (2.2%). The services sector is the biggest contributor to GDP, accounting for 41% of total GDP, followed by industry at 32%, and agriculture with 27%. However, agriculture continues to make a rising contribution to the growth of the Cambodian economy. The sector grew 4.3% in 2012 and accounted for 4.75 million workers out of a labour force of 8 million in 2011.

Figure 2.2.1. **Cambodia's GDP, by sector, 2012**



Source: Government of Cambodia.

StatLink http://dx.doi.org/10.1787/888932937776

Diversification in production is needed to keep economic growth sustainable

Since the economy relies heavily on the labour-intensive agriculture and textile sectors, it needs to diversify to lessen the risks arising from external shocks and to enable the economy to play a more active part in regional supply chain networks. The government is committed to diversification, as it has demonstrated in its recent agricultural policy measures.

Cambodia is putting considerable effort into diversifying its agricultural sector. In addition to rice production, which reached almost 9 million tonnes in 2012 and makes such a major contribution to output growth, it is also now farming rubber, corn, cashew nuts and cassava. Rubber is the second largest commodity crop after rice in Cambodia and the production of rubber latex is expected to reach 300 000 tonnes by 2020. Corn production rose to 770 860 tonnes, cashew nuts to 60 000, and cassava to 6.86 million in 2012. Overall, production of these commodity crops increased 4.9%, while ricefield fisheries grew 6.7%. Rice exports increased by around 28% to reach USD 136 million. The contribution of agricultural exports toward total export growth, however, remains small.

As well as diversifying its agricultural sector, Cambodia has also been putting greater emphasis on productivity and promoting economies of scale in the sector. As part of its 2009-13 Master Plan, it has switched from expanding the area of land under cultivation to intensive farming. This strategy involves improving technology, widening the provision of agricultural services to rural areas, setting up community networks of volunteers and partnerships among agricultural industry players, promoting multi-farming activities, and making the investment environment more attractive.

Food security and agricultural productivity are the most important issues

Like other ASEAN member states, Cambodia is becoming increasingly aware of the issue of food security which has come to the fore as a result of commodity price volatility in the uncertain economic climate. Cambodia's response has been to adopt the SRI[1] to enhance productivity. The Centre for Studies and Development of Cambodian Agriculture (CEDAC) first experimented with the SRI in 1999. Its successful trials secured government approval. The Ministry of Agriculture, Forestry and Fisheries (MAFF) set up a national SRI Secretariat in 2004 before officially endorsing the system in 2005 and incorporating it into the National Strategic Development Plan (NSDP) for 2006-10. It also revised SRI for inclusion in the NSDP for 2009-13.

As already stated, rice is Cambodia's most important agricultural product, contributing about 10% to GDP. Although Cambodian rice exports accounted for less than 1% of global rice exports in 2011, it grew 17% over the past three years against a backdrop of higher overall local production and improving yield. Under its Development Master Plan, Cambodia has put rice at the heart of its agricultural improvement efforts. The result has been increased rice production and more efficient paddy rice harvesting and processing, logistics and marketing. The SRI, too, has played a key role in improving productivity.

Sustainable rice cluster method to enhance productivity

To sustain the growth of rice production, the government has devised and implemented a programme that uses the sustainable rice cluster (SRC) method. SRC has increased rice cultivation by some 40% over conventional methods. Essentially, it is an improved, environmentally friendly irrigation and farming method that does not use chemicals. The idea is to phase in organic rice farming so as to ensure sustainable growth. SRC is in its early stages and still being developed since Cambodia remains a factor-driven economy. SRC capitalises on the abundance of low-cost labour and arable land that has not been subjected to intensive use of chemical fertilisers. At the same time, the use of SRI has benefitted poor farmers who have no access to funding and cannot afford fertilisers. The SRI has cut the cost of rice cultivation and delivered yields that are nearly 100% higher than those of conventional methods.

Table 2.2.1. **The advantages of sustainable rice farming in Cambodia compared to other key rice-producing Southeast Asian countries – Viet Nam, Thailand, the Philippines and Indonesia**

Create	SRI Irrigation and integrated pest management (IPM) Practice	Use 70% less water than conventional rice farming. IPM alongside reduces pesticide/fertiliser/ fungicide loads
	Contract Farming Initiative	Provide farmers guaranteed buyers
	Adopting farming innovation faster (synergies with eco-tourism and fair trade in garments)	Adopt seed varieties, irrigation systems and natural compost practices which drive yields close to conventional rice farming
Inherit	Large amount of arable wetland available for cultivation	Reduce cost of conversion to sustainable agriculture (SA) which is prohibitive in other regions
	Relatively large pool of agricultural labour	Reduce cost of production
	Historically low level of chemical inputs (lack of availability although now using some toxic fertilisers)	Reduce cost of cleaning and shorten adoption cycle of certification

Source: Bedi, A., GCA Paderaga and H.S. Vath (2012), *Sustainable Rice Cluster in Cambodia*, Project for PP5279: Clusters and National Competitiveness, Lee Kuan Yew School of Public Policy.

If SRC is to reap success in Cambodia, the government must improve poor farmers' access to markets. It is crucial that smallholders should be able to sell their produce on key export markets. They stand to gain, in this respect, through the contract farming programme for growing sustainable rice, which helps generate greater economies of scale. Contract farming is an organised institutional arrangement between farmers and contractors that benefits smallholders by opening up new markets for them, providing them with equipment, and lending them technological and financial support. At the same time, it reduces the costs and risks associated with selling rice harvests and offsets the uncertainties associated with timing, pricing, and quality standards. The government also promotes contract farming for small farmers as part of the sustainable rice value chain.

The practice of contract farming has evolved over the last 15 years in Cambodia, shaping the country's agricultural community which has organised into farming co-operatives and commune associations. Organic farmers are no exception. In 2008, over 7 800 of them became members of co-operatives or commune associations and today that number may have swollen to 130 000, all practising SRI farming. Local demand condition for sustainable rice scheme has steadily increased as more farmers have adopted SRI.

A particularly important measure would be to create a niche market for the sustainable rice-growing scheme. Branding would help improve the competitiveness of Cambodia's organic rice against other regional signature products like jasmine rice from Thailand and Indian basmati rice.

Finally, collective action and knowledge-based farming to improve labour productivity in rice farming and SRC is crucial. This will not only improve farmers' understanding of sustainable farming and productivity, it will also increase their bargaining power both in domestic and regional markets.

Land reform to improve the lot of farmers an important goal in the NSDP

Statistically, Cambodia covers a surface area of 18.1 million hectares, of which 2.7 million hectares are cultivated land and 1 million are taken up by urban areas, towns, infrastructure and waterways. Agricultural concessions cover 800 000 hectares, landmine-contaminated areas 100 000 hectares, and protected forestland 1.5 million.

To support landless farmers, the government has included a land reform agenda in its National Strategic Development Master Plan 2009-13. Reform focuses on strengthening land management, distribution and use. In the agricultural sector, the main thrust is to ensure access to land resources, ownership, and security for poor rural farmers and the effective socio-economic development of land markets. Reform also seeks to promote agricultural industrialisation by freeing up land and to make it available for commercial purposes by clearing it of mines.

The Economic Land Concession (ELC) scheme is an important land reform measure that is designed to develop intensive agricultural and industrial-agricultural activities. Its objectives include achieving a set of agreements on land development; increasing employment in rural areas through intensive farming, the diversification of livelihood opportunities, and natural resource management; and generating government revenues at provincial, communal, and state levels through taxation and related service fees.

ELC has, however, come in for criticism as just a way of selling off land. The government must ensure that ELC is implemented transparently and that land concessions are granted and managed within a sound legal and policy framework.

To pave the way for the completion of land reform, the government should speed up related preparatory measures like mapping and registration – particularly of indigenous community land in line with policies for the development of indigenous peoples. Indeed, it is critical that land is equitably and properly distributed to all landless farmers.

In April 2013, the government released a new draft of its public policy guidelines for the country's contentious land sector. It contains new laws and guidance on how to facilitate the use and management of land and natural resources for socio-economic development in efforts to move toward equitable and sustainable growth.

POLICY FOCUS

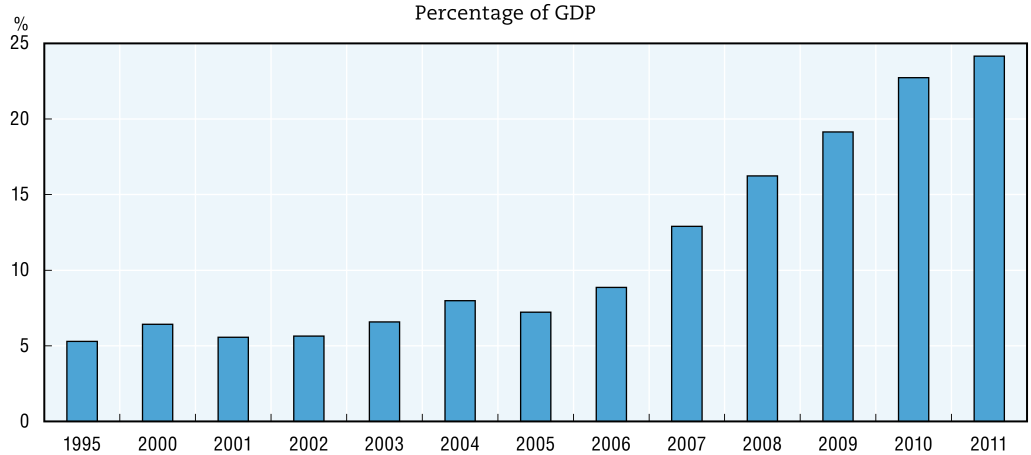
Improve the prudential and supervisory framework for the financial sector

Fast credit growth raises supervisory and regulatory challenges

Credit growth in Cambodia has continued to surge on the back of excess liquidity from domestic savings, external financing and increased financial needs. Owing to the Cambodian economy's consistently high growth, the current growth in domestic credit to private sector is fuelling concerns over loan quality. Compared to its regional neighbours at the same stage of development, the economy has witnessed high, rapid growth in credit to private sector – in 2012, credit grew 34.2%, up from 31.6% the previous year. Since 2005, domestic credit provided by the banking sector has increased rapidly, while the lending rate has consistently declined and the savings rate has remained steady since 1995 (Figures 2.2.2 and 2.2.3).

Figure 2.2.2. **Domestic credit provided by the banking sector in Cambodia, 1995-2011**

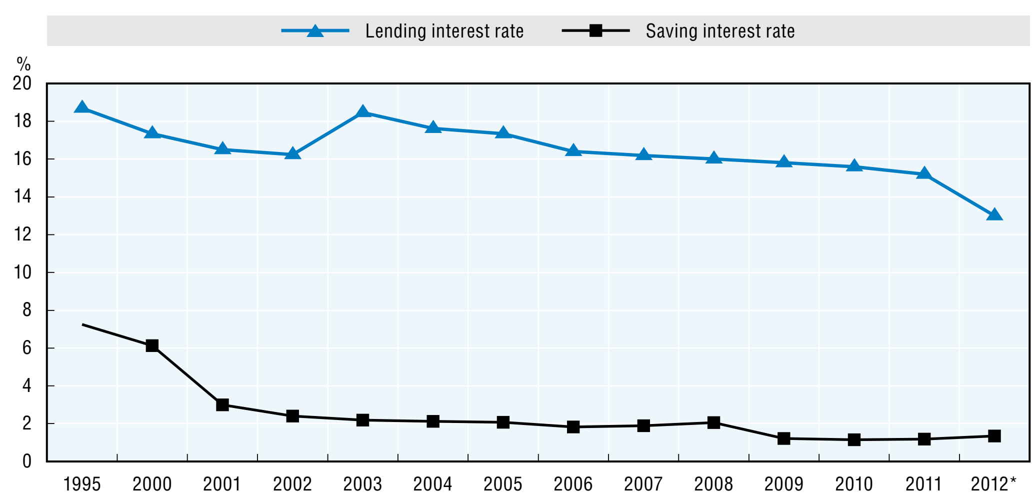
Percentage of GDP



Source: Government of Cambodia.

StatLink http://dx.doi.org/10.1787/888932937795

Figure 2.2.3. **Average annual lending and saving interest rates in Cambodia, 1995-2012**



Source: Economist Intelligence Unit (2013),"China economy: Fiscal challenges mount", *The Economist Intelligence Unit*, 13 May.

StatLink http://dx.doi.org/10.1787/888932937814

Given the strong private demand for financing and fiercer competition among domestic banks, credit growth is expected to maintain its momentum this year. There are rising concerns over faster credit growth prompted by rising bank deposits, declining lending rates, and growing risks from the lower credit underwriting standards that arise from the constraints on bank management capacity. Adequate prudential regulations and supervisions are required to monitor and control rising household indebtedness and prevent financial sector risks like bubbles and increases in non-performing loans. Other concerns are the rise in the external debt of the banking sector and foreign lending activities.

In response to such policy challenges, the National Bank of Cambodia (NBC) tightened its monetary policy with a hike in reserve requirements to 12% in foreign currency and 8% in local currency deposits. In October 2012, the NBC again raised the reserve requirement to 12.5%.

Cambodia has also gradually implemented other supporting initiatives as the banking sector has expanded. It has, for example, put in place a credit bureau to help banks and microfinance institutions (MFIs) improve risk management and credit allocation practices by sharing credit information. In December 2012, the National Clearing System was also introduced to facilitate inter-bank electronic payments and single-day check clearance across all banks.

Nonetheless, weak external demand has made the government reluctant to tighten monetary policy much more in 2013. Most important is to stabilise the financial sector and prepare the economy for further global uncertainty. The government should therefore consider employing more macroprudential tools such as higher capital requirements and lending ratios.

The goal of Financial Sector Development Strategy (FSDS) 2011-20 is financial sector development which, by supporting economic growth and affording the poor greater access to financial services, can help reduce poverty. There are two main thrusts to FSDS 2011-20. One is to upgrade the legal and co-operation frameworks that govern the finance and banking sector in order to avoid inconsistencies and overlaps and adjust to international standards. The other is to ensure crisis preparedness in the event of global financial turmoil. Cambodia needs an early warning system and stable financial market to counter any internal or external disruption to its financial sector. In response, FSDS 2011-20 focuses on ensuring close co-operation between the banking and other sectors in order to build effective joint supervision and surveillance, combat money laundering and the funding of terrorism, and improve governance.

Dollarisation still poses risks to the financial system

Foreign currency continues to be used nationwide in Cambodia. The United States dollar (USD) is still a much favoured medium of exchange, store of value, and unit of account in Cambodia. The local currency – the Cambodia riel (KHK) – is typically used for rural trade in agricultural goods, as well as for the payment of tax and public utility bills. Over 95% of bank deposits are denominated in US dollars as are most deposits in the central bank, while there continues to be a lack of demand for the riel. The considerable inflows of US dollars that started in the early 1990s in the form of foreign funding aid, foreign assistance, and FDI totalled more than USD 2 billion by 2009.

A high degree of dollarisation can limit the flexibility of exchange rate policy in the event of external shocks. Equally, it could restrict the NBC's ability to manage the money supply in the economy and hamper the development of domestic interbank market. Cambodia uses foreign currencies principally because of constraints related to macroeconomic stability and the level of development of the country's financial, banking and monetary system. To encourage greater use of the riel, the confidence of Cambodians and investors in the country's economy and currency needs to be built. To that end, the government should consider market-based policies to ensure a stable macroeconomic environment. It should also have in place an appropriate policy for holding the exchange rate stable and further develop the money market to reduce risks associated with the dollarisation of credit to the non-tradeable sector. Moreover, a sound financial policy and prudential regulations could help boost intermediation with the riel. Currently, the NBC is pursuing its practice of managing a floating exchange rate along with promoting the use of national currency through its KHR-denominated certificates of deposit.

POLICY FOCUS

Develop tourism-specific infrastructure

International tourism has made, and is making, a growing contribution to Cambodia's GDP growth. The sector has expanded considerably over the past five years, with the number of foreign arrivals climbing from 2.1 million in 2008 to 3.6 million in 2012 and generating total revenues of some USD 2.2 billion. In 2013, the expansion has continued. The number of visitors was up by 15.4% in January over the previous year and in February by 19.8%. As for the provenance of tourists, those from ASEAN accounted for 32.4% of all arrivals at the beginning of 2013, thanks to an easing of visa requirements and intra-regional border restrictions.

Cambodia needs to develop its tourism-specific infrastructure

In 2011, Cambodia recorded the highest international tourism receipts of any ASEAN country as a share of GDP (15%). However, its regional ranking is low when it comes to travel facilitation and competitiveness (WEF, 2012b). It improved its ranking in 2012, but there is plenty of room for improvement in areas such as tourism infrastructure, accommodation, and financial facilities such as automated teller machines (ATMs) that accept Visa cards. Box 2.2.1 describes examples of tourism-specific institutions in OECD countries put in place by governments keen to improve industry competitiveness.

Box 2.2.1. **Government initiatives to improve industry competitiveness: Examples from OECD countries**

The role of government in tourism is continually evolving and most countries address supply-side issues as well as the demand side of marketing and promotion. Supply-side improvements focus on enhancing the competitiveness of the tourism industry by increasing productivity and quality and encouraging innovation (OECD, 2006b). They may seek to develop niche markets (e.g. the revitalisation of health and spa tourism in **Hungary**); improve infrastructure; build the capacity of tourism businesses to capitalise on the Internet and ICT; provide skills training; or reduce negative social and environmental impacts. Below are some examples from OECD countries.

The **Australian** Tourism Data Warehouse (ATDW) system is a central distribution and storage facility for tourism industry product and destination information from all Australian States and Territories. Content is compiled in a nationally agreed format and electronically accessible by tourism business owners (operators), wholesalers, retailers and distributors for use in their websites and booking systems. The ATDW also provides an online education programme for the Australian tourism industry comprising a complete suite of tutorials with information on basic online marketing concepts such as website design to more complex issues including the use of online booking systems (www.atdw.com.au).

Box 2.2.1. (contd.)

The **Canadian** Tourism Commission (CTC) is Canada's national tourism marketing organisation. Its objective is to sustain a vibrant and profitable tourism industry. Together with its industry partners, it provides a consistent voice and strong visibility for Canada in the international tourism marketplace. It supports a co-operative relationship between the private sector and governments at the federal, provincial and territorial levels. As part of its governance structure, its five advisory committees are mostly made up of highly skilled, knowledgeable players from the industry which advise on core and emerging markets, brand experiences, Meetings, Conventions and Incentive Travel (MC&IT) and research.

FONATUR is the central government agency responsible for the development of tourism in **Mexico**. It identifies potential large-scale tourism development projects; assists and supports sub-national governments in the planning of local tourism development projects; contributes to the construction of basic infrastructure in tourism destinations; and is in charge of attracting private investment to them.

The Madeira Regional Secretariat for Tourism and Transport (in **Portugal**) won the 2011 UNWTO Ulysses Award for Innovation in Governance for its work on the environmental certification of tourism businesses.

Mature destinations are experiencing a loss of competitiveness because of territorial saturation, environmental impacts, and ageing infrastructure and equipment (in **Spain**). The associations representing the private sector have expressed concern. The General Secretariat for Tourism and Domestic Trade has made significant efforts to change the Spanish tourism model since the creation of the Tourism Plan 2020 and to revitalise coastal tourism. It is undertaking specific activities through the Programme for the Integral Requalification of Mature Tourism Destinations in four pilot destinations: Beach of Palma in the Balearic Islands; Costa del Sol in Andalusia; San Bartolomé de Tirajana; and Puerto de la Cruz in the Canary Islands.

Source: OECD (2012a), *Tourism Trends and Policies 2012*, OECD Publishing, Paris; Canadian Tourism Commission, *Helping Tourism Businesses Prosper*, 2013-2017 Corporate Plan Summary, http://dx.doi.org/10.1787/tour-2012-en.

The Cambodian government recognises the importance of the tourism sector and has made developing and improving it a priority. In 2006, for example, it introduced an electronic system in 25 languages to facilitate tourists' online visa applications. It is also seeking to encourage more visitors and longer stays. To promote itself as a tourist destination, Cambodia has launched a marketing campaign called "Cambodia – Kingdom of Wonder", which also promotes the country's clean cities and resorts and its good-quality services.

Transport infrastructure not yet fit for the tourism purpose

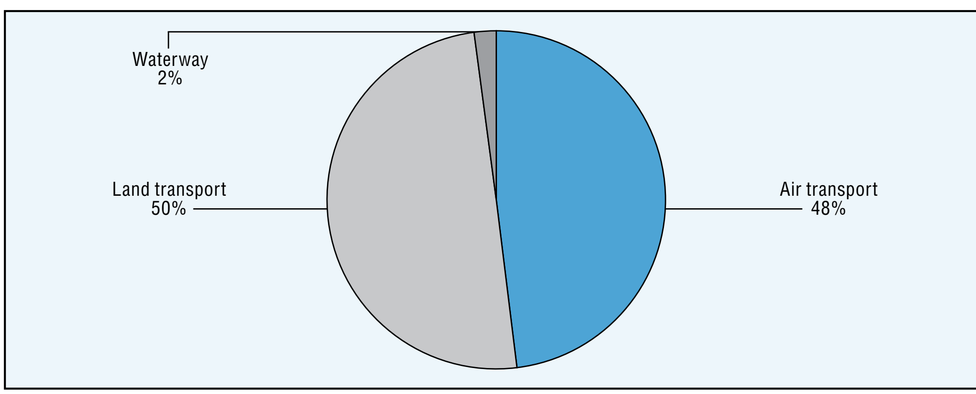
Among the tourism development measures that are considered top priority is the continued implementation of the ASEAN Open Skies Policy. The policy is a component of ASEAN's economic integration. Due to be in place by 2015, it is designed to boost regional air transport connectivity and allows all regional air carriers to fly freely between ASEAN member states.

In 2012, 1.7 million tourists entered Cambodia through Phnom Penh and Siem Reap International Airports. However, both airports are still small and inadequate for growing needs. Phnom Penh Airport has limited capacity as a gateway for investors and business people or high-value imports and exports. Clearly, airport expansion is vital to the country's fast-growing tourism sector.

A considerable challenge for Cambodia's road infrastructure is natural disasters such as the 2011 floods that destroyed infrastructure and affected over 1 million people. In 2012, Cambodia increased its flood-related maintenance budget to USD 73 million from USD 11 million in 2007 and its road infrastructure budget to USD 50 million from USD 19 million in 2007. Yet road density in Cambodia remains relatively low – 0.26 in 2012 compared to 0.35 in Thailand and 0.78 in Viet Nam in 2009.

The government has not overlooked its rail network. It is also rehabilitating its two main railway lines – the Northern and Southern Lines – and supporting the Trans-Asian Railway which will run from Singapore to China and Russia and from South Korea to Europe.

Figure 2.2.4. **Modes of tourist arrivals in Cambodia, 2012**



Source: Ministry of Tourism, Cambodia.

StatLink http://dx.doi.org/10.1787/888932937833

Diversify tourist destinations and ensure sustainable tourism

The main tourist attraction in Cambodia is the Angkor Wat temple in Siem Reap. However, to further promote tourism, the government needs to attract tourists to other destinations such as the tropical beaches on the south-west coast and the colonial and historical buildings in Phnom Penh. Diversifying tourist destinations will have knock-on benefits for the local economy. For example, local people have acknowledged that community-based tourism development in the coastal areas near Sihanoukville has created jobs and helped to revitalise local nature tourism and the arts and crafts industry.

In this respect, the government must ensure that sustainable tourism practices are in place to encourage the conservation of natural resources and the protection of the environment and Cambodia's cultural heritage.

Sustainable tourism should also contribute effectively and efficiently to poverty reduction in Cambodia. Siem Reap, visited by more than half of all foreign tourists, is one of the most popular tourist destinations in Cambodia. Yet it is still the country's second poorest province with about 52% of its population living below the poverty line. The main barriers to reaping the benefits of tourism include skills shortage, poor education, lack of capital, weak family structures, insufficient social networking and inadequate transport infrastructure.

The tourism sector has weak linkages with the rest of the economy

In 2005, approximately 30% of revenue from tourism in Cambodia was leached out of the economy by imported foreign products purchased precisely to serve the tourism sector. Although such losses of income appeared to decline slightly in 2012 to around 25%, they are still significant enough to hurt the country's balance of payments. The government has realised that the import of equipment and agricultural products from neighbouring countries such as Thailand and Viet Nam to meet the demand of Cambodia's hotels and restaurants is a serious issue. The national development plan included an agenda to address the problem by identifying local enterprises that could be developed and improved to compete with imported products and supply their wares to the tourism – and related – sectors.

Efforts to upgrade the tourism sector will need to take place on several fronts. The diversification of tourist destinations and the development of tourism-specific infrastructure and facilities are crucial. The government should also seek to promote tourism, put in place legal measures to protect the environment, ensure that there is cultural heritage management and stakeholder collaboration, and develop human resources. It should also address the questions of political stability, national security, safety, and regional co-operation as part of its commitment to Cambodia's tourism sector.

Note

1. The System of Rice Intensification (SRI) is a less resource-intensive irrigation method which uses environmentally friendly farming techniques for improving soil fertility, ploughing and planting. It ensures high quality crops, reduces production costs and causes less pollution.

Indonesia

A. Medium-term economic outlook (Forecast, 2014-18 average)

GDP growth (percentage change):	6.0
Current account balance (% of GDP):	-2.9
Fiscal balance:	-1.6

B. Medium-term plan

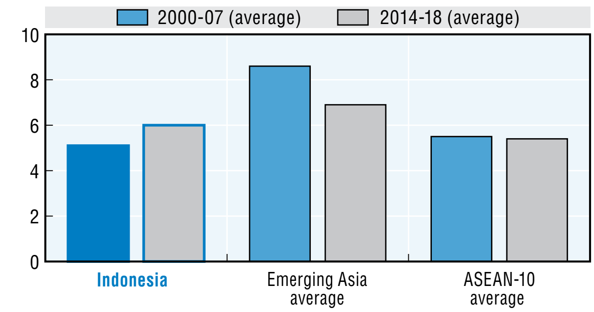
Period: 2010-14
Theme: Realisation of an Indonesia that is prosperous, democratic and just

C. Basic data (in 2012)

Total population:	244 million*
Population of DKI Jakarta	9.6 million (in 2010)
GDP per capita at PPP:	4 977 (current USD)**

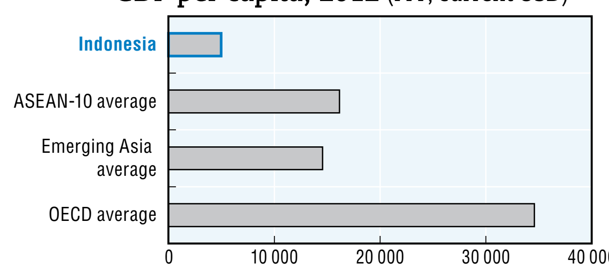
Note: * Total population data for 2012 are estimates.
** IMF estimate
Sources: OECD Development Centre, national sources and IMF.

GDP growth rates (Percentage change)



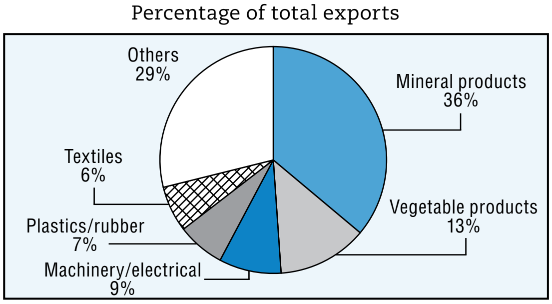
Source: OECD Development Centre, MPF-2014.

GDP per capita, 2012 (PPP, current USD)



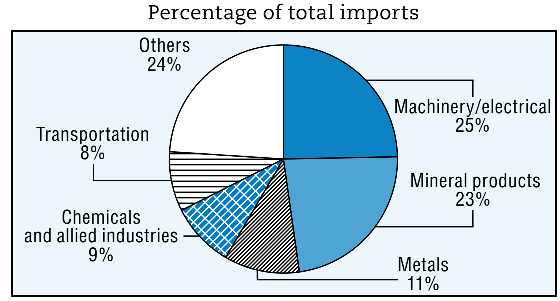
Source: IMF and national sources.

Composition of exports, 2012
Percentage of total exports



Source: Trademap.

Composition of imports, 2012
Percentage of total imports



Source: Trademap.

Indonesia needs to further increase its efforts if it is to meet the goals it set in its 2010-14 National Medium-term Development Plan (RPJMN 2010-14) and its Master Plan for the Acceleration and Expansion of Indonesia's Economic Development 2011-25 (MP3EI). It can achieve equitable growth only if it makes education more widely accessible, strengthens natural disaster management especially with respect to floods, accelerates social protection reform, particularly the pension system. In the meantime it should maintain economic growth by improving the business climate.

It can widen access to education by improving government policies and making its current scholarship and CCT programmes more efficient. Indonesia is highly exposed to natural disasters that claim lives and wreak and financial and economic damage, with the poor disproportionately affected. Its natural disaster management system, particularly with regard to flooding, needs to be strengthened. Reform of the country's pension system, which is one of the pillars of its social protection system, must be accelerated. It is currently inadequate for providing secure income for the majority of the retired population. Indonesia must rise to these three overriding policy challenges against the backdrop of sustained economic growth. It must further improve the recent progress it has made to its investment climate by moving to simplify business procedures.

Indonesia's medium-term policy challenges and responses

- Widen access to education, in particular for low-income households
- Strengthen natural disaster management and protection infrastructure
- Accelerate reform of the pension system to improve transparency and quality

POLICY FOCUS

Widen access to education, in particular for low-income households

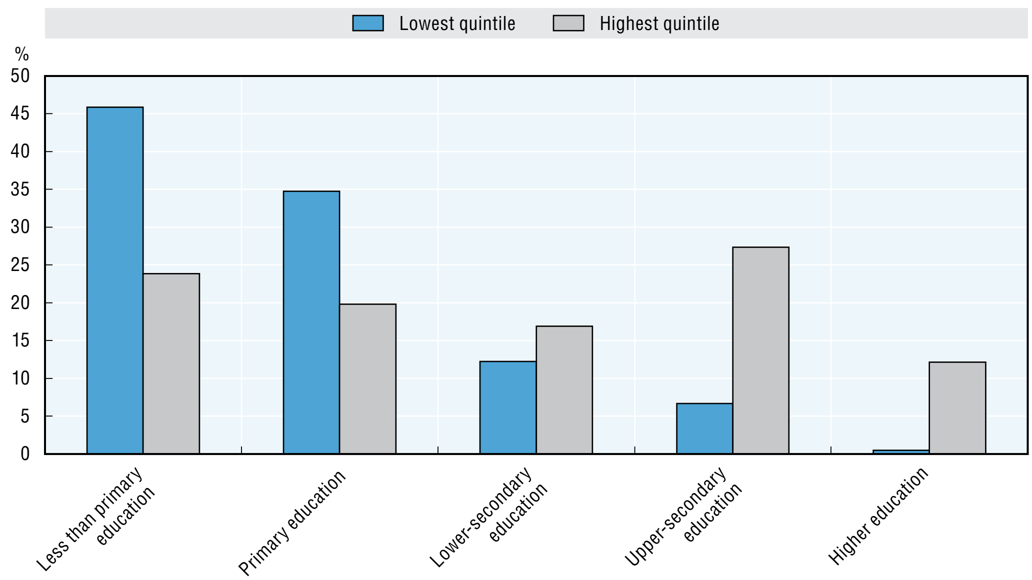
Despite progress, access to education needs to be strengthened further

Under the terms of the MP3EI, the government is committed to providing the poor with economic assistance in the form of subsidies and cash transfers to improve the access to education. After nine years of free, compulsory schooling, Indonesia has steadily improved access to basic education (OECD 2012b; 2013a). Nevertheless, for reasons of cost and opportunity, education is still beyond the reach of many children from disadvantaged families. The government should strengthen demand-side measures – such as targeted scholarship programmes and complementary CCT schemes – to help low-income households send their children to school.

Educational attainment in low-income households is substantially below that of the rest of the population. In 2008, the lowest quintile of the population aged age five years and upwards did not even have primary education. By contrast, in the highest quintile of the same subset of the population 40% had attained upper-secondary education or higher (Figure 2.3.1). The fact that expenditure on education rises with non-food household expenditure (Figure 2.3.2) suggests that low-income families do not have the financial means to continue to support their children beyond free basic education (OECD, 2010b).

Figure 2.3.1. **Educational attainment in Indonesia, by income level, 2008**

Highest qualification in percentage of population aged at least 5 years or over

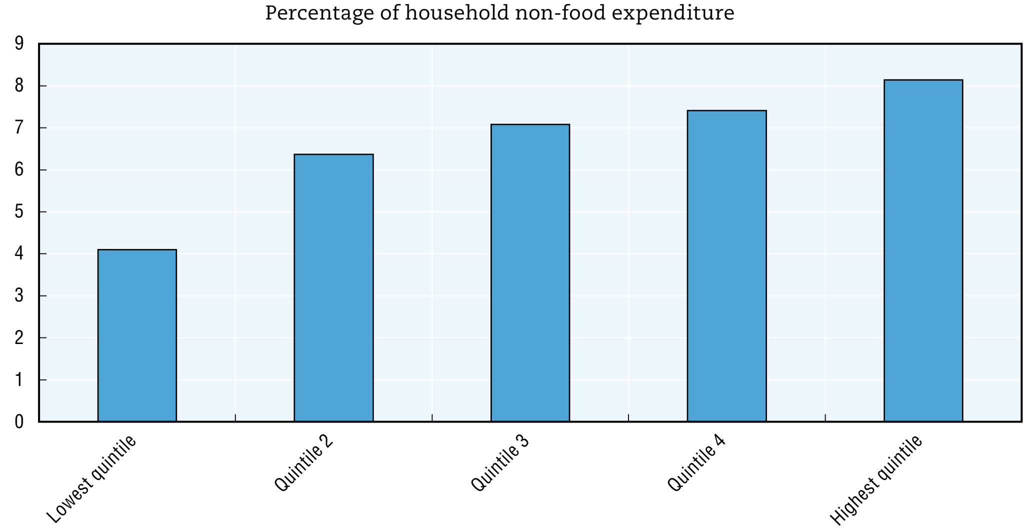


Source: OECD (2010b), *OECD Economic Surveys – Indonesia*, OECD Publishing, Paris.

StatLink http://dx.doi.org/10.1787/888932937852

Figure 2.3.2. **Household expenditure on education in Indonesia, by income level, 2008**

Percentage of household non-food expenditure



Source: OECD (2010b), *OECD Economic Surveys – Indonesia*, OECD Publishing, Paris.

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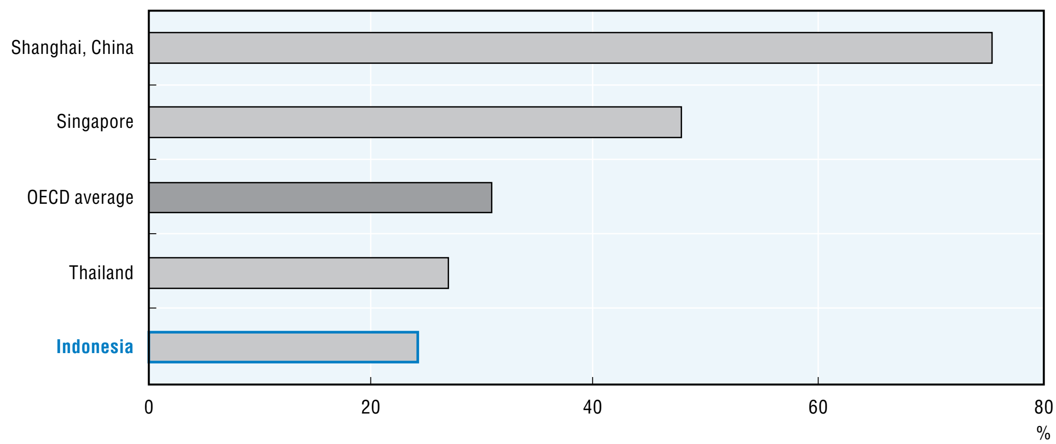
The performance and upward mobility of students from poor households need to be strengthened considerably. According to the results of tests in the 2009 round of the OECD's *Programme for International Student Assessment* (PISA), the proportion of disadvantaged students who perform better in reading than would be thought from their socio-economic backgrounds is not only lower in Indonesia than the OECD average, but also lower than among its regional peers such as Thailand (Figure 2.3.3).

Figure 2.3.3. **Percentage of resilient students among disadvantaged students in Indonesia and other selected economies, 2009**



Note: A student is classified as resilient if he or she is in the bottom quarter of the PISA index of economic, social and cultural status (ESCS) in the country of assessment and performs in the top quarter across students from all countries after accounting for socio-economic background.

Source: OECD (2010c), *PISA 2009 Results: Overcoming Social Background – Equity in Learning Opportunities and Outcomes Volume II*, OECD Publishing, Paris.

StatLink http://dx.doi.org/10.1787/888932937890

Mixed results from education attainment measures on supply and demand side

The government's strategy to enhance the educational attainment of students from poor families has combined supply-side and demand-side measures. Supply-side interventions include the School Operational Assistance Programme (BOS) (for further detail see OECD [2013a]). It provides direct financial assistance to schools with the aim of increasing enrolment rates and easing the financial burden of education on households. On the demand side, it has delivered assistance in the form of scholarships and CCT programmes.

Indonesia introduced its first pro-poor education programme, the Social Safety Net scholarship scheme (Jaring Pengaman Sosial, [JPS]), in the wake of the 1997-98 Asian crisis with the aim of improving the access of students from poor families to education (OECD, 2010b). Apart from problems with geographical targeting and leakages to non-poor students, especially in rural areas at primary school level, the programme is considered to have been successful in raising enrolment rates.[1] The cash transfer contained the increase in drop-out rates by easing households' need to draw on the labour of their children. Nevertheless, more accurate targeting would have improved the efficiency of the programme (Sparrow, 2004).

The Special Assistance for Students scheme, or Bantuan Khusus Murid (BKM), was introduced in 2001 with the objective of complementing and phasing out the JPS scholarship programme. As fuel subsidies were reduced at the time, the purpose of the BKM scholarship programme was to reduce the negative impacts of fuel price increases on the welfare of poor households by easing the burden of education expenses. However, as a result of inadequate co-ordination and the lack of long-term financial planning and monitoring, the programme proved inefficient (SMERU, 2003). In 2005, as it introduced the BOS programme providing block grants to schools, the government substantially reduced coverage of the BKM scholarship and gradually phased out the scheme.

In 2008, Indonesia initiated Bantuan Siswa Miskin (BSM), the Help Poor Students scholarship programme. Its aim was to raise the efficiency and widen the coverage of targeted scholarship programmes. BSM, a package of cash transfer programmes, provides currently enrolled students from poor households with an annual cash transfer to pay for school fees and other non-fee school costs, such as transport and uniforms, in one lump-sum instalment. However, the BSM scheme has a number of weak points: its targeting and coverage are poor;[2] it lacks co-ordination and is poorly thought out;[3] the scholarship is inadequately endowed;[4] and poor design hampers the transition from elementary to junior high school[5] (Agustina et al., 2009 and World Bank, 2012b).

Indonesia needs to enhance the effectiveness of its scholarship programmes by targeting, designing, and co-ordinating them better. It should fine-tune their design to ease the transition between school levels – particularly from primary to junior secondary education – by increasing support for students in their final year. The benefit package also needs to be revised upwards to reflect rising education costs. The different scholarship schemes could be consolidated into a single programme to avoid fragmentation at school and district levels and between secular and faith-based establishments. Moreover, independent monitoring arrangement should be introduced for greater efficiency and transparency.

Scholarship programmes do encourage parents to send their children to school by reducing overall education cost for households. However, they are not so successful in addressing other non-financial issues – such as the low perceived value of education – and essentially target only students who are already in school (Agustina et al., 2009). By contrast, CCT programmes make school attendance a condition for receiving assistance. In this way, they send strong signals to parents about the value of education and increase the opportunity cost of dropping out of school. They are important, efficient complementary demand-side interventions (Agustina et al., 2009).

In 2007, the government launched two pilot CCT schemes. One was the Family Hope Programme, or Programme Keluarga Harapan (PKH), which targeted households. The other was an incentivised community block grant scheme, the National Community Empowerment Programme – Healthy and Smart Generation (Programme Nasional Pemberdayaan Masyarakat – Generasi Sehat dan Cerdas, [PNPM Generasi]). It targeted the very poor and was conditional on school attendance and the use of maternal and child health-care services. An interesting and welcome feature of these CCT pilot programmes was their impact evaluation architecture: together with control groups, the government incorporated random assignment into the selection of beneficiaries (i.e. built-in randomised control trial design) to allow for rigorous assessment.

More effectively designed and targeted CCTs are needed to increase school enrolment

The impact of PKH on school enrolment rates among the very poor has been limited so far. Although the children who have benefited from the PKH stay in school longer, the already high enrolment rates and low drop-out rates in basic or junior secondary education have not changed. Nor have there been significant reductions in child wage labour (World Bank, 2012c).

One of the main reasons for PKH's limited impact may be that the cash transfer does not cover the full cost of attending school. For instance, a PKH cash transfer for junior secondary schooling covers only 43% of total education costs when transport costs are included (World Bank, 2012c). Moreover, according to Febriany et al. (2011), PKH's effectiveness in increasing the use of basic school services is also hindered by the lack of general infrastructure – transport, energy, and water and sanitation – in remote areas, inefficient compliance monitoring, the lack of support from schools, and the jealousy-induced conflict with non-recipients.

Overall, PKH needs further support, fine-tuning and extension to the whole country. Above all, the programme should co-ordinate and collaborate more closely with education service providers and other local government services, as well as with the community-based PNPM Generasi scheme. It is also important to better integrate conditional income-support programmes with micro-credit schemes to ease the transition towards self-empowerment (OECD, 2010b). Also, the skills and capacity of facilitators, the front-line contacts with households, need to be enhanced. Benefit levels, too, which have been the same since the start of the programme, should be reviewed and indexed to the cost of living. A final point is that CCT programmes which impose performance-related conditions, such as not failing grades, can increase efficiency (Saavedra and Garcia, 2012).

By contrast, the PNPM Generasi programme is generally considered successful. Community funds are allotted to villages, with the amount depending on the number of beneficiaries in a village, and then spent on improving the provision and use of maternal and child health care and basic education services (OECD, 2013a). The benefits include the expansion and improvement of physical facilities and easier access to basic education services. According to Febriany et al. (2011), PNPM Generasi reduced drop-out rates and absenteeism, while boosting students' motivation. Olken, Onishi and Wong (2011), find that PNPM Generasi's most notable impact was the increased participation rate among the children of primary school age group, particularly in areas with low baseline education indicators. PNPM Generasi needs to be further expanded by prioritising regions with low health and education indicators.

The efficiency of current scholarship and CCT programmes can be improved substantially through more accurately targeted financial support to students from disadvantaged backgrounds. Poor targeting leads to leakages as non-poor students are nearly as likely to receive benefits as poor ones. A national targeting system (NTS) could be the cornerstone of better designed and implemented targeting methods and more closely co-ordinated programmes. An NTS would serve as a unified registry, providing sufficient quality data for all kinds social assistance programmes. Progress has already been made in this direction since a large-scale survey in 2011 – Data Collection for Targeting Social Protection Programs (Pendataan Programme Perlindungan Sosial [PPLS11]). Conducted to identify poor households, PPLS11 covered around 45% of the population; it found that an NTS would need to be managed in an accountable, transparent way. As for the different targeting methodologies, besides proxy means-testing, community-based and self-targeting methods could increase accuracy and further satisfy community needs (World Bank, 2012d; Alatas et al., 2012).

Box 2.3.1. **Conditional cash transfer (CCT) programmes: Examples from OECD countries**

Conditional cash transfer (CCT) programmes implemented in OECD countries are generally considered to be effective in increasing school attendance.

The best known CCT within the OECD, the *Oportunidades* scheme, was launched in **Mexico** in 1997. The programme covers around 20% of families. Eligibility is determined by first identifying geographical communities with high proportions of poor families and then by selecting low-income households with the help of proxy means-testing. An interesting feature is that the actual cash transfers are paid to mothers directly, as evidence shows that they are more likely to spend the money on children. Beyond the positive impact of *Oportunidades* on school attendance, it is also considered to have reduced the head-count poverty rate by 10% and to have had an even more significant positive impact on measures of extreme poverty such as depth and severity.

The **Turkish** Social Solidarity Fund, introduced in 2001, targets the poorest 6% of children and has around 2.6 million beneficiaries. Low-income families are identified through proxy means-testing. The programme also seeks to address gender bias in education by paying more to girls both at primary and secondary school levels. Evaluations show a favourable impact on poverty reduction and a measurable positive effect on school enrolment and attendance.

Further CCTs with educational objectives implemented in OECD countries include the Opportunity NYC programme from New York, **United States** which requires no early childhood or health measure conditions. The only requirement is participation in compulsory education. There are also CCT programmes – in **Austria**, **Australia** and **Germany**, for example – that continue to pay child benefits that are conditional on the child going on to higher education once he or she is over the age of 18.

Source: OECD (2009a), *Doing Better for Children,* OECD Publishing, Paris.

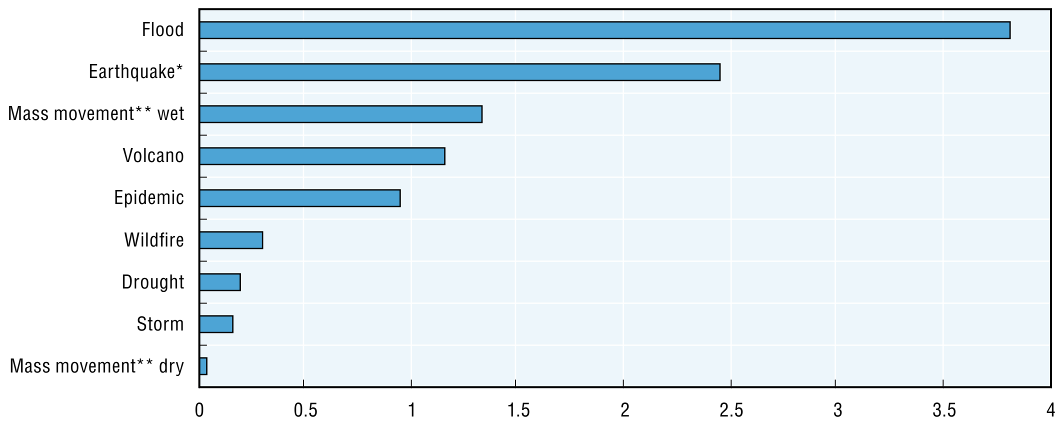
POLICY FOCUS

Strengthen natural disaster management and protection infrastructure

Indonesia needs better mechanisms to cope with natural disasters, particularly flood protection infrastructure

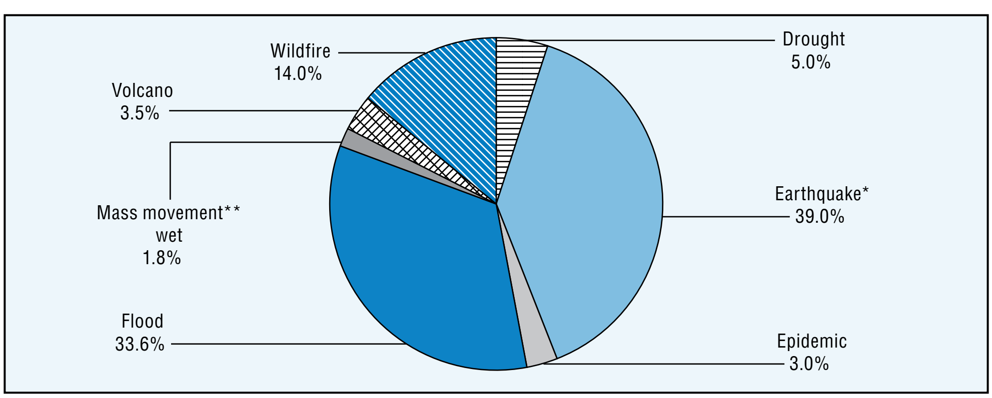
Indonesia's geographic location and inadequate disaster risk management infrastructure expose it to natural disasters. The country suffers from droughts, wildfires, floods, landslides, earthquakes, volcanic eruptions and tsunamis. Between 1980 and 2010, more than 21 million people all over the archipelago were affected by 321 sizeable natural disasters, which claimed over 190 000 lives. Although earthquakes – and attendant tsunamis – kill more than other natural disasters (the tsunami that struck the province of Aceh in 2004 caused more than 100 000 fatalities), floods are the most frequent natural hazard (Figures 2.3.4 and 2.3.5.). The number recorded by the Ministry of Public Works almost tripled between 2006 and 2011.

Figure 2.3.4. **Average annual occurrence of natural disasters in Indonesia, by disaster type, 1980-2010**



Notes: * Earthquake includes tsunami. ** Mass movement includes subsidences, rockfalls, avalanches and landslides.
Source: UNISDR (2013a), *Prevention Web: Indonesia Country Profile* (www.preventionweb.net/english/countries/statistics/?cid=80).
StatLink http://dx.doi.org/10.1787/888932937909

Figure 2.3.5. **Percentage of reported people affected in natural disasters in Indonesia, by disaster type, 1980-2010**



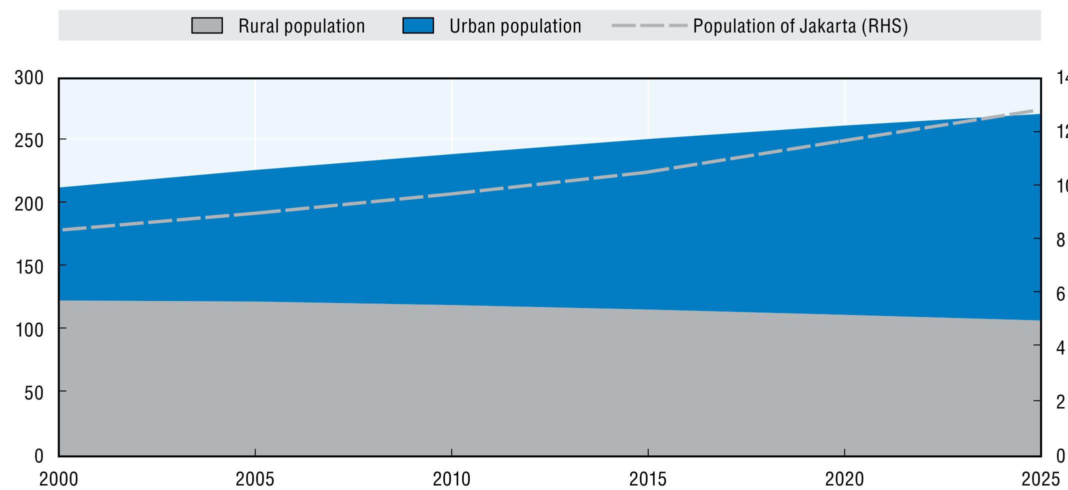
Notes: * Earthquake includes tsunami. ** Mass movement includes subsidences, rockfalls, avalanches and landslides.
Source: UNISDR (2013a), *Prevention Web: Indonesia Country Profile* (www.preventionweb.net/english/countries/statistics/?cid=80).
StatLink http://dx.doi.org/10.1787/888932937928

Climate change and the resulting increase in rainfall are one element behind the rise in the incidence and severity of floods in recent years. Furthermore, the damage caused by floods is aggravated by the fact that they often happen in major cities that are built in basins and rendered especially vulnerable by their dense populations, unplanned urban sprawl and the lack of flood management infrastructure. In other words, the climate-change-induced rise in the amount and intensity of rainfalls combined with the rapid pace of urbanisation puts further strain on flood protection infrastructure.

Jakarta's flood protection infrastructure needs to be improved as Indonesia continues to urbanise

Indonesia is steadily urbanising. By 2025, according to the 2011 Revision of the UN's *World Urbanisation Prospects*, the urban population will account for some 60% of the population – over 160 million. The population of Jakarta alone will rise by around 30% to nearly 13 million habitants (Figure 2.3.6). Although the Jakarta metropolitan region and other urban areas in Java will continue to lead urbanisation, medium-sized cities across the rest of country will grow at a steady pace as well.

Figure 2.3.6. **Expansion of the urban population in Indonesia, 2000-25**
Million people



Source: UN (2012), *World Urbanization Prospects, the 2011 Revision*, Population Division of the Department of Economic and Social Affairs, United Nations, http://esa.un.org/unpd/wup/index.htm

StatLink http://dx.doi.org/10.1787/888932937947

The floods that perennially affect Jakarta have been growing worse in recent decades. Estimated financial and economic flood-related losses in 2002 were over USD 1 billion (World Bank, 2012e). The most recent flood – in January 2013 – affected around 8% of the city's area, claimed 41 lives and, according to official government estimates, caused economic losses through damage to property, production downtime, and other factors, that could be as high as USD 3.3 billion (Al Azhari, 2013).

Severe flooding also curbs investment in affected areas and has a disproportionate impact on the poor, who tend to live in hazard-prone areas that are low-lying or situated along waterways.

Jakarta sits in a low-lying coastal basin, with 40% of the city lying at, or below, sea level. Its exposure to flooding is compounded by the high annual average rainfalls and rising sea levels caused by climate change. Moreover, rampant urbanisation has overrun water catchment areas, green areas and wetlands, turning them into extensions of city sprawl and drastically weakening the absorption and retention capacity of the flood control system. The incidence and severity of the floods that overwhelm Jakarta are further aggravated by land subsidence. It increases the risk of tidal floods and weakens the gravitational pull that channels storm water out to sea.

The two pillars of Jakarta's structural flood control system – the West and the East Flood Canals, completed in 1992 and 2009, respectively – can only partially ease Jakarta's vulnerability. Even though the East Flood Canal still has some unfinished parts, the fact that the two major canals are not connected will always substantially impair overall flood control efficiency. Moreover, the Ministry of Public Works and Jakarta City Council (DKI) lack the capacity to maintain the flood control infrastructure. The result is considerable sediment build-up in primary floodways and drains (Jha, Bloch and Lamond, 2012).

Some progress in disaster risk reduction, but budget allocation as well as co-ordination and early warning systems need to be improved

As it happens, Indonesia has improved its disaster risk reduction system in recent years. In 2004 a tsunami devastated the province of Aceh. The government responded in 2006 by formulating the first National Action Plan for Disaster Risk Reduction (NAP DRR). The following year it enacted the first comprehensive law on disaster management (ASEAN Inter-Parliamentary Assembly, 2012). Indonesia has also established the National Agency for Disaster Management (Badan Nasional Penanggulangan Bencana [BNPB]) as the first independent disaster management body in the country with real powers at ministerial level. By the time the 2010-14 Disaster Management Plan was formulated in 2009, all provinces had developed their own disaster management plans. However, despite the progress Indonesia has made in nationwide disaster management, the budget allocated to it remains limited and, even though it is increasing, it is smaller than in developed countries.

When it comes to flood control planning and management, there are co-ordination difficulties across the relevant authorities. For instance, the inadequate spending on floodway maintenance by the Ministry of Public Works, which is responsible for the floodways that cross provincial boundaries, also has a negative effect on the drains and retention basins within the boundaries administered by the DKI. As for land planning, there is also a lack of co-ordination between regencies in Greater Jakarta (Jha, Bloch and Lamond, 2012).

However, with respect to contingency planning there are promising signs, such as the hazard impact modelling tool, Indonesia Scenario Assessment for Emergencies (InaSAFE). InaSAFE was launched in October 2012, after being tested during the 2011-12 Jakarta flood season. It proved effective in providing an understanding of hazard impacts through maps and estimates of potential damage and communicating them to support disaster risk management decisions.

To protect Jakarta's remaining natural flood absorption capacity, there should be no new property developments on any undeveloped land such as water catchment areas, green spaces and wetlands. In the same spirit, those green spaces that have already been converted into urban areas should be repurposed back into non-urban areas as far as possible (Rukmana, 2013).

In order to alleviate flood impacts, the flow and retention capacities of existing infrastructure should be enhanced through river dredging and the construction of retention basins. The flood control systems affected by subsidence ought to be realigned as well, while the East Flood Canal should be connected to the West flood Canal for further flood protection. Upstream management and coastal protection, which require long-term planning, need to be prepared and implemented on a consensual basis by all stakeholders (World Bank, 2012e).

However, Jakarta will continue to be exposed to the risk of flooding despite all the flood mitigation efforts. It is therefore essential to continue to develop and improve early-warning systems (Box 2.3.2) and contingency planning and to invest in community preparedness.

Box 2.3.2. **Flood early-warning systems and risk assessment: Examples from OECD countries**

The **Japanese** flood warning system is characterised by a very high level of efficiency in the collection of data on flood incidence. There is also close co-operation between government agencies – such the Japan Meteorological Agency (JMA) and the Ministry of Land, Infrastructure and Transport (MLIT) – and relevant research institutes, such as the Public Works Research Institute (PWRI) and the International Centre for Water Hazards and Risk Management (ICHARM). Flood forecasts draw on a highly sophisticated, accurate watch system. Rainfall and river levels are monitored through radar, rain gauges and telemeters, while high-capacity IT networks communicate flood forecasts to cities, towns, and even villages. Disaster prevention information is supplied in real time on a designated website (www.river.go.jp.).

In the **United Kingdom**, a large-scale regional monitoring programme covering the southern part of the country was implemented to ensure a systematic approach to the collection, management and analysis of data for use in strategic and operational management of coastal erosion and flood risk. The monitoring programme includes analytical databases and geographic information systems that provide high quality, long-term, time-series data sets, at appropriate spatial and temporal resolution. The programme's design also ensures that the different agencies responsible for the management of short sections of the coastline work in effective partnership.

The tool for flood risk management developed in **France** by IRSTEA (Institute of Research into Science and Technologies for the Environment and Agriculture) draws on local socio-economic criteria and comprehensive river basin data. It produces final risk maps that build on hazard and vulnerability maps. While vulnerability maps take into account both the economic value of damages and the social cost of floods, the design of hazard maps uses detailed assessments of catchment areas and river behaviour as well as past flood experience and theoretical models.

Source: OECD (2009b), *OECD Reviews of Risk Management Policies: Japan 2009: Large-Scale Floods and Earthquakes*, OECD Publishing, Paris.

POLICY FOCUS

Accelerate reform of the pension system to improve transparency and quality

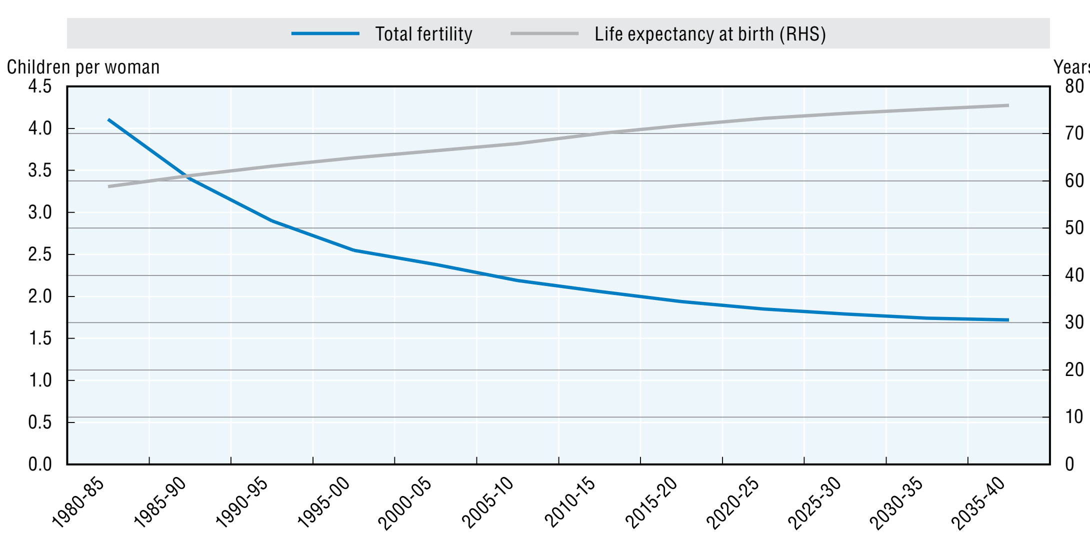
Demographic changes make pension reform urgent

Indonesia is reforming its social protection system through the Masterplan for Acceleration and Expansion of Indonesia Poverty Reduction (MP3KI). The MP3KI seeks to transform social protection programmes from current poverty alleviation schemes – like the Help Poor Students scholarship programme and other conditional cash transfer measures discussed in *Policy Focus* on education – into a comprehensive set of actions that will ensure a sustainable livelihood for the poor and vulnerable.

The Indonesian pension system, a pillar of the social protection system, is inadequate for providing a secure income for most retired people. The need for reform is driven by various factors, such as the ageing population, the weakening of family support and the growing middle class. Recognising this, the government is committed to implementing a social safeguard system in the form of universal social insurance in accordance with the Master Plan for the Acceleration and Expansion of Indonesia's Economic Development 2011-25 (MP3EI). However, there is room for improvement in extending coverage, ensuring financial sustainability, providing adequate retirement income, consolidating and rationalising existing pension schemes, and improving overall governance and transparency of the pension system.

As Figure 2.3.7 shows, the demographic transition arising from the combination of falling fertility rates and rising life expectancy is leading to a rapidly ageing population in Indonesia, as in most Southeast Asian countries and China (OECD, 2012b). The percentage of the population aged 65 and over is projected to almost triple from 5.6% in 2010 to 14.9% by 2040. The old-age dependency ratio will follow the same trend, rising almost three-fold from 8.2% to 22.2% over the same period (Figure 2.3.8).

Figure 2.3.7. **Fertility rate and life expectancy in Indonesia, 1980-2040**



Source: UN Population Division of the Department of Economic and Social Affairs, *World Population Prospects: The 2010 Revision*.

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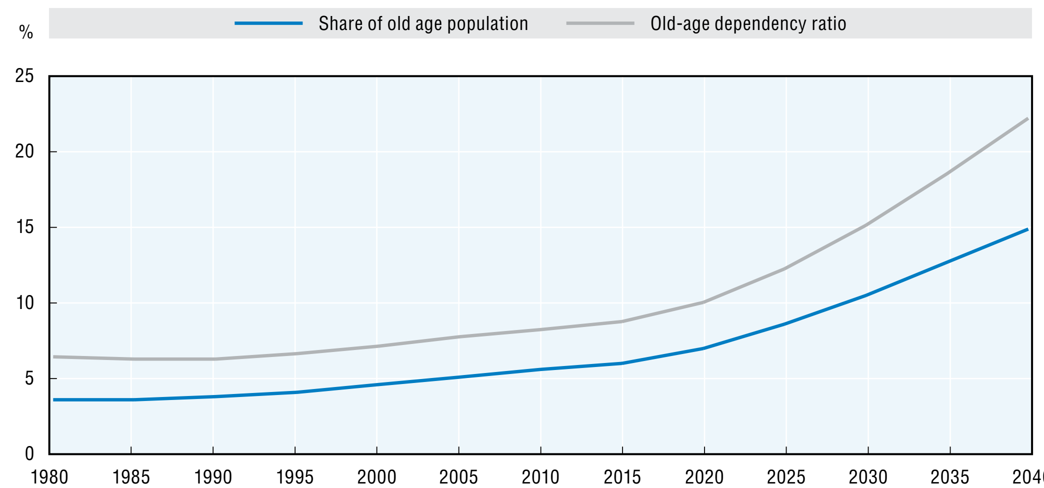
Figure 2.3.8. **Share of old-age population (i.e. aged 65 years or over) and old-age dependency ratio in Indonesia, 1980-2040**



Note: Old-age dependency ratio is the percentage of population aged 65 years or over to the population aged between 15 and 64 years.

Source: UN Population Division of the Department of Economic and Social Affairs, *World Population Prospects: The 2010 Revision.*

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The current pension system in Indonesia is composed of different retirement-income schemes for different labour market groups. The schemes differ from each other in retirement age, type of benefit scheme and benefit payment mode, legal status and contributions (Table 2.3.1).

Table 2.3.1. **Pension system in Indonesia**

	Civil service pension	Jamsostek Old Age Savings		Private pensions
Type of workers	Civil servants, military and police	Private sector workers	Informal sector workers	Private sector workers
Type of benefit scheme	Defined benefit (DB)	Defined contribution (DC)		Both DB and DC
Legal status	Mandatory	Mandatory	Voluntary	Voluntary
Retirement age	56 or 50 with 20 years of service	55 or after 5 years of contribution		Normally 55, but maximum 60
Accrual rate	2.5% for each year of service	5,70%		DB: max. 2.5%/year; DC: max. 20%/year
Maximum benefit	75% of basic salary	-		DB: 80%; DC: 20%/year
Benefit payment method	Lifetime annuity	Lump sum payment		20% lump sum, 80% lifetime annuity
Employee contribution	4.75% of wages	2% of wages	2% of income (at minimum wage level of IDR 1 million/month)	Maximum: 60% of employer's contributions; and total contributions in a year shall not exceed 20% of pension base earnings
Employer contribution	Varies on actual expenditure	3.7% of wages	None	Depending on the scheme
Coverage (participants contributing)	4.5 million (2.8% of population aged between 15 and 64)	9.3 million (5.7% of population aged between 15 and 64)	0.4 million (0.2% of population aged between 15 and 64)	2.8 million (1.7% of population aged between 15 and 64)

Source: OECD Development Centre's compilation based on Muliati (2013), "Pension reform experience in Indonesia", paper prepared for presentation at the IMF Conference for Designing Equitable and Sustainable Pension Post Crisis World, Tokyo, 9-10 January.

Pension coverage and benefits need to be enhanced significantly

The majority of the population is still not covered by any old age pension scheme. Except for civil servants, the military and police personnel, coverage is very low. The total number of active contributors to any retirement saving scheme as a percentage of the population aged between 15 and 64 is only around 10.5%. Although the coverage of the mandatory Jamsostek private-sector savings scheme has widened in recent years, only some 25% of eligible workers actively contribute, which indicates high levels of evasion (Muliati, 2013). Nevertheless, expanding the coverage of the pension system in its current form would not be feasible. Extending it to the formal sector alone would cost 2.13% of GDP and covering the entire labour force would swallow 5.83% of GDP (Guerard et al., 2012). Increasing coverage would be feasible only if costs were also rationalised. A possible first step towards expanding the span of the pension system might therefore be to increase the retirement age for those who stand to benefit the most from the current setting – civil servants – then use the proceeds to widen coverage.

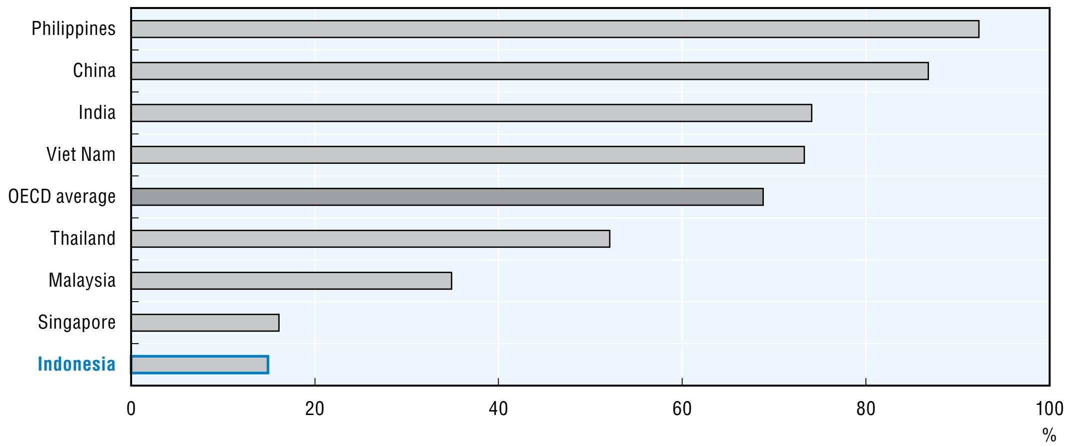
The fragmentation of the present retirement income system causes disparities. Apart from those that arise from the sheer size of the population without any pension coverage, there is the gap between civil servants, the military and the police, who receive relatively generous benefits, and everyone else.

More importantly, the current system of pension programmes must be enhanced particularly for old-age income security. First, as the benefit payment of the Jamsostek programme is a lump sum rather than an annuity, it is up to employees to decide whether they will save it as a lifetime old-age income. In fact, around 90% of the benefit payment is made before retirement[6] indicating that it is used for purposes other than retirement (Muliati, 2013).

Second, benefit levels can be improved. Measured by the net replacement ratio,[7] the pension levels of the mandatory Jamsostek saving scheme for private-sector workers are very low (Figure 2.3.9). Even under the otherwise generous civil service system, benefits for higher paid civil servants can be less than 20% of total salary at retirement, as they are calculated from the final base pay without bonuses and allowances. Benefits at all income levels also need to be adjusted to ensure old age income security by guaranteeing the fiscal sustainability of the system.

Another important measure would be to reform the pension benefit scheme in line with pay policies in the civil service. Under the civil service pension programme – a defined benefit scheme – the indexation of benefits should take the form of pension payments that are automatically adjusted to reflect changes in the cost of living. Such an arrangement would protect the value of pensions and contain costs.

Figure 2.3.9. **Net replacement rate of pension entitlements for average earners in Indonesia and other selected countries**



Note: The net replacement rate is defined as the individual net pension entitlement divided by net preretirement earnings, taking account of personal income taxes and social security contributions paid by workers and pensioners.

Source: OECD (2012c), *Pensions at a Glance Asia/Pacific 2011*, OECD Publishing, Paris.

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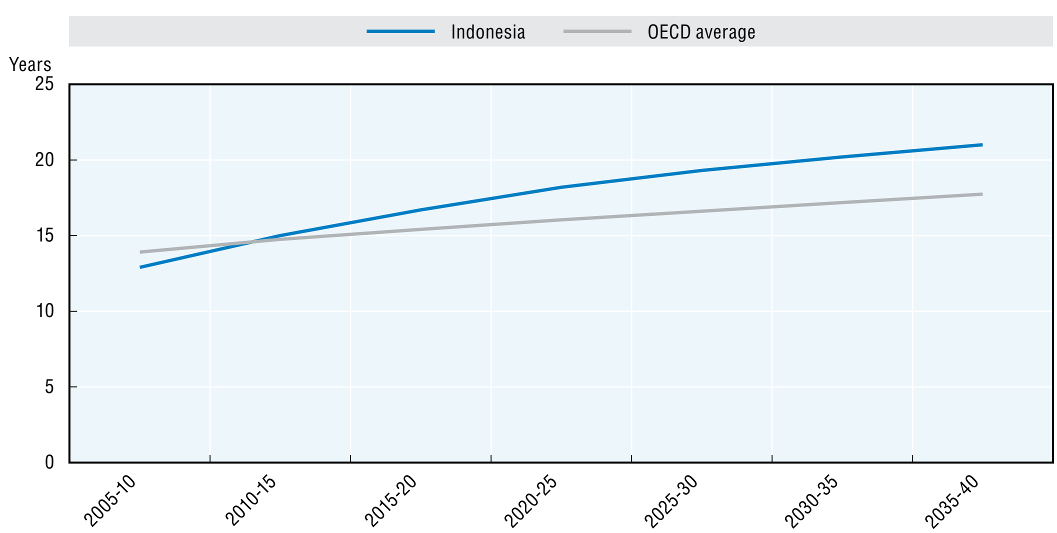
Figure 2.3.10. **Longevity of retirement with constant retirement age at current levels in Indonesia and OECD countries, 2005-40**



Notes: In the case of Indonesia, longevity of retirement is calculated with constant retirement at the age of 55. In the case of OECD average, longevity of retirement is calculated with constant retirement at the age of 65.

Source: UN Population Division of the Department of Economic and Social Affairs, *World Population Prospects: The 2010 Revision.*

StatLink http://dx.doi.org/10.1787/888932938023

Sustainability and transparency of the pension system should be further enhanced

A fast ageing population will place strains on the fiscal sustainability of the pension system in the medium and long term. As the retirement age has not been adjusted to longer life expectancy, the longevity of retirement is projected to increase substantially. The result will be shorter contribution and longer benefit periods. Given a life expectancy of 70 years old and retirement at the age of 55, the length of time that an Indonesian can currently expect to spend in retirement is 15 years. If the retirement age remains at current levels, then the time spent in retirement will increase to over 20 years by 2040 (Figure 2.3.10). The retirement age needs to be increased to reflect improving life expectancy and support the pension system's fiscal sustainability, while possibly widening its coverage and providing adequate benefits.

The transparency and the quality of the different pension schemes' accounting standards are inadequate. The civil service benefit fund supplies no accurate, transparent information as to its financial status and the pay-as-you-go accounting practice it applies is not in line with international accounting principles. Although the Jamsostek fund has improved its management practices by starting to publish annual financial statements, there is a real need for further disclosure of information relating to participants' benefits. Moreover, Indonesia's pension fund asset growth is hampered by the lack of management oversight and the poor transparency of the mandatory pension plans (Muliati, 2013). The regulation and supervision of mandatory pension funds should be developed along the lines of the Ministry of Finance's strict regulation of private pension funds to improve transparency and governance. It is also important to ensure consistency in funding and prudential requirements and enhance accounting practices (OECD, 2012b).

In response to the 1997-98 Asian financial crisis and its dire social consequences, Indonesia amended its constitution to require the establishment of a national system of social protection. The National Social Security (SJSN) Law, which was enacted in 2004, furnished the blueprint for a comprehensive system of social protection that would cover all Indonesians. The SJSN Law envisaged five national social security programmes, including pensions, that would be funded through workers' contributions and would provide the same benefits for all under the management of social security administrative bodies (BPJSs) (OECD, 2013a).

New law paves way for separately administered transparent, sustainable pension system

Mindful of the situation, the government has taken a major step towards actual implementation of the comprehensive system of social protection, with a law enacted at the end of 2011 providing for the creation of social security administrative bodies. One such body was to be BPJS Employment (BPJS Ketenagakerjaan) that would administer pension as well as occupational health and safety benefits, old-age pensions, and death-related programmes. The law also mandated that BPJS Employment would be a public legal entity managed as a trust fund on a non-profit, compulsory-participation basis.[8] It is scheduled to start providing SJSN employment programmes in 2015.

Reform of the new pension system under the terms of the BPJS law will generally improve governance, management and supervision. The BPJSs themselves will be governed by Boards of Commissioners, comprising government, employee and employer representatives, and Boards of Directors, also made up of professional members (Muliati, 2013).

The BPJS Law establishes important safeguards by separating BPJS assets from social security fund assets. BPJSs are to be monitored both internally by the Board of Commissioners and an internal audit department and externally by the National Social Security Council (DJSN), the new Financial Services Authority (OJK), and the State Financial Audit Board (BPK). The BPJSs will be responsible not only for registering participants and collecting contributions, but also for keeping beneficiaries informed about the status their savings and applying sanctions in the event of non-compliance.

Although the BPJS' regulatory structure and design are still to be decided in detail and yet to be implemented, some issues will need to be addressed, e.g. the collection of contributions from micro-enterprises, the organisational capacity needed to transform the Jamsostek fund into BPJS Employment, and the issuance of identification numbers needed for registration. Furthermore, the contribution rates and benefits of the new national pension programme administered by BPJS Employment will need to be designed with care so that it addresses effectively such considerations as old age security, financial sustainability, impacts on the labour market, and the future viability of private pension programmes.

Box 2.3.3. **Linking pensions to life expectancy: Examples from OECD countries**

Notional defined contribution (NDC) pension systems link pensions to life expectancy by assigning contributors' payments to an individual notional account. Although the system is still financed by pay-as-you-go contributions, the future pension payment flow on retirement adjusts to current life expectancy. The objective of NDC schemes is to ensure financial sustainability through pension payments from a given notional capital account which decrease if life expectancy lengthens.

Some OECD countries – **Italy**, **Norway**, **Poland** and **Sweden** – have already introduced NDC pension systems, albeit with different characteristics.

In **Italy**, the conversion rate of notional capital to pension benefits depends on the age of retirement, with values determined according to a formula based on actuarial equivalence. **Poland** and **Sweden** both apply an annuity divisor. In Poland it is linked to average life expectancy on retirement and individual retirement, while Sweden takes contemporaneous life expectancy based on unisex mortality rates in the previous five years.

Regarding the valorisation of notional accounts, contributions are uprated in line with the five-year moving average of nominal GDP growth in **Italy**, with the real growth of the wage bill in **Poland**, and with earnings growth in **Sweden**.

Source: OECD (2012d), *Pensions Outlook 2012*, OECD, Paris.

Annex. Strengthen the investment climate by simplifying business procedures

Important as they are, the reform policies discussed in this country note will come into their own only if they are carried out against the backdrop of a vigorous, attractive business environment.

In recent years, one of Indonesia's overriding priorities has been to improve the country's investment climate in order to attract more foreign and domestic investors. It is beyond doubt that Indonesia has been mostly successful in its goal of the country appealing to investors. According to the Investment Co-ordinating Board of the Republic of Indonesia (Badan Koordinasi Penanaman Modal [BKPM]), foreign direct investment (FDI) almost doubled between 2007 and 2011 when it reached USD 20 billion. In parallel, the credit rating agencies, Fitch Ratings and Moody's, uprated Indonesia to investment grade status.

The main measures the Indonesian government has taken to improve the investment climate and distribute investment more evenly across the country's different regions are as follows:

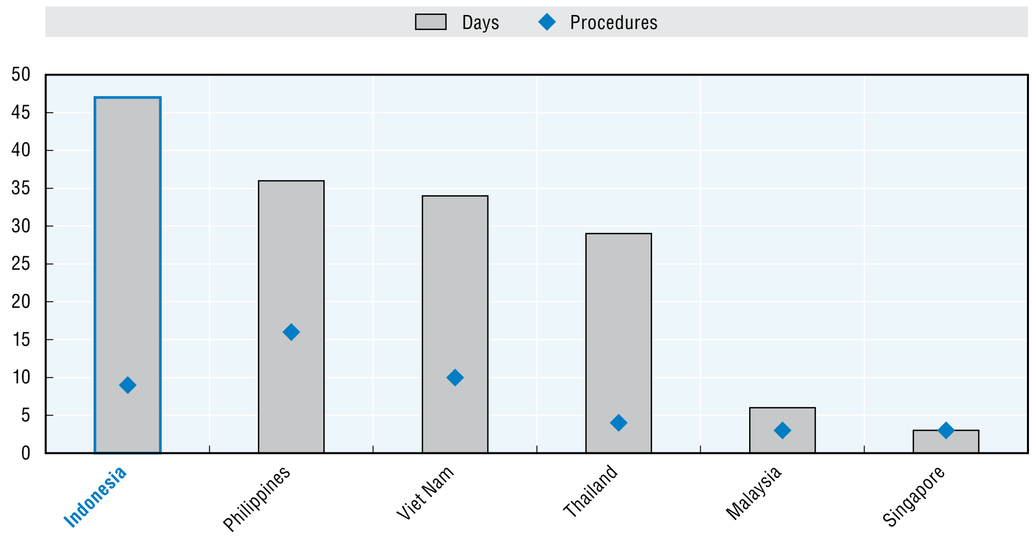
- simplify business procedures,
- improve investment-related laws and regulations,
- develop a national logistics system,
- enhance the information system for export and import processes,
- develop Special Economic Zones.

The Indonesian government has also already put together a package of incentives in the form of tax allowances and holidays for the business sectors it considers strategically important to economic growth and competitiveness.

However, the single greatest hindrance to improving the investment climate is cumbersome business procedures. They must be improved. The World Bank (2013a) ranks Indonesia 128th out of 185 countries for ease of doing business. Even more worrying is the fact that the country is further still down the rankings – 166th – for ease of starting a business. It takes 9 procedures and 47 days (Figure 2.3.A1).

To ease business procedures, the government has opened one-stop-shops throughout the country to provide a single port of call for investment licence formalities at both district and provincial levels. By June 2013 there were 468. However, an outstanding challenge is to put in place a standardised procedure and services for one-stop-shops themselves and to make the licensing process and fees transparent. The licensing process has been improved by an online tracking system for investment licensing introduced in 2012 by the Investment Co-ordinating Board. There are plans to implement the system in ten provincial and ten district one-stop-shops by the end of 2013.

Figure 2.3.A1. **Number of days and procedures needed to start a business in Indonesia and other Southeast Asian countries**



Source: World Bank (2013a) *Doing Business 2013: Smarter Regulations for Small and Medium-Size Enterprises*, World Bank, Washington, DC.

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Notes

1. The programme did not only improve coverage with some 2.1 million children benefitting from the scholarship by February 1999. Sparrow (2004) also found that it increased the probability of children attending school in the previous week by 1.5 percentage points and reduced the incidence of child labour from 14% to 10%.
2. The overall coverage of the BSM programme is 3% of enrolled students. Only around half of all BSM scholarships are distributed to the poorest 40% per cent of households. The rest benefit middle-class and better-off households in the top 60% (World Bank, 2012b).
3. The BSM programme consists of ten largely independent scholarship programmes with responsibilities and budgets delineated by type and level of education (World Bank, 2012b).
4. As the values of BSM scholarships are fixed in nominal terms from year to year, they do not keep pace with yearly price inflation. Between 2003 and 2009, nominal education costs rose at yearly rates of over 27% in primary education, 18% in junior secondary schools, and 13% at senior secondary level, with real education expenditure mounting much faster for poor than for non-poor households (World Bank, 2012b).
5. Education expenditure rises most steeply when pupils move from one education level to the next one. Expenses are always highest at the beginning of the registration period. As a result drop-out rates are highest during transitions between different levels of education. Nevertheless, owing to design issues and administrative difficulties, the BSM programme does not distribute scholarships to students in the final grades of any schooling level (the sixth year for elementary and the last semester of the third year for junior and senior secondary) (World Bank, 2012b).
6. The early withdrawal rule allows participants to withdraw their accumulated pension benefit after five or more years of service (Muliati, 2013).
7. The net replacement rate is defined as the individual net pension entitlement divided by net preretirement earnings, taking account of personal income taxes and social security contributions paid by workers and pensioners.
8. The administrators of the social insurance programmes for civil servants and military and police personnel (PT Taspen and PT Asabri) will be only transformed later, but prior to 2029, as the integration of these programmes into the national social security system require more time (Muliati, 2013).

LAO People's Democratic Republic

A. Medium-term economic outlook (Forecast, 2014-18 average)

GDP growth (percentage change): 7.7
Current account balance (% of GDP): -19.1

B. Medium-term plan

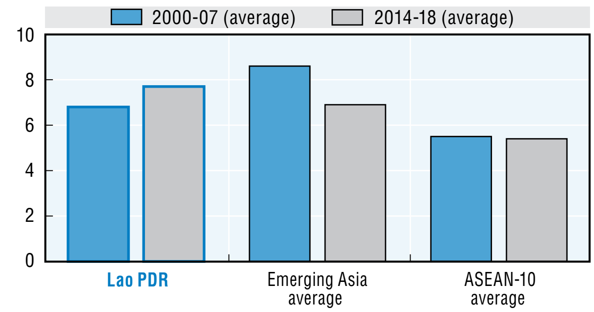
Period: 2011-15
Theme: Socio-economic development, industrialisation and modernisation by the year 2020

C. Basic data (in 2012)

Total population: 6.4 million*
Population of Vientiane 0.7 million (2005)
GDP per capita at PPP: 3 011 (current USD)**

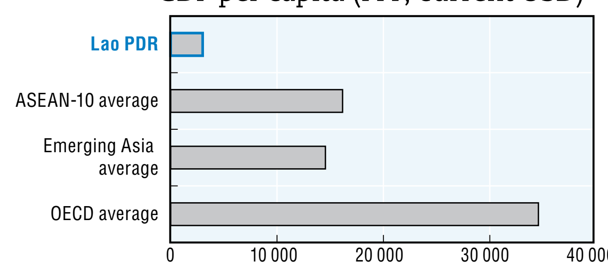
Note: * Total population data for 2012 are estimates.
** IMF estimate
Sources: OECD Development Centre, national sources and IMF.

GDP growth rates (Percentage change)



Source: OECD Development Centre, MPF-2014.

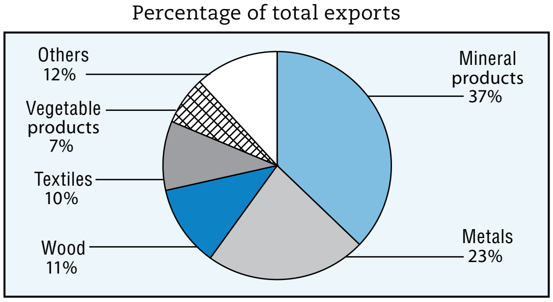
GDP per capita (PPP, current USD)



Source: IMF and national sources.

Composition of exports, 2012

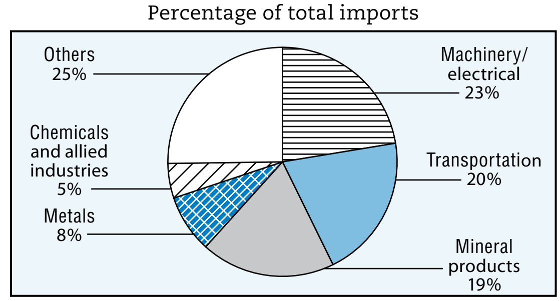
Percentage of total exports



Source: Trademap.

Composition of imports, 2012

Percentage of total imports



Source: Trademap.

Lao PDR's resource-based economy – driven by forestry, agriculture, hydropower and minerals – is on a robust, impressive growth path. However, development is uneven and poverty consequently remains widespread. The government should adopt a sustainable, inclusive growth model so as to reduce poverty and implement sound, suitable strategies for natural resource management to ensure that the country's economic growth is environmentally sustainable.

Infrastructure development, too, will need to keep pace with the country's fast economic growth and rapid urbanisation to ensure sustainable growth and improve the welfare of the people.

LAO PDR's medium-term policy challenges and responses

- Reduce poverty through inclusive growth
- Improve national resource management, in particular mining, to ensure environmental sustainability
- Develop transport infrastructure to speed up rural development

POLICY FOCUS

Reduce poverty through inclusive growth

The Lao People's Democratic Republic (Lao PDR) continues to develop at a commendable pace. On the back of such growth, it graduated to the rank of lower-middle-income country in 2006. It is now enjoying the fruits of its investment in infrastructure, economic and social development, as well as regional co-operation and integration. Robust growth has helped alleviate poverty, but more needs to be done to ensure that such growth is sustainable and inclusive. In other words, Lao PDR is now at the crossroads of development: the economy needs to balance economic growth with equity and sustainability to ensure that current and future generations can participate in and benefit from economic growth.

Despite rapid economic growth, poverty remains widespread

Although Lao PDR's economic growth has been impressive, poverty and disparities remain widespread. In fact, measured in income per capita, the gap between Lao PDR and the ASEAN-6 widened in 2011.

The poverty head count ratio in Lao PDR in 2008 was 33.9, an improvement over 1992 when it was 55.7 (Table 2.4.1). The improvement is in line with the trend in Southeast Asia. According to the Asian Development Bank's Asia and Pacific Key Indicators (2012), there has been a decline in the percentage of people in Southeast Asia living under the poverty line of USD 1.25 per day.

Table 2.4.1. **Poverty reduction in Lao PDR and other Southeast Asian countries**

Percentage of population

Country	Poverty headcount ratio at USD 1.25 a day (PPP)	
	Earliest	Latest
Cambodia	44.5 (1994)	22.8 (2008)
Indonesia	54.3 (1990)	18.1 (2010)
Lao PDR	55.7 (1992)	33.9 (2008)
Malaysia	1.6 (1992)	0.0 (2009)
Myanmar	32.1 (2005)	25.6 (2010)
Thailand	11.6 (1990)	0.4 (2009)
Viet Nam	63.7 (1993)	16.9 (2008)

Note: Poverty headcount ratio at USD 1.25 a day (PPP) refers to the percentage of the population living on less than USD 1.25 a day at 2005 international prices.

Source: ADB (2012a), *Key Indicators for Asia and Pacific 2012,* ADB, Manila.

The poverty gap in Lao PDR has narrowed – a positive development in that the narrower the gap, the easier it is to bring people living below the poverty line above it. However, the concern is how to eradicate poverty completely, not just to lift people out of it. After all, even while they are moving out of it, they still remain poor.

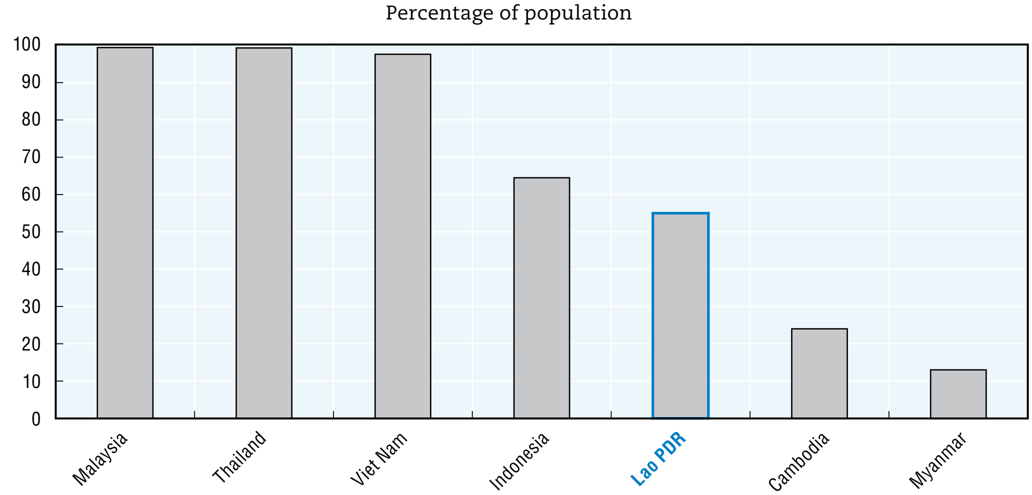
The government generally concentrates its efforts on the extremely poor, directing social payment and poverty reduction measures there, rather than on the moderately poor, i.e. people living on between USD 1.25 and USD 2 a day. This throws up another challenge to government efforts to alleviate poverty. The percentage of employed people living on less than USD 1.25 a day, the "working poverty rate", is 20% in Lao PDR. The inference is that the quality of employment is very low and that there is not much decent work available in the country. The economy needs to create more quality jobs if the issue of poverty is to be adequately addressed.

According to the latest Integrated Household Living Conditions Survey (IHLCS) conducted by the United Nations Development Programme, Lao PDR's poverty incidence (poverty head count index) was high – 27%. It was above that of Myanmar, where is was approximately 25% in 2011, with a significant urban-rural differential. It was lower than Cambodia (32%), but far above Viet Nam (13%).

Poverty restricts access to basic facilities – housing, electricity, water, sanitation, etc. From 2005 to 2010, access to safe drinking water increased modestly, from 63% to 69%, across Southeast Asia. The percentage of the population with access to safe drinking water was 67%. As for access to electricity (Figure 2.4.1), Lao PDR's population fares better than those of Cambodia and Myanmar, even though the country remained part of ASEAN's low-access group in 2011.

Figure 2.4.1. **Access to electricity in Lao PDR and other Southeast Asian countries, 2009**

Percentage of population



Source: World Bank (2012f), *World Development Indicators 2012*, World Bank, Washington, D.C., http://data.worldbank.org/data-catalog/world-development-indicators/wdi-2012.

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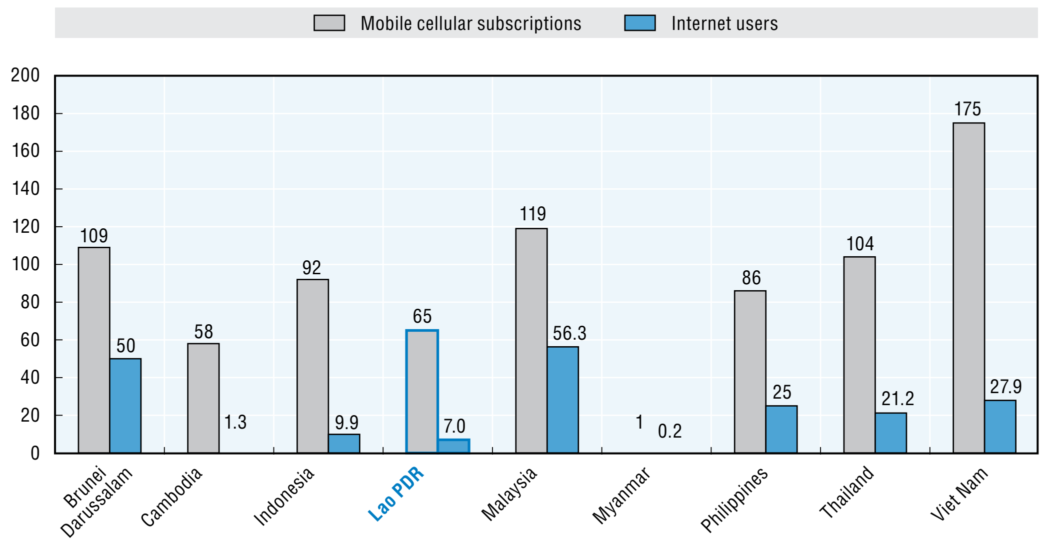
Similarly, cell phone density and Internet access in Lao PDR are low compared to the more advanced ASEAN member countries (Figure 2.4.2): 65% of Laotians have a cell phone but only 7% have Internet access. Nevertheless, Lao PDR's communication index in 2010 was higher than Cambodia's or Myanmar's.

Figure 2.4.2. **ICT indicators in Lao PDR and other Southeast Asian countries, 2010**

Per 100 people



Source: World Bank (2012f), *World Development Indicators 2012*, World Bank, Washington, D.C., http://data.worldbank.org/data-catalog/world-development-indicators/wdi-2012.

StatLink http://dx.doi.org/10.1787/888932938080

Poverty reduction has been accompanied by rising inequality

In the recent years, income disparities have widened in Lao PDR. The reason for income disparities among the 83% of the population who depend on agriculture for their livelihoods is the lack of opportunity in specific localities because rapid growth is concentrated elsewhere in the economy and region. Rural livelihoods are also under threat as the conversion of agricultural lands to cater to the needs of foreign direct investment (FDI) leads to the displacement of populations away from their traditional sources of income.

Lao PDR's Gini coefficient was 36.7 in the 2000s. Although that rating was comparatively low by ASEAN standards, it was an increase from 30 in the 1990s. The increase may have come about as a result of closer linkages to global markets, as well as to market-oriented reforms in the economy.

Besides hampering poverty reduction efforts, inequality can also lead to the misallocation of human capital. Those with little wealth or low incomes are unable to invest in their human capital or wealth- and income-enhancing activities and remain caught in the vicious cycle of poverty. At the same time, inequality restricts the access of the poor to basic infrastructure services, utilities and sanitation, which in turn affects their health and well-being.

Lao PDR has made great headway towards the Millennium Development Goals

Lao PDR posted an impressive economic growth rate of 8% in 2012 and 7% for the whole of the past decade – among the highest in the region. The government has put considerable effort into reducing poverty in the economy. As a result, poverty incidence has declined remarkably on the back of solid economic growth, successive five-year plans focused on poverty reduction, and aid support for remote communities.

The country has also made significant progress towards achieving the Millennium Development Goals (MDGs). The poverty headcount dropped from 46% in 1992-93 to 28% in 2007-08 and is expected to achieve the related MDG target of 25% by 2015. A reflection of their strong commitment to tackling poverty issues, the authorities have adopted poverty eradication as one of their main strategic orientations. They have also placed strong emphasis on macroeconomic stability and on fostering inclusive, sustainable, private-sector-led growth and regional integration. The goal is to attain a gross domesetic product (GDP) growth rate of at least 8% annually in order to reach GDP per capita level of at least USD 1 700 by 2015.

The seventh National Socio-Economic Development Plan (NSEDP) 2011-2015 is geared to achieving the MDGs and the government is pursuing its commitment to addressing social welfare issues. It has made considerable progress towards poverty reduction – the first of the MDGs. In 2010, it completed a framework and financing plan for accelerating achievement of the MDGs by setting six specific targets: access to enabling infrastructure; sustainable practices for improved food security and environmental sustainability; universal access to basic education and gender equity; women's equal participation and empowerment; improved maternal and child health; safe water supplies and improved sanitation for all rural areas and remote communities.

Encourage broad-based, sustainable and inclusive growth for poverty alleviation

Lao PDR's long-term development agenda is based on its gradual transformation from a closed and centrally planned economy to an open, private sector-led economy. The current development strategy aims to support sustainable economic growth and reduce poverty and inequality. However, there are obstacles to inclusive growth that the government needs to bear in mind. Lao PDR has to contend with six.

1. An increasing lack of educated and skilled human resources that hinder private-sector growth and economic diversification.

2. An inefficient, underdeveloped financial sector that slows domestic private-sector growth.

3. Inadequate connectivity between rural and urban areas that restricts the access of families and firms in outlying areas to opportunities in hubs of business, economic, social and cultural activity.

4. Poor nutrition and food insecurity that lead to low worker productivity.

5. Weak governance arising from weak institutions that slows economic growth.

6. Declining competitiveness in the non-resource sector that could affect the economy's potential for achieving inclusive growth.

The current development strategies under the Seventh NSEDP are designed to support sustainable economic growth and reduce poverty and inequality. The strategies involve diversifying and deepening economic activities, significantly scaling up human capital, improving labour productivity, and promoting the inclusion of women, ethnic groups and those living in remote areas. The most important of all is to ensure the quality of growth by achieving the MDGs, protecting the environment, ensuring political stability and peace, working towards regional integration and strengthening linkages with the global economy.

The Seventh NSEDP contains five major thrusts: *i)* national economic development; *ii)* rural development and poverty eradication; *iii)* the promotion of livelihoods; *iv)* improved public administration; and *v)* competitiveness. Towards those five goals, efforts to ensure inclusive growth will focus on rural areas where the majority of the poor live. There will be policy efforts to develop road and energy infrastructure, enhance value chains, improve access to markets and social services, and forge stronger rural-urban linkages. Infrastructure development and natural resource management, which are key to achieving inclusive growth, will be discussed below in the relevant sub-sections.

Active participation from stakeholders (e.g. businesses, trade unions, non-governmental organisations, indigenous peoples) should be an inherent part of the development and implementation of national strategies for sustainable development. Box 2.4.1 gives examples of good practices in stakeholder participation from selected OECD countries.

Box 2.4.1. **Good practices in stakeholder participation: Examples from OECD countries**

Sustainable development involves trade-offs between economic, social and environmental objectives which cannot be determined by the government alone. These value judgments require participatory approaches to sustainable development that engage the public through effective communication. However, the extent to which stakeholders are involved in policy processes reflects national institutional settings and preferences. Structures vary widely across OECD countries in terms of the status, timing and breadth of involvement of stakeholders.

Czech Republic – The Government Council for Sustainable Development includes government, businesses, academics, NGOs and other stakeholders and serves as the umbrella group for developing, implementing and revising the national sustainable development strategy.

Portugal – One of the four principles of the national strategy (*Estrategia Nacional de Desenvolvimento Sustentavel*) is to progress towards a society of solidarity and knowledge through interventions to strengthen the citizen components of education and greater access to information and participation in decision making, which is exemplified in the Council for the Environment and Sustainable Development.

Slovak Republic – The Slovak Republic consulted widely with stakeholders in the development of its national strategy, bringing main business and non-governmental groups into the Slovakian Commission for Sustainable Development to oversee implementation.

Source: OECD (2006b), *Good Practices in the National Sustainable Development Strategies of OECD Countries*, OECD Publishing, Paris.

POLICY FOCUS

Improve national resource management, in particular mining, to ensure environmental sustainability

Natural resource wealth, if managed properly, can greatly benefit Lao PDR's economy as it can raise average income. Indeed, from the 1990s to 2011, per capita income more than doubled to reach USD 1 281. However, as already emphasised, Lao PDR must develop a capacity for robust natural resource management if it is to move toward sustainable, inclusive growth.

The natural resource sector, particularly mining and hydropower, contributed 3.7% to Lao PDR's output growth in 2010. Projections point to average growth of 3% between 2011 and 2015 and 3.5% between 2016 and 2020 (World Bank, 2010b). Mining, a crucial economic sector, contributed approximately 9% to GDP during the 2006-11 period when it grew at an average annual growth rate of 19.9%.

Lao PDR's natural resource wealth has, in recent years, been transformed into other forms of capital, mainly through sharp increases in mineral extraction and hydropower generation. The average share of mineral exploration in the industry's value added was 35.4% between 2006 and 2011. Lao PDR has continued to legalise mining and processing activities along with the capitalisation of assets in the mineral sector.

The volume of hydropower generated is close to the international average. Hydroelectricity is set to contribute over three times to GDP growth between 2014 and 2020. In addition, on the fiscal side, the combined contribution from mining and hydropower to total government revenues is expected to grow more than 20% between 2000 and 2020, reducing Lao PDR's reliance on international grants. In fact, mining and hydropower revenues are projected to account for more than 5% of GDP *per annum* by 2020.

Natural resource management and environmental sustainability are on the development agenda

Although Lao PDR is a landlocked country, it boasts a diverse wealth of natural resources. It is crucial that the government should ensure their sustainable management so that there is sustainable economic growth and poverty alleviation. The four areas of national resource management that should be of concern are forests, land management, mining management and hydropower production.

Prevent deforestation, regenerate forests, encourage commercial development

Lao PDR continues to rely heavily on its forests to support national development. However, an estimated 91 200 hectares of forest have been lost every year since the early 1990s. To make up for their loss, the government is regenerating and reforesting with the aim of ensuring 65% forest coverage between 2011 and 2015. The aim is to make Lao PDR a greener country and, by 2015, to classify 60% of the country's forests by type, certify 10% of total forest product, strengthen forest management, and support action to mitigate climate change.

The government is also actively encouraging people to get involved in reforestation and tree-planting activities. The private sector has steadily shifted its activities toward wood-processing and is planting commercial trees such as eucalyptus, teak, agar wood and rubber. As a result, deforestation and illegal logging activities have decreased, supported by the laws and regulations that the government has introduced to prevent deforestation. To maximise the effect of its policies, it continuously monitors the progress and evaluates the impact of its law enforcement efforts.

It has also drawn up a classified land management plan at macro level (country, province and district) and micro level (village and *kumban*, or cluster of villages). The purpose is to maximise the benefits of land usage in the country, improve farmers' livelihoods, and sustain natural resources. There are also plans to hand over land management responsibility to organisations and individuals. At the same time, Lao PDR is seeking to increase land revenues collected from tax, rent, transactions and ownership transfer fees so that they account for 15% of national income per year.

Sustainable mine management is profitable mine management

While Lao PDR is one of the most biodiverse countries in the region, mining development pose threats to environmental and human health. As the sector continues to grow and investment proliferates, the current project-by-project approach to governance will become inefficient and inadequate. To date Lao PDR has never tried a systematic macro-governance regime for natural resource management. The authorities need to carefully decide how many projects and of what sort they will allow to go forward and in what sequence. The process of natural resource management must be transparent and the effective implementation of overarching policies and sector strategies must be feasible.

As mining is one of the most important sectors in the economy, proper management will deliver sustainable, inclusive growth in the future. To that end, the government is working to optimise the mining of the country's mineral resources both quantitatively and qualitatively through the geological approach. The prime purpose of geological and mineralogical surveys is to better map and explore mineral lands for purposes of mining development. The goal of exploration is to manage the excavation of important mineral ores and process them into finished or semi-finished product before marketing them. At the same time, mineral exploration will improve the industry's output and productivity.

With the geological approach, the government aims to generate income and accumulate capital and resources that it will then channel into the country's socio-economic development to raise living standards and make Lao PDR a vital member of ASEAN. It will also target the effective use of natural resources, which will include water and minerals, and the conservation and protection of the environment. By mineral survey mapping and exploration, it will assess investment needs, funding availability from international agencies, and mineral milling facilities. The ultimate goal is to produce finished and semi-finished products while phasing out the export of raw minerals with no added value.

In 2015, the government aims to plot a geological and mineral map on a scale of 1:200 000 and to map 75% of the country's area on at least a 1:50 000 scale. Currently, there is a 1:1000 000 scale mineral mining map for every province, a 1:200 000 map of 54.86% of Lao PDR and 1:50 000 maps of some areas, including Sepon, Sanakharm and a stretch of the Mekong River bank in the northern provinces. The aim of these survey maps is an annual discovery targets of 86 000 tonnes of flat copper, 298 000 tonnes of copper dust, 6 tonnes of gold bar, 728 000 tonnes of coal, and 600 000 tonnes of granite. When the mining gets underway, it will be supported by environmental conservation measures to secure more than 65% of the protected mineral areas by 2015.

Harness hydropower for renewable nationwide electricity and fiscal policy to safeguard biodiversity and create revenue for poverty reduction

Lying along the bank of the Mekong River, Lao PDR has benefitted enormously from this abundant water resource. Hydropower production has made a large contribution to national output. With the sheer strength of the river's water flow, Lao PDR's hydropower output in 2012 increased by 29% to 13.8 billion kilowatt hours. It meets domestic demand (30% of total output) as well as demand from its neighbours, Thailand, Viet Nam and China (70%). Because it is important to the economy, water management and hydropower production has been included in the Seventh NSEDP.

Currently, there are 29 dams producing hydroelectricity through the country. A number of hydropower plants are under construction. There is also interest in developing small hydropower dams that could create economic value and efficiency. Such projects are considered part of the overall effort to help the country achieve its targets of supplying electricity to 90% of the population by 2020 and generating power from renewable energy sources.

The expansion of hydropower development projects is changing water management in Lao PDR. The country plays a pivotal role in preserving sustainable water supplies, especially when they are related to the Mekong River. Although a very long stretch of the Mekong and its tributaries run through Lao PDR, the river also flows through other countries in the Greater Mekong Subregion. Any changes to the Mekong River's biodiverse balance will affect the environment and peoples' livelihoods throughout the region. Cognisant of the situation, the Lao PDR government has undertaken numerous policy initiatives and programmes to minimise, mitigate or compensate the environmental and social cost of hydropower production.

Fundamentally, fiscal policy is the main instrument for mitigating the negative effects of natural resource extractions. In the short run, fiscal policy can curb the spread of volatility from commodity prices to the real economy while, in the medium term, it can help policy makers set growth-enhancing public expenditure priorities. The key factor is to ensure transparency during the fiscal term and establish a monitoring mechanism through targeted capacity building and communication with private sector.

For the fiscal regime in the hydropower sector, there is no clear methodology as the approach there is case-by-case. It is important, therefore, to apply a more transparent, less discretionary regime that is internationally competitive. The tax regime, by contrast, should have a standard method for determining the fiscal benefits of all hydropower projects. At the same time, exemptions should be eliminated from primary taxes when the government sets the key taxes and imposes a resource rent tax system.

As for the mining sector, its long and costly exploration times call for a different tax regime. To maintain international competitiveness and attract responsible investors, the government should introduce a clear, more predictable investment regime, together with the greater security of tenure associated with a mining title. Moreover, it should also be easier for investors to approve finder rights and improve their access to essential inputs – geological data, skilled labour, equipment, financing and services.

Compensation for environmental and social costs should be made through government revenue distribution and management. Most important is that revenues should be allocated to poverty reduction and public investment as part of the NSEDP development programme. For example, spending on public investment will stimulate future growth provided that a sound public investment programme (PIP) is in place. An effective PIP should come complete with a comprehensive monitoring and evaluation system to ensure that the projects are effective and free from the risks of capacity constraints, corruption and low absorptive capacity.

A fiscal rule should be in place to help the government manage revenues and ensure macroeconomic stability. In the long run, however, a shift in reliance to the non-resource sector should be considered. A country that is overly dependent on resource-driven growth will be vulnerable to shocks in the mineral commodities market. As a result, it is important for Lao PDR to create conditions conducive to the development of the non-resource sector. These include a favourable investment climate, improved trade facilitation and the development of human capital.

At the sub-regional level, the Great Mekong Subregion (GMS) already has the GMS Environment Operations Centre (EOC) running the Core Environment Program and Biodiversity Conservation Corridors Initiative (CEP-BCI). Since 2006, GMS OEC has been administered by the Asian Development Bank (ADB). The CEP-BCI is a response to rapid economic development across the GMS. The core environmental programmes cover planning, piloting innovation, monitoring and assessment.

Co-ordinated by the GMS EOC, the CEP-BCI's goal is to achieve an environmentally friendly and climate-resilient GMS programme. Additionally, to solve the problem of monopsony in the hydropower market within the region, the memorandum of understanding that establishes the Regional Power Co-ordination Centre has been signed by the representatives of the countries that attended the 18th GMS Ministerial Conference.

POLICY FOCUS

Develop transport infrastructure to speed up rural development

Lao PDR's strong economic growth has brought it face to face with the challenges of rapid urbanisation and inadequate infrastructure. Its weak infrastructure has impaired its manufacturing and industrial potential and does not make it easy to do business in Lao PDR. The transportation costs which weigh heavily on business profitability could be reduced if the government continued its infrastructure development programmes, which include building the roads that would improve national and regional connectivity and, by the same token, the efficiency of business activities.

Lao PDR has put much effort into developing its physical infrastructure

Being a land-locked country with poor infrastructure, Lao PDR must address obstacles to its socio-economic development. The government has introduced regional and sub-regional infrastructure development projects, especially under the ASEAN framework and in the Greater Mekong Subregion and Triangle Development Area.

At the ASEAN level, infrastructure development is essential for all the ASEAN member states. There is an abundance of regional projects, agreements, and studies to boost infrastructure development, which chiefly comprises transportation, energy, and information and communication technology (ICT), all of which have been incorporated into the Master Plan on ASEAN Connectivity (MPAC). Infrastructure is a strategic area which has multiplier effects across the economy.

Transport infrastructure a prime focus of development plans

During the 2006-10 development plan, infrastructure was built on a massive scale. The average annual growth rate of the sector was 11.3% and it contributed to 4.8% of GDP through trade and investments. The government has now implemented 25 projects as part of 11 priority programmes and 111 projects as part of the Eighth Master Plan on Communication and Transport. The emphasis on transport infrastructure is due its anticipated benefits for the tourism industry and the country's logistics. There are two main thrusts to the infrastructure development effort: *i)* construct and improve communication, transport and networking between sub-regions and regions; *ii)* construct and improve communication, transport and networking within the country.

The government's commitment to improving transport infrastructure is reflected in its Master Plan on Communication and Transport, which began in 2011. The objective is to develop road networks to 100% of the Road Plan by 2015 with the aim of improving sub-regional, urban, and rural links, and making selected areas accessible. At the same time, the country has also planned to build infrastructure for air transport and grow the sector by 8-10% annually.

Currently, Lao PDR's transport infrastructure consists of:

Roads for motor vehicles. Road transport accounts for 80% of all goods and passenger transport. The road network serves all parts of the country, but is densest in the central and southern regions. Although Lao PDR's road density is still low compared to other countries in the region (Table 2.4.2), there is ongoing work to develop and expand it.

Table 2.4.2. **Road infrastructure indicators in Lao PDR and other Southeast Asian countries**

	Total road network (thousand kilometres)	**Road density** (kilometers of road per thousand square kilometres of land area)
Cambodia	38.3 (2004)	216.7 (2004)
Lao PDR	39.6 (2009)	171.4 (2009)
Malaysia	39.6 (2009)	300.5 (2004)
Thailand	180.1 (2006)	352.4 (2006)
Viet Nam	160.1 (2007)	516.3 (2007)

Source: ADB, *Key Indicators for Asia and Pacific 2012*.

Between 2006 and 2009, the total length of the road network increased 17% from 33 803 kilometres to 39 568 kilometres. The projects completed include:

- the Thai-Lao Friendship Bridge across the Mekong River from Savannakhet in Lao PDR to Mukdahan Province in Thailand;
- B Road No. 1 in Vientiane Capital;
- Road No. R3 (from Bortan to Husay);
- improvements to Road No. 9 (from Secannakat to Seno);
- Road No. 12 (from Thukack to Gnommalard);
- bridge across the Mekong River (Thakack to Nakonpranom);
- Road No. 2E (Meungkoua to Taijang).[1]

Despite the steady road development, the demand for road transport infrastructure remains high, since just 13.7% of the total road network was paved in 2009 and the paved stretches serve only urban areas. Most of the roads in provincial districts and rural areas are made from natural rocks and earth. This affects linkages between the domestic and regional road transport systems. In general, the length and quality of the road infrastructure remain inadequate.

Waterways. Waterways account for 18% of the total transport network. Most are inland and serve domestic destinations. The exception is the Mekong River which continues to be used for international transport to neighbouring countries. Waterways are particularly widely used in Lao PDR's northern provinces. They are not only an important commercial link with China, they also carry tourists, many of whom prefer to travel by boat from Thailand to Lao PDR or along the Mekong River in the north of the country.

Airports. Lao PDR's two national airlines – state-owned Lao Airlines and joint public-private Lao Air – serve domestic routes, while airlines from neighbouring countries, together with Lao Airlines, offer international flights. There are two Thai Airways departures daily from Bangkok and Vientiane, Chiang Mai, and Luang Prabang. Viet Nam Airlines flies a route that takes in Hanoi, Vientiane, Phnom Penh and Ho Chi Minh City, while China Airlines serves the Vientiane-Kunming-Vientiane route. International flights land at two airports, Vientiane International and Luang Prabang Airport. There are also flights between Vientiane and the northern provinces Luang Prabang, Xayabury, Xamneu, Phongsaly, Lungnamtha, and Xiengkhuang. In total, there are 10 small approved airports in the provincial capitals and 39 others with unpaved runways. The air transport sector has undergone significant reform – particularly with the privatisation of airports and airline operation – and has developed significantly.

Progress in telecommunications connectivity

The progress that Lao PDR has made in developing its telecommunication infrastructure is evidenced chiefly in the 3.6 million connections made. Land lines account for 149 300, mobile phones 3.39 million and wireless landlines 50 000.

Telecommunication capacity has also been expanded in rural areas in furtherance of the aim of 80% coverage. An extra 13 200 kilometers of optical fibre lines have been laid, spanning 90% of all provinces and 80% of all districts. What's more, a new base transceiver station (BTS) for mobile phone communication has led to the installation of 2 000 receiver stations.

Connectivity between countries in the Greater Mekong Subregion substantially strengthened

An infrastructure feat that is nearing completion concerns the three GMS Economic Corridors – the East-West, North-South, and Southern Corridors. Roads and railways are being built to strengthen connectivity along the three trading corridors and facilitate the through transport of goods and services.

There are 12 flagship infrastructure projects along the East-West Corridor, 6 of which concern transport and 6 other infrastructure development projects (Table 2.4.3).

Table 2.4.3. **Infrastructure projects in Lao PDR and other Southeast Asian countries**

Transport infrastructure projects	Other infrastructure projects
East-West Transport Corridor	Development of electric power grid
Waterway development	Regional energy co-operation arrangements
Railway development	Telecommunications backbone development
Airport development	Tourism development
Facilitation of cross-border movement of people and goods	Economic corridor initiatives
Human resource development for the transport sector.	Assorted initiatives from ASEAN ministries of economy, trade and industry (ASEAN–METI), Economic and Industrial Co-operation Committee (AMEICC), and Working Groups on West–East Corridor Development.

Source: OECD Development Centre's compilation based on national sources.

As for economic integration through the North-South Economic Corridor (NSEC), there are also projects underway to improve infrastructure and facilities. They include projects to develop land, water and air connectivity along the three NSEC routes, as well as telecommunication backbones, border checkpoints facilities and cross-border transport facilitation.

Along the Southern Economic Corridor (SEC) projects are being undertaken to develop the physical infrastructure. A particularly important one is for the build of three power transmission lines from Kampot to Sihanoukville; Tay Ninh in Viet Nam to Kampong Cham and Kratie in Cambodia; and Hat in Lao PDR to Stung Treng in Cambodia.

Lao PDR must build on its infrastructure development achievements to meet its targets

The government should continue its efforts to develop infrastructure, with a special focus on road transport, inland waterways, airports and railways. It must extensively improve the transport network to support sub-regional linkages between north, south, east and west and ensure that roads in urban areas are maintained and upgraded.

The authorities should also continue to improve and renovate all municipalities through proper urban planning and water and wastewater management. Road safety, too, deserves serious attention in order to reduce the number of accidents, while the telecommunication infrastructure must also be further developed in all parts of the country with the use of up-to-date technology.

Lao PDR's Seventh NSEDP sets targets for domestic infrastructure development from 2011 to 2015. One is to develop machine- and electricity-based agro-irrigation that covers 60% to 70% of cultivated flat and mountainous land or 50% of rice and livestock land and industrial plantation areas.

A second target is to build eight hydroelectricity plants with a combined installed capacity of 2 862 MW by 2015. Electricity infrastructure development also includes extending medium-voltage (22 kV) power transmission lines and providing off-grid electricity supplies in rural and remote areas so as to bring electricity to 80% of all households in the country by 2015, as mentioned in NESDP.

As for transport, the NSEDP calls for the construction and/or expansion of road networks linking sub-regions, towns and cities, and rural areas and villages. It also sets the goal of growing its air transport sector by 8%-10% *per annum*.

The fourth and fifth targets are to pipe drinking water to approx 60% of the urban population and to expand the telecommunication service network to cover 90% of villages nationwide. Optical fibre networks 17 192 kilometres long will be built and telephone connectivity will be expanded through cell phones and land lines to reach 80% of the population.

In all its efforts to provide all kinds of infrastructure the government should bear in mind a critically important consideration: it is crucial not only to provide infrastructure but to build the capacity to manage and operate it.

In sum, Lao PDR has moved forward in its efforts to develop its infrastructure. There is still much room for improvement, however. But with support from international organisations and neighbouring countries, improved infrastructure can help further stimulate the country's economic development, deepen regional co-operation, and boost regional economic growth.

Note

1. Road No. 14A is a currently ongoing project. Another completed project is the Dongphousy-Thanalang stretch of railway line, which is three kilometres long.

Malaysia

A. Medium-term economic outlook
(Forecast, 2014-18 average)

GDP growth (percentage change):	5.1
Current account balance (% of GDP):	5.2
Fiscal balance:	-4.5

B. Medium-term plan

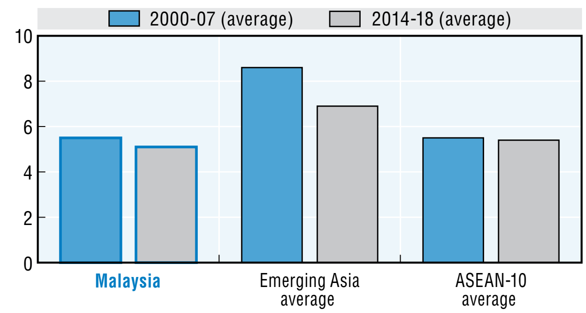
Period: 2011-15
Theme: Charting development towards a high-income nation

C. Basic data (in 2012)

Total population:	29 million
Population of Kuala Lumpur	1.7 million
GDP per capita at PPP:	16 922 (current USD)

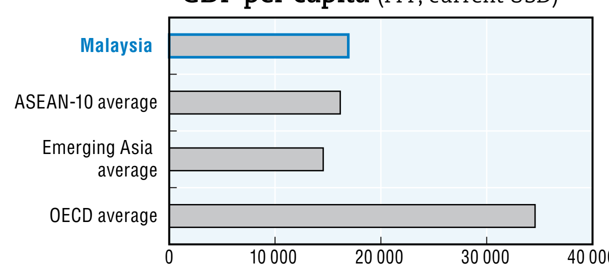
Sources: OECD Development Centre, national sources and IMF.

GDP growth rates (Percentage change)



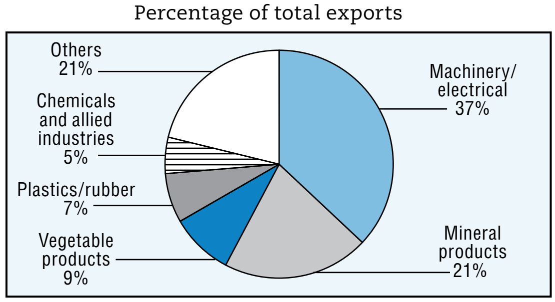
Source: OECD Development Centre, MPF-2014.

GDP per capita (PPP, current USD)



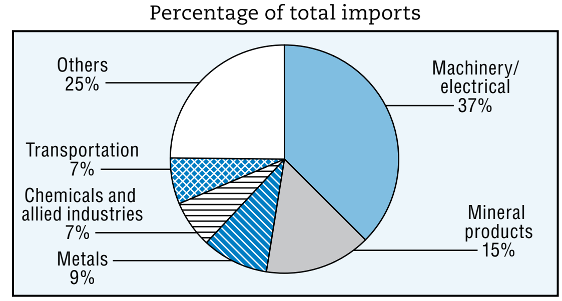
Source: IMF and national sources.

Composition of exports, 2012
Percentage of total exports



Source: Trademap.

Composition of imports, 2012
Percentage of total imports



Source: Trademap.

The Malaysian economy has proved to be resilient at a time of global economic headwinds. Over the medium term, however, there are important long-standing structural issues that may affect its march towards developed country status by 2020.

Such structural problems affect the education system and continue to be a stumbling block in efforts to improve productivity and attract the value-adding high-tech industries that require skilled labour. Small and medium-sized enterprises (SMEs), which contribute so heavily to employment, are especially hard hit as they face difficulties in attracting skilled labour. While the fiscal balance continues to improve, uncertainties in the external environment, coupled with the failure of fiscal reforms to rein in spending on subsidies or implement a goods and services tax (GST), may have an impact on the economy's public finances.

Malaysia's medium-term policy challenges and responses

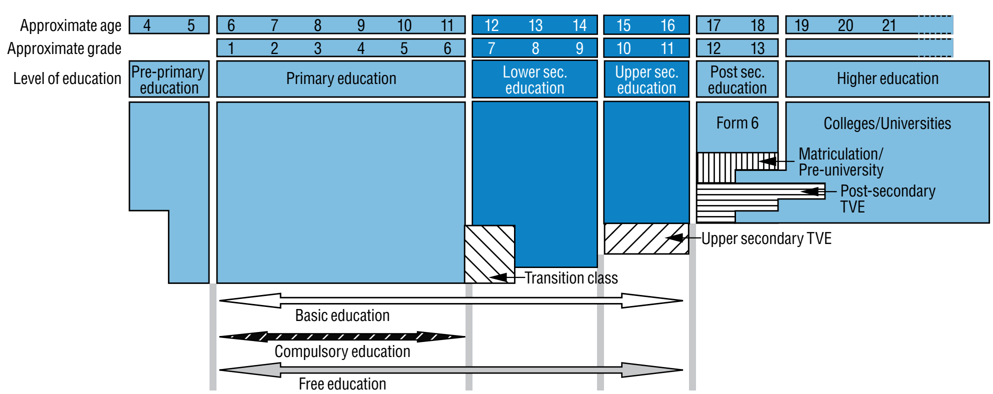
- Improve the quality of education
- Improve the productivity of SMEs
- Widen the tax base and improve tax administration and compliance

POLICY FOCUS

Improve the quality of education

The Malaysian education system has made steady progress. At the time of Independence in 1957, more than half of the population had no formal schooling, while only 6% of children had been educated to secondary level and just 1% to the post-secondary level. Five-and-a-half decades later, education enrolment rates at every education level have risen substantially. In 2011, Malaysia's enrolment rates reached 94% at primary level and 87% at lower secondary level (forms 1 to 3). The upper secondary level (forms 4 to 5) has seen tremendous improvements in enrolment, too – from a rate of 45% in the 1980s to 78% in 2011 (Ministry of Education, 2012).

Figure 2.5.1. **At-a-glance overview of the Malaysian education system**



Source: UNESCO (2011), *Secondary Education Regional Information Base: Country Profile – Malaysia.*
StatLink http://dx.doi.org/10.1787/888932938099

Improved educational access in Malaysia has also been followed by improved educational attainment. From 1950 to 2010, the proportion of the adult population with no schooling declined from 60% to less than 10%, while the share with secondary schooling rose from around 6% to slightly more than 61% (Ministry of Education, 2012).

Educational outcomes have deteriorated

In spite of the significant improvements in access and attainment, the standard of educational outcomes has not been encouraging. International comparisons show that Malaysian student competencies are far from satisfactory. In *PISA 2009 Plus*,[1] Malaysia was placed in the bottom third of the 74 participating countries, below the international and OECD averages.[2] The results reveal that students in Singapore; Korea; China; Hong Kong, China; and Shanghai performed as though they had three or more years more schooling than their counterparts in Malaysia.

Another considerable challenge is the disparity in quality between student outcomes in urban and rural areas. Primary school evaluation tests (UPSR) for children in the Malaysian equivalent of grade 9 pointed to a 4 percentage-point gap between urban and rural school outcomes. The results of examinations for the SPM (Malaysian Certificate of Education, approximately grade 11) showed that the gap had doubled to 8 percentage points (Ministry of Education, 2012).

Educational quality affects students' performance at school and, later as school leavers, in the labour market. A study by the OECD to relate cognitive skills – as measured by PISA and other international instruments – to economic growth found that relatively small improvements in the skills of a nation's labour force can have very powerful impacts on future well-being. While both basic skills and advanced skills are important for developing countries, only quality education can deliver the advanced skills needed to help a country escape the middle-income trap and move up to high-income status.

The oversupply of graduates suggests that issues related to access may not be critical in Malaysia (Ministry of Higher Education, 2012). A more urgent need is to improve the overall quality of education in Malaysia if it is to keep pace with its regional competitors.

There are 20 public universities and 60 private higher education institutions nationwide and "every year about 180 000 students graduate with diplomas and degrees", as Malaysia's Prime Minister observed in his budget speech on 28 September 2012. In May of the same year, the then Deputy Human Resources Minister, Datuk Maznah Mazlan, told Parliament that some 76 200 graduates in Malaysia were unemployed (Ibrahim, 2012). She was drawing attention to a very real problem that receives no media coverage. In general, the perception is that unemployment in Malaysia is due to the unavailability of jobs (UNESCO, 2012).

However, despite the oversupply of graduates, there are jobs that private sector employers have not been able to fill because of the mismatch between industry needs and graduates' qualifications. The labour market, especially in the private sector, requires more science and technical graduates. Also, new science and technical graduates do not meet industry needs owing to their lack of crucial communication and technical skills and knowledge (Ministry of Higher Education, 2012).

Improve the quality of teachers

In 1999, 2003, and 2007 Malaysia took part in the Trends in International Mathematics and Science Study (TIMSS)[3] which assesses achievement in mathematics and science in schools. The country participated as part of its commitment to raising its educational quality and competing with developed nations. In 1999, its results in the TIMSS mathematics and science tests for the eighth grade were well above the international average. In 2007, however, they fell back below that benchmark. 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 lagged behind their counterparts from the high-income economies in the region.

Malaysia's 2007 TIMSS results suggest that, if it is to improve the quality of its secondary education provision, it will need to ensure the continuous training of high-quality teachers who are able to respond to complex educational and social needs.

Table 2.5.1 shows the results of a 2010 study by the National Higher Education Research Institute (IPPTN) into how higher education administrators perceived the quality of teachers in Malaysia. Respondents were asked to judge teachers against four "Dimensions" – fundamental quality, personal quality, citizenship quality, and knowledge and skills – and to rate their performance on a five-point scale in ascending order, where a score of 1 was "very weak" and 5 was "excellent" (Ismail et al., 2010).

Table 2.5.1. **Mean scores and standard deviations of teacher quality as perceived by university and teacher education institute administrators in Malaysia, 2010**

Score between 1 "very weak" and 5 "excellent"

Dimensions	Mean score	Standard deviation
Fundamental quality	3.64	0.48
Intellectual	3.38	0.59
Social skills	3.97	0.52
Communication	3.63	0.65
Numeracy	3.53	0.51
Personal quality	3.78	0.61
Attitude	3.93	0.70
Philosophy	3.81	0.71
Values	3.77	0.71
Adaptability	3.59	0.64
Citizenship quality	3.71	0.62
Citizen advocacy	3.77	0.68
Culture worthy	3.49	0.64
Social diversity	3.87	0.73
Knowledge and skills	3.89	0.60
Teaching, learning and class management	3.89	0.64
Co-curricular activities	3.62	0.88
School management	3.88	0.73
ICT skills	4.42	0.59
Technical skills related to performance of teachers' role	3.65	0.59
Total mean score perceived by higher education administrators	**3.88**	**0.50**

Source: National Higher Education Research Institute (IPPTN).

It is also noteworthy that of all four main quality dimensions "fundamental quality" had the lowest mean score at 3.64 (0.48 standard deviation). Within that dimension, "intellectual" was the quality rated lowest at 3.38 (with standard deviation of 0.59).

It may be inferred from these results that the teaching profession is not attracting the most able candidates, even though the policy of the Ministry of Education's teacher training institutes for a number of years has been to attract the best. Teaching is no longer a profession of choice, but one of last resort. Hardly surprising, then, that a 2011 study found that only 50% of teachers delivered their lessons effectively. Put another way, the lessons did not engage students sufficiently. They were passive, delivered like lectures, and focused on achieving surface-level content understanding, rather than higher-order thinking skills (Ministry of Education, 2012).

Policy priority: professional, real-world education driven by political will rather than interference

Many other factors, both within and outside the education system, affect academic standards and outcomes. According to a 2004 OECD study, one common factor in countries that perform well in PISA tests is that the authorities put much effort into improving the education system. In those countries, it enjoys high political priority and is largely independent of the political orientation of the ruling government (OECD, 2004).

Other priorities pursued as part of high-performing countries' commitment to improving the quality of education include:[4]

- a focus on ICT, mathematics and science,
- higher levels of English-language competence,
- closer co-operation between schools and the world of work,
- higher standards in pre-service and in-service teacher training.

Policies to strengthen the Malaysian education system and reverse the sharp fall in standards and outcomes should concentrate on:

- attracting the best candidates and improving the work of currently serving teachers,
- allowing schools greater autonomy in curriculum delivery and learning methods,
- moving the current school funding model to one that is needs-based.

Attract the best candidates and improve the work of incumbent teachers

There should be incentives for the best graduates who have a passion for teaching to join the profession. At the same time, performance-based contractual employment would filter out any recruits who might perform poorly.

Another important measure is to improve the current teacher-training curriculum so that it offers a more even balance between pedagogical content knowledge and teaching skills relevant to life in the 21st century. Reshaping the teacher-training curriculum is a prerequisite for any action to address the supply-side issues of new teachers.

Addressing the quality of currently serving teachers requires distinguishing between teacher quality and teaching quality. Government intervention is noticeably more focused on improving the quality of teachers, with generous grants and study leaves to help teachers upgrade their academic qualifications.

While the quality of teachers is important, greater emphasis should be placed on better teaching standards. One way to do so would be through a systemic reform of current practices in teachers' continuing professional development (CPD) and teacher performance evaluation. The *Malaysia Education Blueprint 2013-2025* has made this shift in emphasis, and rightly so. To address the issue of poor-quality teachers, it calls for upgrades in the quality of CPD for teachers, allowing them to focus on their core teaching function, and recommends the implementation of competency and performance-based assessment.

Allow more school autonomy in curriculum delivery and learning methods.

Malaysia's school and schooling provision accords rural and urban areas the same levels of infrastructure, resources and support to ensure that every child in the public school system receives an equal standard of education. However, despite equity in the allocation of resources, gaps in student achievements still persist as socio-economic factors outweigh school-related ones.

Addressing school governance can help right this imbalance: schools could be allowed more autonomy in curriculum delivery and learning methods. Schools would thus enjoy greater flexibility in their work to improve student performance through creative, innovative education practices. Schools should be empowered to determine strategies and customise their curricula to incorporate practices that would improve student learning.

Move the current school funding model to one that is needs-based

At present, funds for curriculum support and school operations are allocated on a per capita basis (i.e. per enrolled student). Per capita allocation is simple, objective, and relatively easy to administer and monitor. However, Malaysia's model of equitable public expenditure leaves room for improvement. Many such schools are located in remote, disadvantaged areas and the current funding policy which does not distinguish between urban and rural locations puts them at further disadvantage. The result is an ever-widening of the gap in student outcomes.

POLICY FOCUS

Improve the productivity of SMEs

The *Malaysian Census Report on SMEs 2011* recorded a total of 645 136 small and medium-sized enterprises operating in Malaysia. They accounted for 97.3% of all business establishments. Census findings also showed that 90.1% of SMEs were in the services sector, 5.9% in manufacturing and 3% in construction. The remainder operated in agriculture (1%) and mining and quarrying (0.1%).

SMEs contributed nearly one-third (32.5%) of GDP in 2011, compared to slightly more than large firms' two-thirds (67.5%). In the same year, the output of SMEs expanded at a faster pace (6.8% year-on-year) than that of the overall economy (5.1%). Employment in SMEs also grew faster than total employment growth – 3.9% against 3.7%.

By far most Malaysian SMEs do business in the services, generating a total of value added in 2011 that accounted for 20% of national output (Table 2.5.2). Manufacturing sector SMEs come a distant second, contributing just 7.9%.

Table 2.5.2. **Contribution of SMEs to GDP in Malaysia, by key economic activity, 2007-11**

	2007	2008	2009	2010	2011
Agriculture	3.4	3.3	3.4	3.4	3.4
Mining	0.1	0.1	0.1	0.1	0.1
Construction	0.7	0.7	0.8	0.8	0.8
Manufacturing	8.2	7.8	7.4	7.7	7.9
Services	18.2	19.1	19.9	19.8	20.0
Plus: import duties	0.1	0.2	0.2	0.2	0.3
Total SME value-added	30.7	31.2	31.7	32.0	32.5

Source: Department of Statistics, Malaysia.

Malaysian SMEs face a number of constraints:

- lower productivity than their counterparts in the more developed nations,
- lower business formation rates than in high-income nations,
- output and employment is concentrated in a relatively small number of firms,
- many operate in the informal sector.

In July 2012, Malaysia launched its SME Masterplan which seeks to boost the contribution of SMEs to GDP from 32% to 41%. The Masterplan's objectives include:

- raising the productivity of SMEs,
- increasing the SME business formation rate,
- expanding the number of high-growth, innovative companies,
- intensifying entry of SMEs into the formal sector.

SME productivity still lags behind

Malaysian SMEs have outstripped large firms in productivity growth in recent years. In 2010 and 2011, they recorded two consecutive years of positive growth (0.9% and 2.8% respectively), while big firms' productivity growth was negative in 2010 (down 9.3%) before rebounding in 2011 (0.9%) (SME Corporation Malaysia, 2012a).

The productivity performance of Malaysian SMEs has been attributed to the government's encouragement of automation and the adoption of information and communication technology (ICT), as well as to capacity building programmes. There is evidence that Human Resources Development Fund (HRDF) training programmes have had a positive impact on SMEs, helping them to increase their value added, investment, labour productivity, and wages.

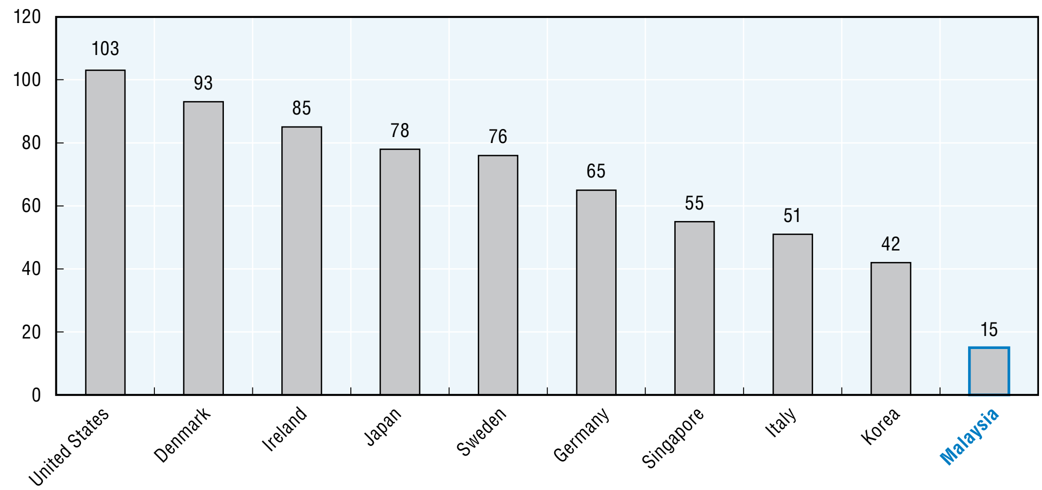
However, there is no denying that the productivity performance of Malaysian SMEs still lags behind that of large domestic firms. The most recent estimates put the average productivity of SMEs at MYR 50 498 (Malaysian ringgit) per employee, 64% lower than the MYR 140 691 per employee estimated for large firms. The gap is attributable mainly to SMEs' sizeable employment of unskilled workers in labour-intensive industries across all economic sectors (SME Corporation Malaysia, 2012a).

More importantly, the productivity of Malaysian SMEs is significantly lower than that of their counterparts in the advanced economies. In the United States, for example, SMEs were nearly seven times more productive in 2008 (Figure 2.5.2).

In a rapidly globalising economic environment, Malaysian SMEs may not be able to withstand competition from even foreign-based SMEs. Enter the *SME Masterplan*, which sets out a vision of SMEs that can effectively compete on the global stage.

One main objective of the *SME Masterplan* is to raise the productivity of SMEs – a daunting challenge. The findings from a survey of SMEs conducted by the Associated Chinese Chambers of Commerce and Industry of Malaysia (ACCCIM) in 2012 show that nearly one-third (32%) of respondents from agriculture, timber, fishery, farming and the gardening industry indicated that they were innovating to improve productivity. While this sounds like good news, it should be noted that the aggregated results across all sectors reveal that only 11% of respondents stated that the prime purpose of their innovation activities was to improve productivity. This lower percentage also suggests that the largest SME contributors to national GDP by economic activity – services and manufacturing – are not giving productivity enough priority.

Figure 2.5.2. **SME labour productivity in Malaysia and other selected countries, 2008**
Value added per worker in USD thousand



Source: SME Corporation Malaysia (2012b), *SME Masterplan 2012-2020: Catalysing Growth and Income.*
StatLink http://dx.doi.org/10.1787/888932938118

However, SMEs cannot really be faulted for not giving enough importance to innovation. They possess inherent traits that may weaken their ability to innovate and advance technologically. These include:

- key decisions made by individuals, owners, or small groups;
- short-term gains more important than long-term vision;
- predominant focus on cutting costs and getting more for less;
- low or no investment in research and development due to lack of funds or skills.

Inadequate human capital holds back productivity growth

An inadequately educated and trained work force is a major impediment to business and growth. As mentioned above, one major reason why Malaysian SMEs' productivity is poorer than that of large domestic firms is the large number of unskilled workers that they employ in labour-intensive industries across all economic sectors.

There is a mismatch between labour supply and demand in Malaysia because the labour supply lacks job readiness. The curricula of Malaysian universities, colleges, technical schools and polytechnics has little industry perspective or up-to-date industry knowledge. The quality of students has suffered.

Even though graduates in Malaysia face unemployment and underemployment, SMEs often have trouble attracting and retaining workers because they cannot pay such high salaries as larger firms. The talent pool in Malaysia has also been dried out by the brain drain, as qualified and highly skilled workers flock overseas to seek better career opportunities. SMEs have suffered more than large firms.

SMEs' lack of interest in staff training has not helped matters. The ACCCIM 2012 survey of SMEs reveals that only 26% reported that they conducted regular staff training courses, 50% that their training programmes were irregular, and 24% that they provided no training at all. There are various reasons for this. One, according to 33% of the respondents in the ACCCIM survey, was limited human resources – in other words, sending employees for training disrupted business. Many employers also feared their trained staff would be poached by other firms or that trained employees would leave to join a competitor.

SMEs widely perceive training as a cost and fail to appreciate the long-term benefits of productivity gains. Many also fail to realise that their employees need constant training and skills upgrading if they are order to improve their capacity to innovate. Finally, the simple lack of relevant courses is also a possible reason why SMEs show little interest in training (SME Corporation Malaysia, 2012b).

Some priorities for improving SME productivity

How efficiently a firm converts inputs into outputs determines its productivity. Firm productivity is therefore a reflection of both labour ability and technology. It is shaped chiefly by factors that include the quality and size of the workforce, use of technology, management capabilities, organisational structure and level of capital sufficiency.

The obstacles to higher productivity that SMEs have to contend with include the lack of skilled human capital, new technologies and limited capital resources. They are already covered by Malaysia's laudable, comprehensive *SME Masterplan 2012-2020* and its six focus areas:

1. access to financing
2. innovation and technology adoption
3. human capital development
4. market access
5. legal and regulatory environment
6. infrastructure.

Step up innovation-related activities

As there appears to be a positive relationship between innovation rates and productivity (Hall, 2011), it is important that SMEs should be involved in innovation-related activities. According to the 2012 ACCCIM survey of SMEs, 12% of respondents stated that innovation activities did not matter to them. It may be inferred that the remaining 88% consider that innovation activities are important. This is indeed good news. However, there are obstacles. The two main ones that SMEs must contend with in their innovation-related activities are financing and a grasp of technology. That the *SME Masterplan 2012-2020* should include both access to finance and innovation and technology adoption as two of its six focus areas is an encouraging sign.

Raise awareness of the importance of TVET

Results from the same ACCCIM survey also indicate that 62% of respondents face a shortage of workers and have problems hiring. Of those respondent SMEs, 30% face shortages of skilled workers, with sectors such as construction and contracting (59%) and manufacturing (42%) experiencing the most problems in that regard.

To improve the competencies of its workforce and accelerate the supply of skilled labour, Malaysia will need to focus on its technical and vocational education and training (TVET) programmes. Skills gained from TVET programmes seem especially appropriate for SMEs because their levels of technology are lower than those of the highly capital-intensive large firms.

While the government has been trying to raise the skills level of the labour force by broadening access to TVET, the take-up rate has been low. According to Malaysia's Economic Planning Unit, only 10% of students enrol in upper-level secondary technical and vocational education. In OECD countries, the average enrolment rate is 44% (EPU, 2010). The currently low TVET enrolment rates point to huge untapped potential for training which could increase the supply of skilled workers – with SMEs in particular standing to gain. TVET participation rates need to be raised. To that end, there should be campaigns to raise students' and parents' awareness of the benefits of TVET. In this respect, progress is actually being made.

Action taken to promote and widen TVET take-up

The Ministry of Education has introduced two pilot vocational colleges (VCs) as part of its efforts to mainstream TVET and allow students to enter vocational streams of study from the age of 15. As part of this initiative, 78 technical/vocational schools are to be converted into VCs with seven additional new VCs in place by 2015. The Ministry of Education will collaborate with other public training institutes as part of its overall plan to enrol 187 000 students by 2015. That number would represent an increase in TVET enrolment of up to 20%, compared with 10% in 2010.

In 2011, the Department of Skills Development, under the purview of the Ministry of Human Resources, launched the SkillsMalaysia[5] campaign to raise interest in TVET. As part of SkillsMalaysia, action has been taken to promote TVET through various media channels and skills competitions at both local and international levels.

Additional initiatives seek to pave clear further-education pathways for TVET graduates. With the establishment of the Malaysian Technical University Network (MTUN) in 2006, graduates of public training institutes are able to pursue their studies at a higher level in four public universities and other selected universities in the technical field.

Malaysia has adapted Germany's National Dual Training System (NDTS) to enable training programmes to be conducted in accordance with industry needs. Since the scheme started in 2005, it has produced more than 30 000 skilled workers with more than 1 100 companies taking part. Yet that number of companies remains very low, despite the success of the programme in meeting industry's need for skilled workers. Limited resources and time constraints chiefly account for the lack of SME involvement in the NDTS.

As for the issue of skills mismatches, the government introduced industry lead bodies (ILB) in 2011 to promote closer collaboration between training institutions and industry and to help develop a curriculum that would contribute to narrowing the skills gap. More ILBs will be set up in the future – particularly in critical sectors – in order to foster even closer collaboration between stakeholders in drawing up a quality curriculum.

POLICY FOCUS

Widen the tax base and improve tax administration and compliance

Malaysia's finances a serious cause for concern

Over-reliance on the oil and gas sector

The largest contributor to tax revenue in Malaysia is the oil and gas industry (Ministry of Finance, 2013), which exposes the budget to the volatility of oil prices. Oil-related revenue from state-owned oil and gas company Petronas alone – in the form of dividends, corporate tax, petroleum income tax (PITA), royalty payments and export duties – ran to 28% in 2012. The country's over-reliance on Petronas to finance its budget is a source of concern as its oil and gas reserves are limited.

Malaysia has a narrow tax base

Out of a population of about 28 million, slightly more than 12 million make up the labour force, of whom 6.4 million are registered individual taxpayers. However, only 1.8 million pay tax. The same pattern is to be found in the business community. Of the 508 150 registered companies that are supposed to pay tax, only 107 043 actually do so (Ministry of Finance, 2013). In 2012, as Table 2.5.3 shows, taxes collected from individuals and companies accounted for 35.7% of Malaysia's total revenue.

Table 2.5.3. **Federal government revenue in Malaysia, 2012**

Tax revenue	**72.9**
Direct tax	**56.2**
of which:	
Companies	24.7
PITA	16.3
Individual	11.1
Indirect tax	**16.7**
of which:	
Excise duties	5.9
Sales tax	4.6
Non-tax revenue	**26.4**
of which:	
Licence and permits	6.5
Investment income	17.7
Non-revenue receipt	0.7
Total revenue	**100.0**

Source: Ministry of Finance, Malaysia.

Over-reliance on subsidies

In the early years of independence, Malaysia made limited, very selective use of subsidies aimed not at consumption but at production and investment (Thillainathan, 2008). The investment activities that it subsidised heavily included:

- irrigation, which the government provided free of charge to allow double cropped paddy rice production;
- land development and resettlement, with the government waiving the reimbursement of administrative costs from settlers.
- The subsidies extended to paddy farmers and settlers were equitable as the two groups were amongst the country's poorest. In that respect, some types of subsidies do serve useful purposes.

In later years, Malaysia also directed subsidies at consumption. It began subsidising transport fuel, for example, in 1983 to keep it affordable for ordinary citizens. By making input costs lower, the subsidy indirectly makes goods and services that use transport fuel cheaper (e.g. public transport).

However, subsidies can come at a high cost. They can hinder efforts to reduce budget deficits. They may widen socio-economic gaps because the rich may also benefit if subsidies are not confined to the truly needy. The Ministry of Finance's *Economic Report 2012/2013* estimated that its budget allocation for the fuel subsidy – the largest subsidy – reached MYR 25.2 billion in 2012. That is more than 50% of the federal government's total development expenditure in 2012 (estimated at MYR 49.8 billion).

Need for reform in tax administration and compliance

Goods and services tax (GST) to broaden the tax base

The spread of value-added tax (VAT), also called goods and services tax (GST), was a very important development in taxation. It is a broad-based consumption tax that over 130 countries have now introduced. In such countries (which include OECD members), it typically accounts for one-fifth of total tax revenue. The recognised capacity of VAT to raise revenue in a neutral and transparent manner has prompted all OECD member countries (except the United States) to adopt it (OECD, 2006c).

As GST is based on consumption rather than income, it spreads the tax burden more evenly and widens the tax base. It would give the federal government wider scope for tax collection as it would help diversify the tax base away from reliance on direct taxation, which accounts for slightly over 56% of total revenues. As sales tax contributes just 4.6% of the government's total revenue, GST has much potential for helping to bolster the sustainability of Malaysia's public finances. It could also allow corporate and individual income tax rates to be reduced. Malaysia should introduce GST as soon as possible.

Cut subsidies

To improve spending efficiency the Malaysian government should reduce subsidies. In particular, funds allocated to the transport fuel subsidy could be better used in, for example, human capital development. In 2012, the allocation for education and training was estimated at 16.1% of total development expenditure, and that for health at 4.0%.

Subsidies in their current form are inefficient, with most benefitting middle- and high-income groups, foreigners and businesses. The government needs to confine subsidies to the truly needy and eliminate unproductive tax incentives. It has started to rationalise the system, but implementation is expected to be a long drawn-out affair as the government seeks to contain inflationary pressures and to soften the blow to consumers, businesses, lower-income households, and the rural population.

Improve tax administration and compliance

- Improving tax administration and compliance is one plank of the Economic Transformation Programme (ETP). The focus is on reducing the tax gap, which would improve tax collection and help bolster public finances. Measures include:
- widening field audit and investigation coverage;
- audit-based control of exporters and importers of liquor and cigarettes in duty-free islands and free commercial zones;
- improve customs enforcement.

Successful implementation of the measures will however depend on the competence of the responsible officers. Staff competence is critically important in tax administration. In *Principles of Good Tax Administration* (1999) the OECD recommends that tax authorities practice meritocracy and equal opportunity when recruiting, training and promoting employees. It also highlights the need for tax authorities to remunerate employees sufficiently well to attract and retain competent individuals.

Closing the tax gap involves two key measures – reducing the opportunities for evasion and improving compliance. Methods of curbing evasion, which intersect with the goal of improved compliance, should include strengthening third-party reporting requirements and expanding the tax authority's access to reliable third-party data. Third-party information is that provided by, for example, financial institutions. Access to credit and debit card transaction reporting by financial institutions would allow the tax authorities to better target their audits and strengthen enforcement.

Notes

1. Sixty-four economies originally participated in PISA 2009 (see endnote 2). Ten additional partner participants, who were unable to participate within the PISA 2009 project timeframe, participated in the PISA 2009 study on a reduced and delayed timeline in 2010. This is known as the PISA 2009+ project. The PISA 2009+ economies are: Costa Rica, Georgia, India (Himachal Pradesh & Tamil Nadu), Malaysia, Malta, Mauritius, Venezuela (Miranda), Moldova, United Arab Emirates. PISA 2009+ involved testing just over 46 000 students across these ten economies, representing a total of about 1 377 000 15-year-olds (Australian Council for Educational Research, www.acer.edu.au/media/acer-releases-results-of-pisa-2009-participant-economies/)

2. Launched in 1997 by the OECD, the Programme for International Student Assessment (PISA) is an international study to evaluate education systems worldwide every three years. It assesses 15-year-olds' competencies in the key subjects of reading, mathematics and science.

3. For the past 20 years, TIMSS (Trends in International Mathematics and Science Study) has measured trends in mathematics and science achievement at the fourth and eighth grades. It has been conducted on a regular 4-year cycle since 1995, making TIMSS 2011 the fifth assessment of mathematics and science achievement trends (TIMSS website, http://timssandpirls.bc.edu/#).

4. These are some of the Finnish government's priorities for education in its 1999-2003 plan.

5. The objective of SkillsMalaysia campaign is to raise awareness of the opportunities in skills training and job-related TVET that can contribute towards developing a high-income nation and in making skills training the first choice for school leavers (SkillsMalaysiwebsite, www.skillsmalaysia.gov.my/).

Myanmar*

A. Medium-term economic outlook
(Forecast, 2014-18 average)

GDP growth (percentage change):	6.8
Current account balance (% of GDP):	-4.4

B. Medium-term plan

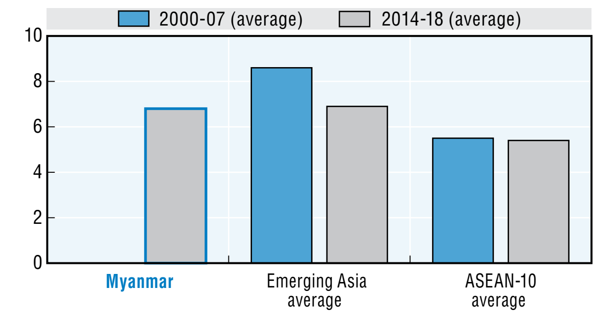
Period:	2012-15
Theme:	Development of industry, balanced development, improvements in education, health, living standards and statistical capacities.

C. Basic data (in 2012)

Total population:	64 million*
Population of Nay Pyi Taw	1 million (in 2009)
GDP per capita at PPP:	1 405 (current USD)**

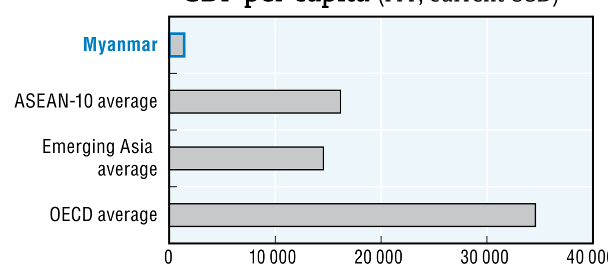
Note: * Total population data for 2012 are estimates.
** IMF estimate
Sources: OECD Development Centre, national sources and IMF.

GDP growth rates (Percentage change)



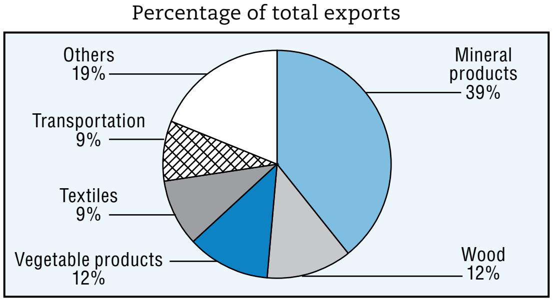
Source: OECD Development Centre, MPF-2014.

GDP per capita (PPP, current USD)



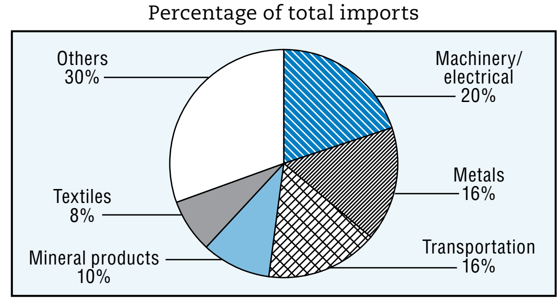
Source: IMF and national sources.

Composition of exports, 2012
Percentage of total exports



Source: Trademap.

Composition of imports, 2012
Percentage of total imports



Source: Trademap.

* This Country Note is largely based on OECD (2013b), *Multi-dimensional Review of Myanmar: Volume 1. Initial Assessment*, OECD Development Pathways, OECD Publishing, http://dx.doi.org/10.1787/9789264202085-en.

Fortunate to be endowed with a wealth of assets, Myanmar is well positioned to engage a multi-pronged development strategy that draws on agriculture, mining and extraction, manufacturing and services. Myanmar can also benefit from its advantageous location between major growth poles and markets, such as China and India, and its proximity to the ASEAN tigers to regain – or even exceed – the importance it once enjoyed as a regional hub. Myanmar has already undertaken some major reforms and the political will to take them even further appears strong. The recent political changes since the transition to a civilian government in 2011 have opened doors around the globe and paved the way for economic ties with bilateral and multilateral organisations. To meet their expectations and include them in its nation-building process, the government needs to devise an inclusive political and economic agenda.

Such an agenda would entail securing peace and setting it as a common goal for all, valuing political diversity and fostering dialogue, preserving ethnic identities and cultures, guaranteeing decent livelihoods, protecting private initiatives and fair returns and, most importantly, distributing the proceeds from the nation's wealth in ways that are sustainable and equitable and take the interests of future generations into account.

Myanmar will also need to address important, long-standing issues related to the economy that include an environment that is still not very conducive to business, the lack of skilled labour, and underdeveloped infrastructure.

Myanmar's medium-term policy challenges and responses

- Create a business-enabling environment
- Upgrade education and anticipate future demands for skilled labour
- Create a stable and efficient financial system

POLICY FOCUS

Create a business-enabling environment

The business sector has the potential to become a driving force of Myanmar's economic development. While foreign direct investment (FDI) is needed to acquire technology, domestic private initiatives are equally important in paving the way to industrialisation. Business supplies value added to society through the goods and services it produces, while developing technology, creating jobs and generating incomes.

The government's private sector development agenda is focused on fostering manufacturing, commercialising agriculture, and nurturing the services industries. Although Myanmar is rich in natural resources and has abundant low-cost labour,[1] it has not successfully managed, among other things, to harness the power of the private sector and realise its full potential. The prime reasons are the country's centrally planned economy, bureaucratic mismanagement, and the economic sanctions imposed by a number of developed countries (UNESCAP, 1996; ADB, 2012b).

Urgent need to ensure a business-enabling environment

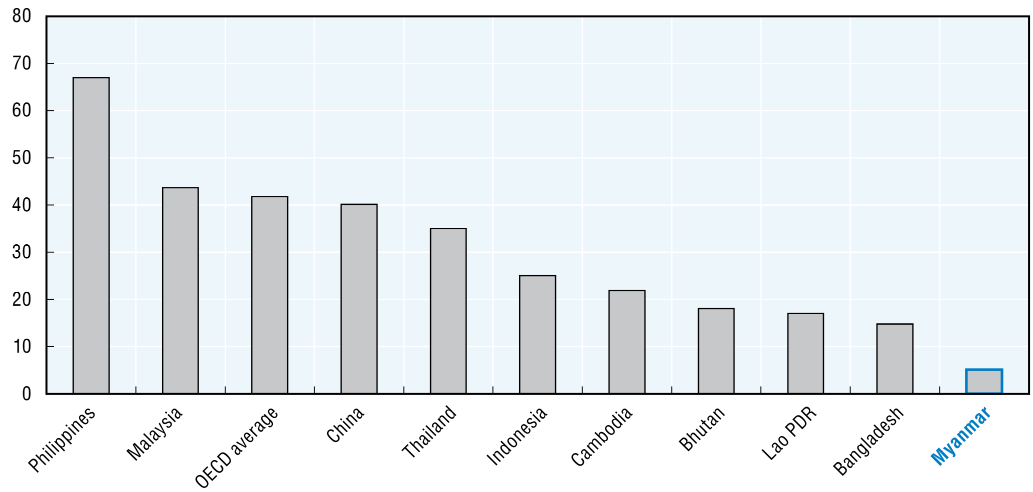
Myanmar has been encouraging business investment from both domestic and foreign sources since the earlier reform process that started at the end of the 1980s. Among the measures it has implemented are six investment-related business laws that generally aim to facilitate the development of the private sector by encouraging business investment, providing incentives to businesses (e.g. tax breaks and land leasing), and keeping business activities (e.g. ownership structures and lines of business) within Myanmar.

However, these efforts will come to nought if the economic environment is not business-enabling. Surveys conducted in Myanmar to date (Kudo, 2002 and 2005; JETRO, 2009 and 2012; Oo, 2013) have identified significant impediments to business. They including such common problems as: limited access to capital and credit; poor trade facilitation and high customs related fees; cumbersome business and trade licensing and permits; shortages of electricity; and weak telecommunications and inefficient transportation systems.

For example, road density in Myanmar is extremely low (Figure 2.6.1) and the country's road network does not run to all townships. The quality of roads is also an issue, with just 21.7% of them being paved. The current rail network, too, is sorely inadequate. Under-investment and insufficient maintenance over past decades have left it very run down. The 5 768 km network runs north to south with branch lines to east and west, but does not connect with neighbouring countries.

Figure 2.6.1. **Road density in Myanmar and other selected countries, 2010**

Kilometres of road per 100 sq. kilometres of land area



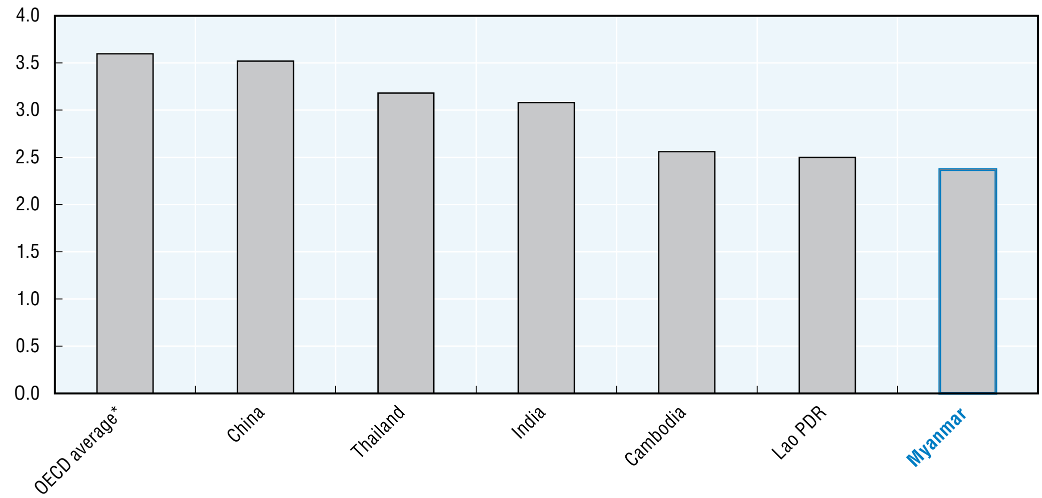
Note: All data are from 2010 except for Philippines (2003), Thailand (2006), Indonesia, Cambodia and Lao PDR (2009).
Source: World Bank (2013b), *World Development Indicators* (database), http://databank.worldbank.org.
StatLink http://dx.doi.org/10.1787/888932938137

Other challenges identified include a shortage of spare parts and raw materials, a low level of advanced technology utilisation, machinery and equipment deficiencies, and shortages of foreign currency. According to the World Bank's Logistic Performance Index (2012g), Myanmar ranked 129th out of 155 countries in the world in terms of logistical efficiency (Figure 2.6.2). Similarly, Transparency International (2012) puts Myanmar near the bottom of its Corruption Perceptions Index – 172nd out of 176 countries – and last among the ASEAN countries.[2]

The government should take note of the results of such studies and surveys in its policy-making efforts to meet investors' requirements and build a more attractive business-enabling environment.

Figure 2.6.2. **Logistics performance index in Myanmar and other selected countries, 2012**

Score between 1 "worst" and 5 "best"



Notes: The logistics performance index is based on six criteria, namely customs clearance process (i.e. speed, simplicity and predictability of formalities); trade and transport related infrastructure (e.g. ports, railroads, roads and information technology); international shipment cost; logistics services (e.g. transport operators and customs brokers); tracking and tracing; and timeliness. *No data for Israel.

Source: World Bank (2012g), *Logistics Performance Index: Connecting to Compete 2012*, World Bank, Washington, DC. http://lpisurvey.worldbank.org/domestic/performance (accessed 27 April 2013).

StatLink http://dx.doi.org/10.1787/888932938156

A robust legal and regulatory framework for business is an urgent priority

The legal and regulatory framework and institutional structure of business in Myanmar is fragmented. There is no effective centralised administrative system which registers or licenses all business establishments – even though the Ministry of National Planning and Economic Development formally has a central business registry. The Ministry has been designated as a one-stop shop for enterprise registration and administration, but has not yet been able to capture the statistics of the entire business community.[3] As a consequence of the fragmented institutional framework, a variety of government-wide committees have been established to co-ordinate issues spanning industries and sectors such as small and medium-sized enterprises (SMEs), industrial development and special economic zones. This, of course, is a source of inefficiency.

Another issue with Myanmar's legal and regulatory business framework is that it favours state-owned enterprises (SOEs), which include military enterprises. SOEs and their joint-venture business partners are afforded a great degree of freedom and economic privilege, which may be conducive to less transparent management practices and finances. Such joint-venture partnerships are not required to register as enterprises unless they apply for incentives under the Foreign Investment Law (2012) or the Myanmar Citizens Investment Law (1994). However, these incentives may not be applicable or relevant to the business operations of private firms. Moreover, there is no clear policy or measure for developing certain activities within the services industry, many of which are still dominated by SOEs.

The current legal and regulatory setting thus has numerous weaknesses, such as the fragmented institutional framework that favours SOEs. Such failings need to be addressed and remedied in order to turn the private business sector into a driver of development. The government must provide a level playing field for business competition – it is a prerequisite for inclusive, sustainable development.

Human capital development is critically important

Sustainable economic development in Myanmar is conditioned by the availability and quality of human capital. A prerequisite for providing the skills needed by the labour market is access to high-quality basic education – i.e. primary and non-vocational secondary education.

While most of Myanmar's adult population have learnt the basic skills of reading, writing and arithmetic, and access to formal education has widened over the last 20 years, high primary school drop-out rates and low enrolment rates in secondary schools point to persistent challenges in access to education. Issues relating to the quality of education have recently been addressed through upgraded teacher training programmes and revised curricula, but tools that measure students' educational attainments and teacher quality more effectively need to be developed.

Many low- and middle-income countries have difficulty moving up the value chain owing to a lack of adequate and specific professional skills (OECD, 2013c). Comparing Myanmar with fast-growth emerging and already industrialised economies suggests that the country has not yet acquired the full set of skills which may be required in the years ahead. A stronger focus on vocational training and a higher proportion of tertiary graduates in education and health are essential.

Although their number has recently grown, there were only one-third as many school-leavers with vocational education qualifications as there were upper-secondary school graduates in academic subjects in the 2010/11 school year. Given that access to ordinary upper-secondary education is itself limited (the gross enrolment ratio was only 38% in 2010), a considerable proportion of adolescents in Myanmar are probably not completing either ordinary secondary or vocational education.

The first step in better identifying future skills demand in Myanmar is to improve co-ordination between ministries that have some responsibility for the education system. Another valuable measure would be to conduct a thorough analysis of the labour market to examine where unemployment is concentrated and how salaries in different sectors and between the public and private sectors compare with each other and other countries. Surveys could also be conducted among employers to identify the present and future skill needs of firms and public organisations (for more detailed information, see next section of country note of Myanmar).

POLICY FOCUS

Upgrade education and anticipate future demands for skilled labour

Under military and socialist rule, Myanmar substantially neglected investment in education. Government expenditure dropped from almost 3% of GDP in 1972 to about 0.5% in 2000. Although recent reforms have slightly restored it – to 0.8% of GDP in 2011 –

it is still lower than in neighbouring countries. In 2010, Thailand reported education expenditure of almost 4% of GDP and Malaysia and Viet Nam of more than 5%. Such shares are equivalent to around 20% of total government spending on education.

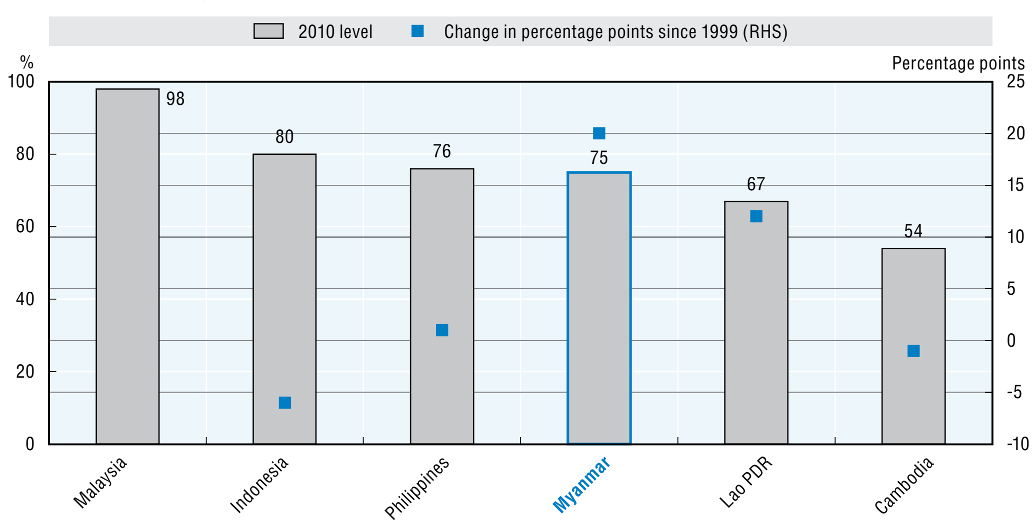
Despite this comparative neglect, Myanmar has seen its literacy rate rise substantially, according to official statistics – from 71% in 1973 to 91% in 2000 and 95% in 2011. Broad access to education, however, does not go far beyond the most basic literacy skills, as only primary school education (5 to 9 years old) is legally guaranteed and compulsory. The short length of schooling has affected the supply of skilled labour in the country.

Sustainable economic development in Myanmar is conditional on the availability and quality of human capital. A look at labour costs in Myanmar, compared to its peers in the region, suggests that it suffers from a relatively greater scarcity of skilled labour. While the wage of a manufacturing worker in Myanmar, for example, is only about one-sixth of that of a comparable worker in China or Thailand, the wage differential narrows in job categories that require higher skills. Engineers are paid of one-quarter of what their counterparts in China earn and one-fifth of their peers in Thailand. In managerial jobs, the wage differential with neighbouring countries further narrows.

Increase primary education attainment rates and the length of compulsory education

The net intake rate in formal primary education of 5-year-olds climbed from 67% in 1988 to 98.5% in 2011. This rise can be explained by the government's commitment to its mandate to provide free, compulsory primary education – building new primary schools in border regions, for example – and by non-governmental organisations' efforts to offset shortages of school materials. However, only about 75% of the pupils reached the last grade of primary education in 2010 (Figure 2.6.3) and only 69% completed the last grade. Although that 69% was a 20-percentage point improvement over 1999, much more needs to be done.

Figure 2.6.3. **Survival rate to last grade of primary education in Myanmar and other Southeast Asian countries, 2010**



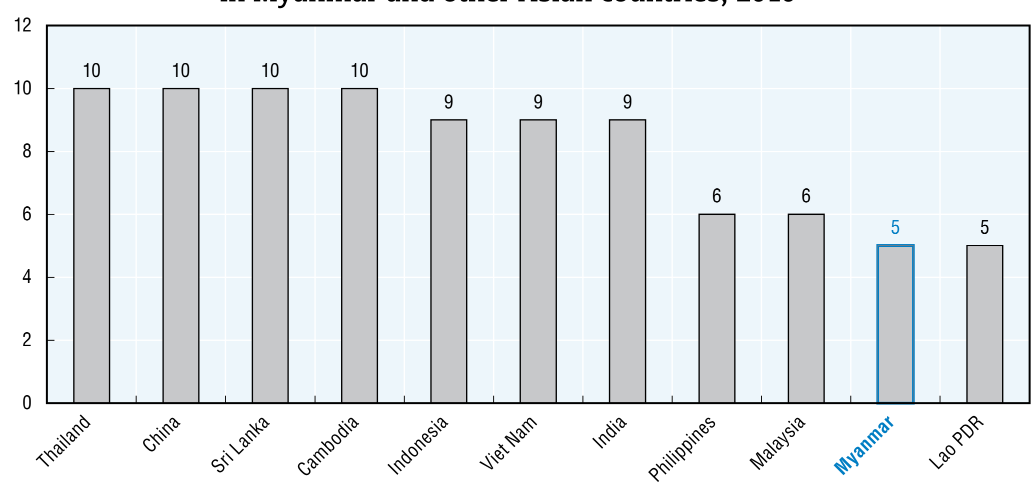
Source: UNESCO, *Institute for Statistics*.

StatLink http://dx.doi.org/10.1787/888932938175

Gross enrolment rates (GER) in both pre-primary and secondary education in Myanmar are much lower than in richer neighbouring countries. For example, the GER in pre-primary education of 10% should be set against 54% in China, 55% in India, and 100% in Thailand. Similarly, the GERs in Myanmar in lower and upper secondary education were, respectively, 62% and 32% in 2010 – far lower than in the region's middle-income countries. Access is so low because pre-primary and secondary schooling is not compulsory in Myanmar.

Only primary school, for children aged between 5 and 9 years old, is compulsory. In this respect, too, Myanmar lags far behind most countries in the region. In Thailand and China, for example, as well as in least-developed countries (LDCs) such as Sri Lanka and Cambodia, compulsory education includes secondary school and lasts ten years – twice as long as in Myanmar (Figure 2.6.4).

Figure 2.6.4. **Number of years of compulsory education in Myanmar and other Asian countries, 2010**



Source: UNESCO, *Institute for Statistics*.

StatLink http://dx.doi.org/10.1787/888932938194

While there are policies to strengthen the educational system – in particular by increasing funding and the number of teachers – more needs to be done. For example, pupil-to-teacher ratios in Myanmar are much higher than in most neighbouring countries. In primary schools the ratio was 28:1 in 2010, an improvement from 31:1 in 1999. At secondary level, the ratio was 34:1, a worsening over the same period from 30:1. In China, by comparison, the pupil-to-teacher ratios were 17:1 in primary schools and 15:1 at secondary level.

Although ongoing initiatives have met with some success, the sustainable provision of basic education for all can be achieved only through a well thought-out increase in government spending on education. To assess in which areas increased education spending is needed, the factors that restrict access to education need to be identified.

On the one hand, access to basic education is conditional on logistics, such as the availability of school facilities, teacher training institutions, transportation to schools and teaching materials. On the other hand, it is also dependent on key stakeholders having the right incentives to get involved in schooling. For example, incentives for training and working as a teacher must match the demand from teachers. Moreover, in a country like Myanmar where about two-thirds of the population live in rural areas, teachers must have sufficient incentive to work there.

Families, too, must have the financial wherewithal to send their children to school. Their means should cover not only money spent on education itself, but the costs associated with the loss of labour when children go to school and can no longer, for example, work on the family farm. Traditionally, families and communities in Myanmar value education highly. However, if parents do not see education as an investment in future success, they may resist sending their children to school.

While upgrading basic education is taking place, more can be done

Since the end of the 1990s, pre-service teacher training institutions have been restructured and upgraded. Today, all existing institutions are affiliated with institutes of education and require students to have successfully completed upper secondary school and passed the higher education entrance examination. As a result, Myanmar's teacher-training system is better co-ordinated. However, practical pre-service training is still not part of the curriculum and the process of training and qualifying as a teacher is significantly shorter than in more developed countries, where a three-year degree course is required to teach in primary and lower secondary schools.

To reduce the percentage of teachers without a nationally approved teaching qualification, Myanmar has introduced several in-service training programmes over the past two decades. They have proven extremely successful: while in 1999 only 60% of primary school teachers were qualified, official statistics suggest that by 2010 all primary school teachers were certified to teach at that level. Similar improvements were reported for secondary schools, where the share of qualified teachers rose from 69% to 99% over the same period.

Finally, Myanmar has recently made improvements to the quality of the educational process itself – which includes the curriculum plus learning and examination methods. Additionally, a new assessment programme has been introduced. It emphasises comprehensive personal records (CPR)[4] and more frequent testing in order to avoid the burden of final examinations. With these changes, Myanmar has sought to reflect its rapidly transforming society and foster its students' more rounded development.

Although quality monitoring initiatives (such as school inspections) were introduced recently, there is a need for more effective tools for assessing policies to improve educational quality. Participation in the Programme for International Student Assessment (PISA), an international comparative study launched by the OECD in 1997, would be one option. It evaluates basic education systems worldwide by assessing 15-year-olds' competencies in the key subjects of reading, mathematics, and science. Policy makers use PISA to determine the level of knowledge and skills of students in their own country compared to those of other participating countries or economies.

Adjusting the supply of skills to meet future demand essential to ensure sustainable long-term growth

As Myanmar's economy transforms, a new and probably wider range of skills will be needed. A look at tertiary education graduates reveals that most of them study the humanities, arts and social sciences alongside science and engineering – possibly at the expense of education, health, management and entrepreneurship skills. The gradual opening-up of the economy will increase demand for greater entrepreneurship and management skills in Myanmar. While economics and business programmes exist within the humanities, no public business or management school exists to date. A stronger effort to help students acquire those skills will be needed in the future.

As well as higher education graduates, an industrialising Myanmar will need a workforce with strong mid-level technical and vocational skills. Although their number has recently grown, there were only one-third as many school-leavers with vocational education qualifications as there were upper-secondary school graduates in academic subjects in the 2010/11 school year. Given that access to ordinary upper-secondary education is itself limited (the gross enrolment ratio was only 38% in 2010), a considerable proportion of adolescents in Myanmar are probably not completing either ordinary secondary or vocational education. In the medium term, a sophisticated and formal apprenticeship programme like the one in Switzerland might be considered for Myanmar.

To better identify future skills demand in Myanmar, it is important to improve co-ordination between ministries that have any responsibility for the education system. Today, there are a dozen such ministries, which has led to significant inefficiency and even misallocations of educational resources. Ideally, only one ministry should be responsible for the provision and quality of education at all levels. There is also a particular need for closer co-ordination of profession-specific education (in higher education as well as vocational training).

A thorough analysis of the labour market should also be conducted to examine where unemployment is concentrated and how salaries in different sectors and between the public and private sectors compare with each other and other countries. Surveys could also be conducted among employers to identify the present and future skill needs of firms and public organisations. Their responses could help guide policies towards meeting labour market needs more effectively and ensure that the right skills are being taught in vocational training and the education system at large.

POLICY FOCUS

Create a stable and efficient financial system

A well-developed financial system has a number of critical functions that contribute to economic growth. It can mobilise savings and enable the trading, hedging and diversification of risk. It can promote investment by identifying and funding good business opportunities. It can facilitate the exchange of goods and services and enhance the efficiency of intermediation by reducing information, transaction, and monitoring costs. These critical functions can lead to a more efficient allocation of resources, an accumulation of physical and human capital, and faster technological progress – all of which feed into economic growth (Creane et al., 2004).

Since the new civilian government took office in April 2011, Myanmar has undertaken important reforms, particularly with regard to exchange rate and monetary policies. An overvalued peg has been replaced by a managed float, with the reference exchange rate determined by an auction mechanism. A new foreign exchange management law designed to lift all restrictions on current payments and transfers abroad has been passed. Indeed, some key exchange restrictions on current international payments and transfers – particularly the requirement to use only export proceeds for imports – have already been removed.

The banking system is segmented and underdeveloped

Restrictive administrative controls that limit formal intermediation have stifled Myanmar's financial sector. Its banking system, which consists of four state-owned banks and 19 private banks (Table 2.6.1), is small and by far the weakest and least developed in Southeast Asia. It is segmented and poorly connected, and competition between banks is weak.

Several specialised state-owned banks emerged from a break-up of the financial system in 1975 after it was nationalised in 1969. For example, the Myanmar Foreign Trade Bank was created to handle foreign exchange dealings and the Myanmar Agricultural Bank was formed to service agriculture. Some state-owned banks used to exercise functions that are normally handled by the central bank, such as managing foreign exchange reserves and distributing currency. The authorities have recently moved to restore these functions to the central bank, starting with the transfer of foreign exchange reserves, which is now largely complete.

Myanmar's private banking sector is small and segmented. A number of private banks, mostly connected to private business conglomerates, emerged from a partial liberalisation of the banking industry in 1988. Entry to the banking market was further liberalised in 2010 for domestic banks and four new private banks were granted licences.

So far, foreign financial institutions have not been allowed to enter, although this is about to change as an official committee has been set up to examine how foreign banks can be allowed to establish branches in Myanmar. Representative offices were recently allowed to open and subsidiaries are likely to be set up in the near future.

An official (regulated) microfinance sector competes with the informal sector, but has not so far replaced it. The lending rate of microfinance institutions is capped at 30% per annum – a ceiling that is close to the interest rates prevailing in the informal market. No usury laws exist in Myanmar and there is protection only under civil law for borrowers in the informal markets. Imposing a ceiling on informal lending rates would make it easier under a civil lawsuit to determine whether there is an unfair business transaction. Many countries set such ceilings, either as an absolute number or as a multiple of the official rate, and protection under civil law applies only if the rate applied is within those limits.

Myanmar's non-bank financial sector is very small, with the insurance sector a major institution. While the non-bank financial sector is essential to the economy, its development has not yet reached the stage where it can assume responsibilities comparable to those of the banking sector.

Table 2.6.1. **Myanmar's financial system**

Type of business organisations	Number of entities	Description	Registration and supervisory office	Legal framework
State-owned development banks	4	Myanmar Foreign Trade Bank Myanmar Economic Bank Myanmar Investment and Commercial Bank (to be renamed the Small and Medium Industrial Development Bank) Myanmar Agriculture and Rural Development Bank	Central Bank of Myanmar and respective line ministries	Central Bank of Myanmar Law (1990); Financial Institutions of Myanmar Law (1990); Saving Bank Law (1992); Myanmar Companies Act (1914);* Myanmar Agricultural and Rural Development Law (1990)
Private banks	19	Private commercial banks	Central Bank of Myanmar	Central Bank of Myanmar Law (1990); Financial Institutions of Myanmar Law (1990); Saving Bank Law (1992); Myanmar Companies Act (1914)
Financial institutions	5	Myanmar Orient Leasing Company Ltd. Myanmar Insurance Myanmar Securities Exchange Centre Company Co., Ltd. Security and Printing Works Myanmar Microfinance Supervisory Enterprise (former Myanmar Small Loan Enterprise)	Ministry of Finance and Revenue and Ministry of Defence (for security and printing works)	Central Bank of Myanmar Law (1990); Financial Institutions of Myanmar Law (1990); Myanmar Insurance Law (1993); Microfinance Law (2011); Microfinance Notification and Directives (2011); Myanmar Companies Act (1914)*
Representative offices of foreign banks	28	Foreign banks mainly from South-East and North-East Asia	Central Bank of Myanmar	Central Bank of Myanmar Law (1990); Financial Institutions of Myanmar Law (1990); Myanmar Companies Act (1914)*
Micro finance providers	1 755	Microfinance institutions (MFIs) Informal and semi-formal sector Cooperatives NGOs (e.g. PACT) Specialised agricultural development companies Village revolving funds Community-based organisations	Ministry of Finance and Revenue, Ministry of Cooperatives and Ministry of Agriculture and Irrigation	Microfinance Law (2011); Microfinance Notification and Directives (2011); Myanmar Agricultural and Rural Development Law (1990); Cooperative Society Law (1992); Law relating to Forming of Organisations-NGO Law (1988); Myanmar Companies Act (1914)*

Note: * The subsection of the Myanmar Companies Act (1914) covers the provision of bankruptcy; thus, the banking and financial sector has to reply on this law for the cases of loan defaults caused by insolvency.
Sources: PWC (2012), *Myanmar Business Guide*, August 2012, PricewaterhouseCoopers LLP, Singapore, www.pwc.com/sg/en/assets/document/myanmar_business_guide.pdf; Aung, Y. and C.O. Khin (2011), "Small and medium enterprises in Myanmar", a presentation at the Asia–Pacific Financial Inclusion Forum, Tokyo, Japan, 6-8 September, Ministry of Finance and Revenue, Government of Myanmar; and Duflos, E. et al. (2013), *Microfinance in Myanmar: Sector Assessment*, January, International Financial Corporation, World Bank Group. Washington, DC? www.cgap.org/sites/default/files/Microfinance%20in%20Myanmar%20Sector%20Assessment.pdf.

Private banks face many constraints

The regulatory and supervisory treatment of state banks and private banks is uneven, while lending by private banks is heavily constrained. It is extremely difficult for the banks to determine the credit-worthiness of potential borrowers (other than the business conglomerates to which they are connected), as financial information and auditing is very weak and small enterprises are not required to produce financial statements.[5] As a result, banks' assets consist mostly of treasury bonds which are issued in maturities of two, three and five years and, as there is no secondary bond market, they are always held to maturity. Otherwise, lending takes place outside the formal sector in an unregulated shadow financial system at interest rates that are high in comparison with the banking sector (2.5-3% per month), but unconstrained by formal collateral requirements.

Bank lending, however, is constrained by very strict liquidity and solvency requirements, which were introduced in the wake of the banking crisis. They include a 10% reserve requirement ratio, a 10% liquidity ratio, a 20% single borrower limit, and a 20% related-party borrower limit. In addition, banks have to hold 50% of their paid-in capital in liquid assets. All lending is collateral-based by law (since 2003) and the value of assets used as collateral is calculated with 40% of their market value as the for-sale value which is, in turn, used as the basis for determining the amount of the loan.

The loan-to-value ratio is not regulated, but banks follow the practice of a maximum of 60-70% of the for-sale value. In addition, deposit and lending rates are fixed by the central bank in order to secure sufficient margins for banks to remain profitable. However, this leaves banks with little scope, or incentive, to engage in competition. The central bank is wary of encouraging competition for fear of seeing the small and medium-sized banks fail.

Lending by Myanmar banks is limited to the short term and for a few purposes only, although long-term lending is envisaged in the near future with an interest rate of 15%. Banks cannot lend to home buyers unless they do so through hire purchase loans with a maximum maturity of 36 months. Until recently, they had also been prohibited from lending to the rural sector, thus limiting their scope of activities and increasing their vulnerability to shocks. The rural sector is covered by the Myanmar Agricultural Development Bank that has a branch in nearly all townships. Income from non-lending activities such as investment in government bonds and remittance handling constitutes a large share of its total income.

As a result of cautious lending policies and significant non-lending activities, the non-performing loan (NPL) rate of private banks is about 2%. State-owned banks have admittedly higher NPL ratios resulting from the lending boom in the 1990s, but their exact size is not disclosed. Those non-performing loans have not been handled as yet, partly because the underlying collateral values are not considered worthy of lawsuits. The Myanmar Agricultural Development Bank currently has a very low NPL ratio, but the ratio is expected to rise following the quintupling of the ceiling for loans per acre (from MMK 20 000 to MMK 100 000 [Myanmar kyat]).

There is relatively little confidence in the financial system

A handicap afflicting the development of Myanmar's financial system is a general lack of public confidence in banks. There is a general suspicion of cronyism, partly because of the banks' close ties to business conglomerates and partly because of their (alleged) money laundering activities. This is a potential source of instability as rumours spread quickly and bank runs can easily take off, as happened in the 2003 banking crisis.

The crisis in 2003 was triggered by the collapse of several informal finance companies that were little more than Ponzi schemes and brought about direct losses for some authorised banks. Exacerbating the crisis were rumours of large-scale money laundering, bank losses on investments in China, and withdrawals of deposits. As the panic began to spread, even the state-owned banks were affected. Soon all found themselves short of liquidity and, as a consequence, they attempted to maintain reserves by limiting depositors' access to their funds. A flight to currency ensued, which led to a shortage of Myanmar kyats – and the means of exchange created by banks (cheques, remittance facilities, credit and debit cards, electronic transfers, etc.) ceased to function.

The banking crisis severely disrupted production and distribution. Though most people in Myanmar did not – and still do not – have bank accounts, many employers and businesses did: large numbers of workers went unpaid for considerable periods, as did suppliers and distributors. Even firms earning foreign exchange were harmed, as they could no longer convert it into kyats to meet their local costs. The situation worsened further when the authorities allowed private banks to recall loans, forcing firms and individuals to meet loan calls by selling assets. A growing secondary market in frozen bank accounts emerged, with a going price of between 60% and 80% of face value. The banks themselves tried to acquire liquidity by selling their properties.

The key reasons why the crisis got out of hand were the failure of the monetary authorities to provide credible, visible liquidity support to halt the crisis and the failure of deposit guarantees to ensure depositor protection.

Work is underway to improve the financial system

A top priority for the Myanmar authorities should be to adopt and enforce high standards of corporate governance, accounting, disclosure, and prudential regulation and supervision within sound financial institutions and a sound financial infrastructure. A number of new laws have been or are being drafted to provide a new framework for the sector that will give more leeway to expand its activities.

Myanmar is working in conjunction with the International Monetary fund (IMF) and World Bank to strengthen supervision and regulation so as to safeguard the stability of the banking system. The IMF's 12-month Staff-Monitored Program (SMP),[6] which the authorities requested for 2013, focuses on two building blocks: *i)* improving the regulatory and supervisory framework; and *ii)* developing treasury markets to provide alternatives to central bank funding of the budget deficit.

To further safeguard stability, deposit insurance of up to MMK 500 000 (USD 570) per account will be enacted soon, with the ceiling expected to double next year. A credit bureau is to be established soon, paving the way for credit card issuance.

While most regulations in banking are intended to ensure the stability of institutions, little attention is paid to efficiency or to consumer protection. More needs to be done to protect consumers if confidence in the financial system is to be restored. Regulations should also require banks to make their products comparable so that customers with low levels of financial literacy can find the one that best fits their needs.

Healthy competition that could drive efficiency gains among private banks should be allowed to flourish. However, it is being inhibited by administered interest rates. Similar constraints weigh on service charges which the government sets at the same level. In fact, private banks have been lobbying for their liberalisation so that they can attract more customers through the lower service charges that they would be able to apply through improved efficiency. Needless to say, the efficiency gains from competition in the banking sector would help improve the financial system's critical functions in the economy.

Notes

1. Myanmar has over 30 million labourers (CSO, 2013). According to a survey conducted by JETRO in August 2010, the wage of a factory worker in Myanmar is only 16% of the wage of his or her Thai counterpart and less than a half of his or her peers in Cambodia and Viet Nam (Makishima, 2012).
2. The Corruption Perception Index ranks countries according to how corrupt the business community perceives their public sector to be.
3. The Ministry of National Planning and Economic Development has set up one-stop business support centres in Nay Pyi Taw and Yangon and plans to open another one in Mandalay in 2013. The government has also planned to set up a number of one-stop service SME supporting centres at the provincial and state levels throughout the country in collaboration with the Union of Myanmar Federation of Chambers of Commerce and Industry (UMFCCI).
4. Comprehensive personal records (CPR) record student participation in a set of selected activities. An independent evaluation of the UNICEF education programme for primary schools in Myanmar lists the CPRs' components as follows:

   CPR elements Primary level CPR

   • 75% school attendance;

   • Sitting regularly the chapter-end tests;

   • Abiding by school rules and regulations and not indulging in social crimes;

   • Fulfilling obligations to school, teachers, parents and the community and taking care of younger students;

   • Growing trees, plants and making the school environment verdant and green;

   • Giving assistance in parents' livelihoods;

   • Participation in sports and physical activities;

   • Participating in aesthetic education such as involvement in literary activities, music, singing, dancing and painting;

   • Keeping oneself neat and tidy.

   Secondary level CPR (additional elements)

   • Participating in the development tasks of the local community and state;

   • Offering voluntary service for community work;

   • Participating in the activities of teams, clubs and associations of the school and social activities such as the Red Cross.

   Source: Clarke, D.J. (2010), *Independent Evaluation of UNICEF Education Programme: Improving Access to Quality Basic Education in Myanmar (2006-2010)*, UNICEF.
5. In addition, the foreclosure procedure is long, often taking a couple of years, and the foreclosed assets are auctioned off by the court.
6. A Staff-Monitored Program (SMP) is an informal arrangement between a country and the IMF's staff to monitor that country's economic policy. The IMF gives no financial assistance.

Philippines

A. Medium-term economic outlook (Forecast, 2014-18 average)

GDP growth (percentage change):	5.8
Current account balance (% of GDP):	2.4
Fiscal balance:	-1.6

B. Medium-term plan

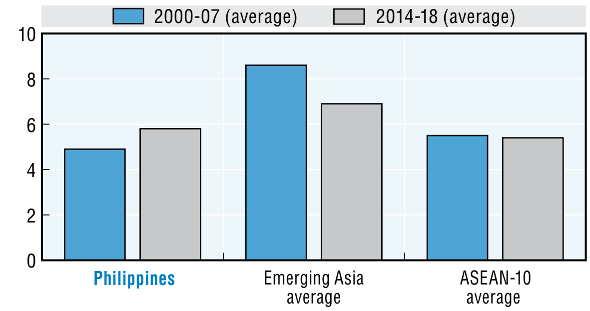
Period:	2011-16
Theme:	Pursuit of inclusive growth

C. Basic data (in 2012)

Total population:	96 million*
Population of Manila	11.9 million (in 2010)
GDP per capita at PPP:	4 429 (current USD)**

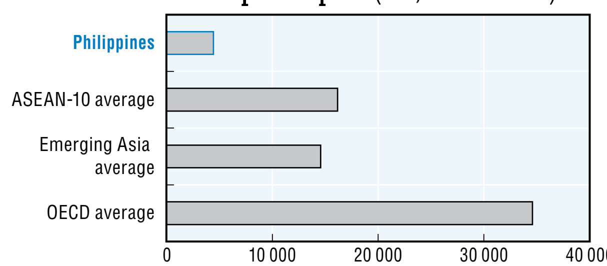
Note: * Total population data for 2012 are estimates.
** IMF estimate
Sources: OECD Development Centre, national sources and IMF.

GDP growth rates (Percentage change)



Source: OECD Development Centre, MPF-2014.

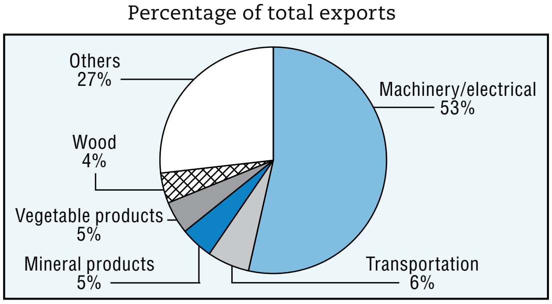
GDP per capita (PPP, current USD)



Source: IMF and national sources.

Composition of exports, 2012

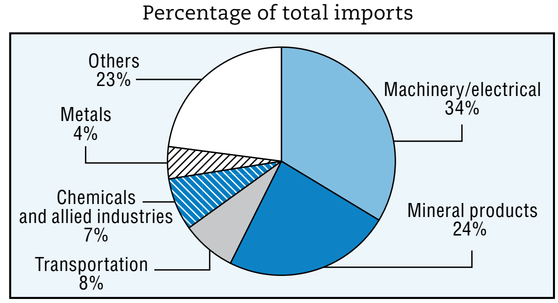
Percentage of total exports



Source: Trademap.

Composition of imports, 2012

Percentage of total imports



Source: Trademap.

The growth momentum of the Philippine economy was robust in 2013 and this favourable trend will continue for the coming years. The current favourable macroeconomic situation has opened a window of opportunity to facilitate several reforms. Structural reforms are essential to maintain the robust growth of the Philippine economy. The country's potential – macroeconomic and political stability, favourable demographics – could provide a good base for the necessary structural reforms.

However, the country also suffers from high degrees of poverty and inequality. The government need to concentrate on policies to create lasting productive employment in order to reduce poverty. It should focus on fostering a favourable business and investment climate, particularly for small and medium-sized enterprises which contribute so much to employment.

The Philippines is one of the countries most prone to natural disasters in the world. It is exposed to multiple natural hazards from typhoons, earthquakes, volcanic eruptions, and especially flooding. Serious aggravating factors are environmental degradation, climate change, and uncontrolled urbanisation. The government will need to take concerted action to build the country's disaster reduction and management capacity. It must sustain that effort, make it holistic, and reinforce it with measures to contain rampant urbanisation.

The Philippines' poorest island grouping, Mindanao, has been overlooked by rural development policies. Its regions' Human Development Index (HDI) rankings are the worst in the country, while income disparities translate into a continuous cycle of low access to infrastructure services, persistent gaps in education and health outcomes, and lower investment and business activity. Yet Mindanao's agricultural production meets 40% of the country's food needs and its fertile land boasts a wealth of resources. To help Mindanao capitalise on those assets, invigorate its economy, and lift its people out of poverty, rural development needs to focus on improving agricultural productivity and the island's woeful transport infrastructure.

The Philippines' policy challenges and responses

- Create more jobs for sustainable poverty reduction
- Build holistic disaster risk reduction and management capacities to reduce vulnerability to natural hazards
- Improve agricultural productivity and transport infrastructure in Mindanao

POLICY FOCUS

Create more jobs for sustainable poverty reduction

Poverty in developing countries is generally measured in absolute terms against a poverty line determined by the monetary cost of a given basket of goods. In high-income countries, however, it is measured in relative terms as a share of a country's average, or median, standard of living. In other words, poverty is defined in relation to the economic status of other members of society and people who live below the prevailing standard of living in a given societal context are poor. On both counts, the Philippines compares unfavourably with selected ASEAN member countries. In 2006, absolute poverty in the Philippines was 23%, and relative poverty was 17%. Those figures mean that not only were a lot of people poor, there was a high degree of inequality.

Tackle unemployment to fight poverty

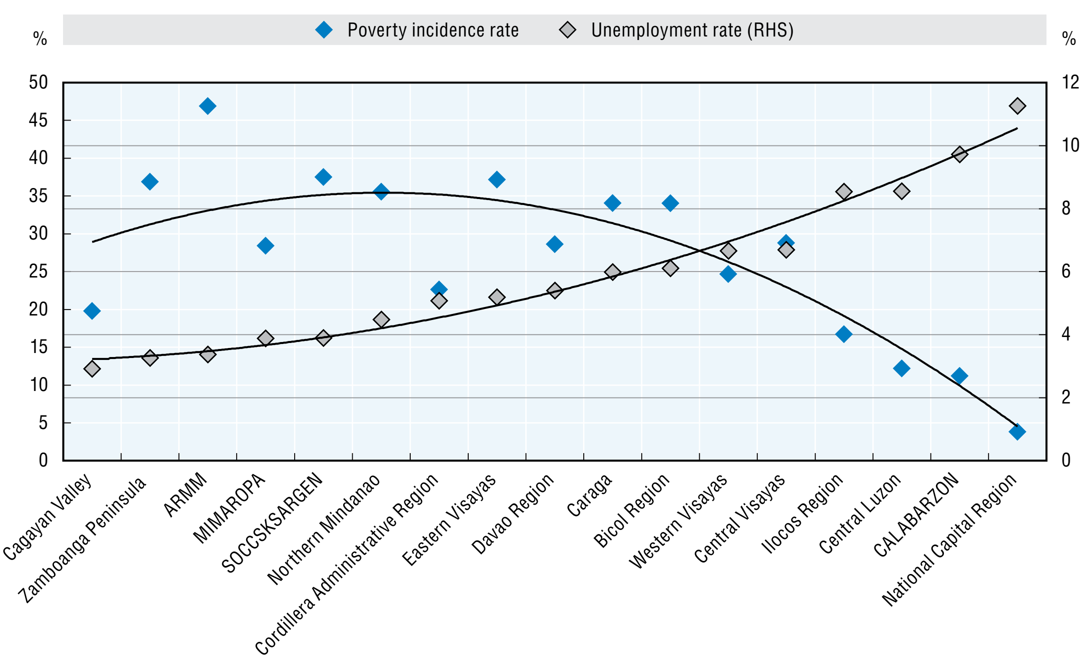
To tackle poverty in the Philippines, the government will need to provide quality jobs to both the unemployed and the underemployed. Yet the Philippine economy has a relatively poor ability to create jobs, as its low employment-to-population ratio (EPR) indicates. Compared to selected ASEAN member countries in 2011, the Philippines had the lowest EPR at 60%. Viet Nam had the highest at 75%, followed by Thailand with 71%, and Singapore with 64%.

That the Philippine economy has a relatively weak capacity for jobs creation is one reason why unemployment and underemployment are persistently higher than in neighbouring countries in the region. And the persistently high unemployment and underemployment make it particularly difficult to alleviate poverty and inequality.

Yet the economy is currently among the top gross domestic product (GDP) growth performers in Southeast Asia. In 2012, GDP grew 6.6%, with private consumption rising by 6.1% and contributing the most to GDP growth on the expenditure side. Higher remittances from overseas Filipino workers, a slight rise in employment, and low inflation all helped drive buoyant consumption. However, that it should such factors pushing growth upwards suggests that, in the absence of structural reforms, the economy will continue to have trouble generating jobs, especially on the scale necessary to make a significant difference.

The link between unemployment and poverty is intuitive and straightforward: high unemployment drives up poverty levels if appropriate policy responses are not found.

Figure 2.7.1. **Poverty and unemployment rates in the Philippines, by region**



Notes: 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. ARMM stands for Autonomous Region in Muslim Mindanao. Data for unemployment rate refer to 2011. Data for poverty incidence rate refer to 2012.

Sources: National Statistical Coordination Board and World Bank, Washington, DC.

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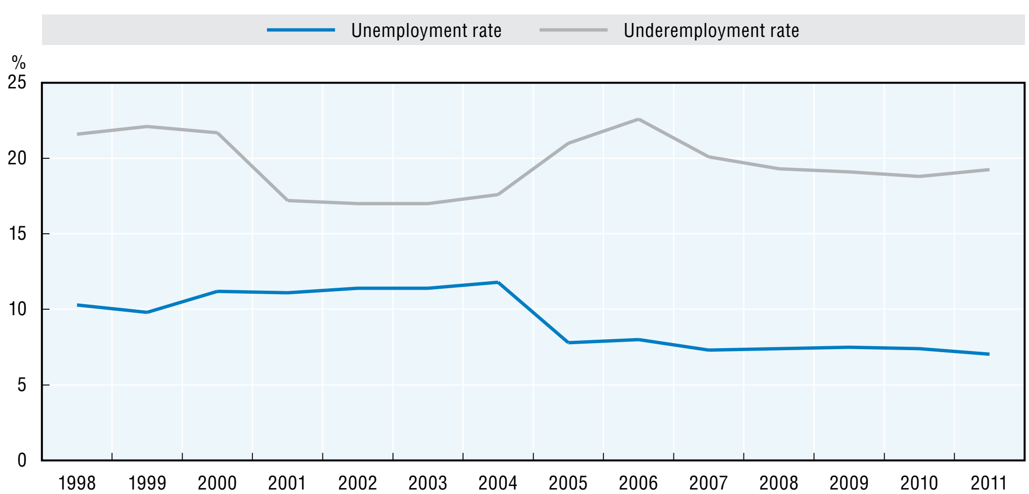
A glance at Figure 2.7.1 seems, however, to suggest that Philippine regions that boast relatively low levels of unemployment may also suffer from relatively high incidences of poverty. And – *vice versa* – regions with relatively high rates of unemployment may enjoy relatively low levels of poverty. In both instances, the results seem counter-intuitive. However, there are possible explanations.

Regions at the low end of the real per capita income spectrum, where poor productive employment opportunities prompt a high outflow of jobseekers, can experience low unemployment but a high incidence of poverty.[1] Similarly, regions that are attractive destinations for migrant job hunters from the less-developed provinces may have high unemployment but low poverty rates. The National Capital Region and neighbouring regions of Calabarzon and Central Luzon, for example, have the highest populations in the country and account for 37.5% of the total. The three regions also happen to have among the highest unemployment rates in the country – and the lowest rates of household poverty. One possible reason is that workers from National Capital Region, Calabarzon, Central Luzon enjoy better access to job opportunities overseas. The remittances they send home help keep the incidence of household poverty in the three regions relatively low.

Underemployment is actually more of a problem

Focusing solely on the unemployed in poverty alleviation efforts, however, overlooks an important group – the underemployed. In recent years, underemployment in the Philippines has run at more than double the unemployment rate (Figure 2.7.2). The most recent Labour Force Survey conducted by the National Statistics Office showed that, in April 2013, the unemployment rate stood at 7.5%, up from 6.9% in the same period the previous year. In the same month, the underemployment was a staggering 19.2% – equivalent to 7.252 million Filipinos (National Statistics Office, 2013). Figure 2.7.2 suggests that the drop in unemployment in 2004-05 did not actually point to an improvement in the labour market because there was a parallel rise in the underemployment rate over the same period.

Figure 2.7.2. **Unemployment and underemployment rates in the Philippines, 1998-2011**



Source: Bureau of Labor and Employment Statistics (2012), *Gender Statistics on Labor and Employment*, Department of Labor and Employment, Republic of the Philippines.

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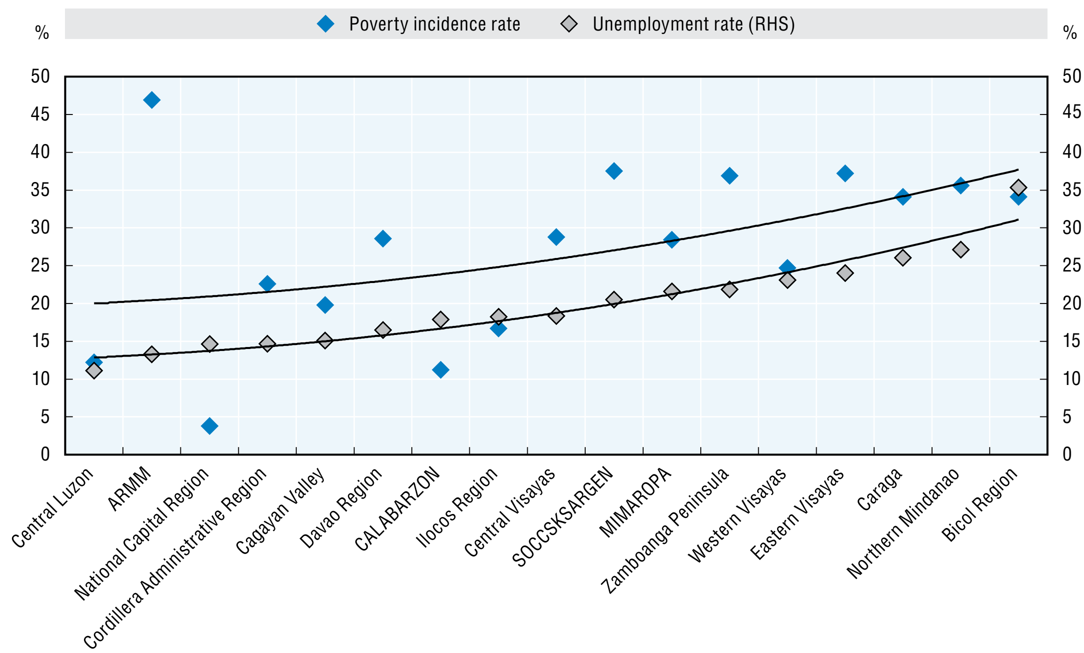
Regional data from the Philippines indicate a strong positive correlation between underemployment and the incidence of poverty (Figure 2.7.3). The Socio-economic Planning Secretary has in fact remarked that underemployment is more of a problem than unemployment in the Philippines and that the poor quality of the jobs of many Filipinos was largely to blame for the extremely slow progress in poverty-reduction efforts over the last two decades.[2]

Figure 2.7.3. **Poverty and underemployment rates in the Philippines, by region**



Notes: 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. ARMM stands for Autonomous Region in Muslim Mindanao. Data for underemployment rate refer to 2011. Data for poverty incidence rate refer to 2012.

Source: National Statistical Coordination Board and Bureau of Labor and Employment Statistics (2012), *Gender Statistics on Labor and Employment*, Department of Labor and Employment, Republic of the Philippines.

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Priority must be given to sectors with the greatest potential for creating jobs

Strategies to create more productive employment opportunities in the Philippines must satisfy at least the two following conditions: *i)* generate enough jobs not only to absorb new entrants into the labour market every year, but also to reduce over time the large pool of unemployed workers and ease underemployment; and *ii)* generate jobs in the less developed parts of the country.

Strategies to create more and better employment opportunities in the Philippines must address deep-seated, structural issues in the economy. In its endeavours to resolve them, the government will need to implement a holistic reform agenda that can foster a business environment conducive to private-sector growth accompanied by job creation. Measures should include: *i)* simplifying business rules and regulations to encourage private sector growth, with a special emphasis on small and medium-sized enterprises (SMEs); and *ii)* enhancing competition and giving priority to sectors with the greatest potential for creating jobs.

Tourism an inclusive growth sector with job creation

One sector that lends itself to efforts to encourage growth and create jobs is tourism. Tourist expenditure tends to rise faster when incomes rise, and that happens mostly in cities and urban areas. Domestic urban-dwelling tourists from the cities and urban areas are more likely to spend their time and money in the provinces, attractive rural areas and traditional locations in the regions away from the city. In this way, tourism can not only make a significant direct contribution to job creation, it also acts as an inclusive employment industry.

Demand in the tourist industry can benefit many different companies and economic sectors. Direct and indirect job creation arises from private investment in related industries like food and beverages, transport, accommodation, and indigenous arts and crafts.

Despite similar natural charms, visitor numbers to the Philippines pale in comparison with Thailand and Malaysia. In 2012, some 4.3 million foreign tourists visited the Philippines (Department of Tourism). Compare that figure with 25 032 708 in Malaysia (Tourism Malaysia) and 22 303 065 in Thailand (Ministry of Tourism and Sports). According to the World Economic Forum's *Travel & Tourism Competitiveness Report 2012*, the Philippines continues to face issues that are holding back the potential of the economy's travel and tourism competitiveness. For example: *i)* the difficulty of starting a business in terms of cost and length of the process; *ii)* safety and security concerns; *iii)* inadequate health and hygiene; and *iv)* underdeveloped infrastructure, *viz.* ground transport, tourism, and information and communication technology (ICT). These are the issues the government will need to take care of. In particular, the country's underdeveloped infrastructure, which has been blamed mostly for the sector's underperformance.

The government should also ensure that strategies to develop tourism should invest in the full spectrum of natural and cultural assets that the Philippines has to offer. These include weaving, sun, sand and sea, sites of natural beauty and historical interest, traditional cooking, and arts and crafts. By promoting all that the Philippines has to offer holiday makers, they will be persuaded to stay longer, return more often, and therefore spend more in the local economy – thereby creating more jobs.

Foster employment in manufacturing SMEs

The manufacturing sector is another ideal candidate for developing productive employment. Policies to that end should not overlook the importance of SMEs. SMEs absorb workers better than large firms and make important contributions to job creation. Labour-intensive industries that have high employment elasticities – like the jewellery trade, leather goods business, sportswear, knitted fabrics, textiles, fabricated metals, and stoneware – are particularly well suited to job creation and should therefore be targeted by employment policies (Das and Kalita, 2009).

However, SME performance in the Philippines has been weak, and can be attributed particularly to poor access to finance, technology and skills, as well as information gaps and difficulties in product quality and marketing (Aldaba, 2013). The competitiveness of the sector continues to be held back by, among other critical factors, access to finance. It noted that many private banks are still reluctant to lend to SMEs, which generally lack start-up funds, and face difficulties in coming up with collateral acceptable to the banks. And according to Nangia and Vaillancourt (2006), funds obtained by SMEs from the banking sector accounted for only 11% to 21% of total capital raised. Compare that to the 30% international benchmark seen in other developing countries such as India and Thailand.

The Philippines government will need to further integrate its SME development strategy into its broader national development strategy and/or poverty reduction and growth strategy. That is because the success of any SME development strategy depends on: *i)* the capacity of the government to implement sound macroeconomic policies; *ii)* the capacity of stakeholders to develop microeconomic environments that are conducive to business; and *iii)* the ability of SMEs to implement competitive operating practices and business strategies.

There is an urgent need to invest in physical infrastructure and business services, build the implementation capacity of policy makers and local administrators, and put in place support structures. All are factors that determine the success of an SME development strategy. To deliver improved outcomes, the government will also need to foster continuous dialogue and partnerships between public sector, private sector and civil society stakeholders with regard to the implementation and review of support measures – particularly those related to capacity building in institutions at all levels.

POLICY FOCUS

Build holistic disaster risk reduction and management capacities to reduce vulnerability to natural hazards

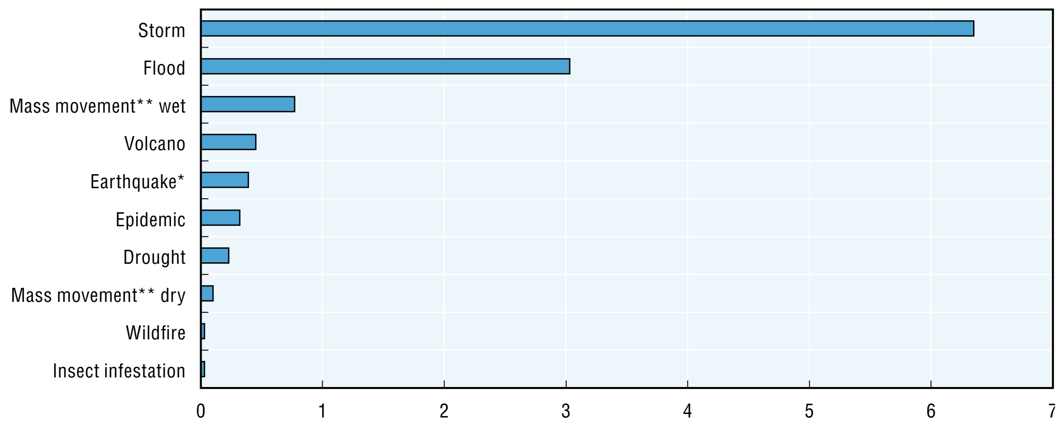
The Philippines is one of the countries most prone to natural disasters in the world. The high incidence of natural disasters can be explained by its geography and geology, but is exacerbated by the effects of environmental degradation, climate change and uncontrolled urbanisation. The people most vulnerable to and worst affected by natural disasters are those who live in poverty and in adverse socio-economic conditions in the most hazard-prone areas.

The Philippines is very prone to natural disaster

The *World Risk Report 2012*, produced by the United Nations University and the Institute of Environment and Human Security (UNU-EHS) ranks the Philippines as the third most hazard-prone country in the world (UNU-EHS, 2012). According to the PreventionWeb project of the UN Office for Disaster Risk Reduction (UNISDR, 2013b), there were 363 natural disasters in the Philippines between 1980 and 2010. They claimed 33 000 lives, affected 116 million people, and caused economic damage estimated at USD 7.5 billion.

Tropical cyclones, floods and landslides are the most prevalent types of hydrometeorological hazards[3] in the Philippines. According to the National Disaster Risk Reduction and Management Council, 84 tropical cyclones struck the Philippines between 1997 and 2007, causing 13 155 deaths and economic losses estimated at over PHP 150 billion. In 2009, for example, typhoons Ondoy and Pepeng wreaked havoc equivalent to about 2.7% of the country's GDP (NDRRMC, 2011).

Figure 2.7.4. **Average annual occurrence of natural disasters in the Philippines, by disaster type, 1980-2010**

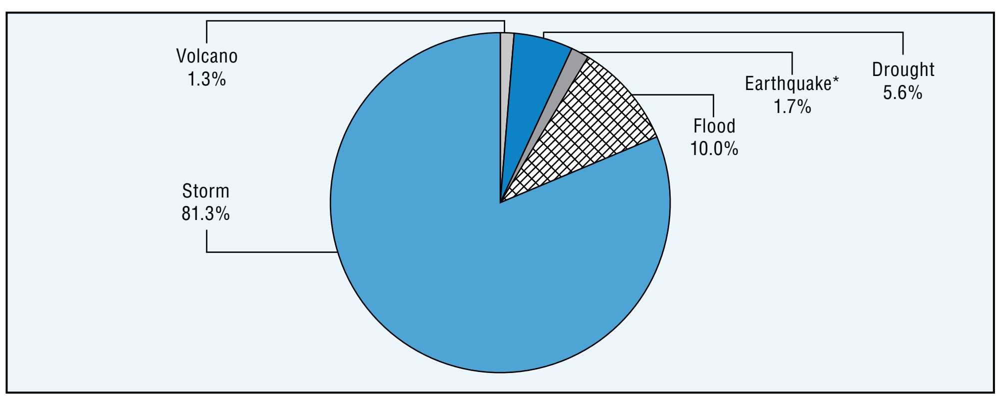


Notes: * Earthquake includes tsunami. ** Mass movement includes subsidences, rockfalls, avalanches and landslides.

Source: UNISDR (2013b), *Prevention Web: Philippines Country Profile*, United Nations Office for Disaster Risk Reduction (www.preventionweb.net/english/countries/statistics/?cid=135).

StatLink http://dx.doi.org/10.1787/888932938270

Figure 2.7.5. **Percentage of reported people affected in natural disasters in the Philippines, by disaster type, 1980-2010**



Note: * Earthquake includes tsunami.

Source: UNISDR (2013b), *Prevention Web: Philippines Country Profile*, United Nations Office for Disaster Risk Reduction (www.preventionweb.net/english/countries/statistics/?cid=135).

StatLink http://dx.doi.org/10.1787/888932938289

The Philippines is also prone to earthquakes and volcanic eruptions. While their destruction exceeds that of typhoons and floods, the recorded casualties and damage caused by the five destructive earthquakes of the last ten years were minor – 15 deaths and economic damage of some PHP 200 million (Philippine pesos) – compared to the consequences of tropical cyclones (NDRRMC, 2011).

And environmental factors such as deforestation are aggravating the risk of floods and landslides. Climate change too has exacerbated natural hazards. The high natural hazard rate is also made worse by uncontrolled urban growth. Poor land use, the falling number of protected forests and riverbanks, and dismal basic amenities such as waste disposal and housing have clogged waterways and increased the risk of floods (NEDA, 2011).

Natural hazards disproportionately affect the poor, especially those who live in the most hazard-prone areas, which in turn further hinders their chances of closing the poverty gap (NDRRMC, 2011). According to the Philippine Development Plan (PDP) 2011-2016, of the 32 provinces with poverty rates of at least 40%, 16 are hit by typhoons at least once a year.

Disaster risk management – recent policies

In recent years, the Philippine government has started to shift its approach to natural disaster management towards a more proactive strategy. This paradigm shift is in line with the country's international commitment to disaster reduction as set out in the 2005-15 Hyogo Framework for Action (HFA). The proposed "priorities for action" include ensuring that disaster risk reduction is a national and local priority with a strong institutional basis for implementation, and identifying, assessing and monitoring disaster risk and enhancing early warning.

- **The Strategic National Action Plan (SNAP)**

After years of disaster risk reduction (DRR) policy that focused heavily on disaster preparedness and response, but little on comprehensively reducing people's exposure to risk, the government speeded up reform in 2010. It introduced the 2009-19 Strategic National Action Plan (SNAP), a long-term master plan for disaster mitigation. SNAP analysed the status of HFA's five priorities for action and drew up its own strategic objectives that include adopting a responsive legal and policy framework, and pursuing cost-effective ways and means to offset socio-economic losses.

- **Philippine Disaster Risk Reduction and Management Act (DRRM Act)**

In May 2010 an important piece of DRR legislation was passed – The Philippine Disaster Risk Reduction and Management Act (DRRM Act). In line with the HFA's international guidelines and the objectives of SNAP, the DRRM Act envisioned a comprehensive, integrated, and proactive approach that involved all stakeholders and all aspects of disaster risk reduction and management.

- **National Disaster Risk Reduction and Management Council (NDRRMC)**

The new National Disaster Risk Reduction and Management Council, under the aegis of the Department of National Defence's Office of Civil Defence, reflects the newly comprehensive approach to disaster risk reduction. It is chaired by the Secretary of the Department of National Defence, while four vice chairpersons are each in charge of a specific area of priority action set out in the National Disaster Risk Reduction and Management Plan.

- **The National Disaster Risk Reduction and Management Framework**

The National Disaster Risk Reduction and Management Framework (NDRRM Framework), which was approved by the National Disaster Risk Reduction and Management Council (NDRRMC) in June 2011, builds on the vision outlined in the DRRM Act. The Framework applies a multi-hazard, community-based approach to the underlying causes of people's vulnerability by institutionalising arrangements and measures for reducing the risk of disaster and improving disaster-preparedness and response capabilities at all levels (NDRRMC, 2011).

- **National Disaster Risk Reduction and Management Plan**

When the DRRM Act became law in 2010, it contained provisions for an action plan, the 2011-28 National Disaster Risk Reduction and Management Plan (NDRRMP). To meet the objectives of the NDRRM Framework, the Plan sets out a roadmap drawn up through a consultative process that brought together representatives from national and local government, civil society organisations, and regional DRRM Councils.

The four areas of priority action at work

The prevention and mitigation priority area seeks to evaluate and lessen hazards, analyses vulnerability, identifies hazard-prone areas, and mainstreams DRRM into development plans. Meanwhile, the priority area of rehabilitation and recovery emphasises issues of employment and livelihood, and infrastructure and lifeline facilities. Under the terms of the National Disaster Risk Reduction and Management Plan, priority projects include developing further plans (e.g. local DRRM plans and a National Disaster Response Plan), guidelines for communications and information protocols before, during and after disasters, and evacuation standards, and establishing DRRM training institutes, local councils and offices.

Disaster risk management – key challenges ahead

Although the Philippines has substantially enhanced its disaster risk reduction practices and capacity over the past few years with the new framework and national plan underpinned by Philippine Disaster Risk Reduction and Management Act, the threat of natural disasters remains. The main challenges identified and targeted by the National Disaster Risk Reduction and Management Plan are to: *i)* address the underlying causes of people's vulnerability; *ii)* enhance convergence between DRR policies and climate change adaptation (CCA) programmes; *iii)* mainstream DRR and CCA into development plans; *iv)* develop new information and campaign materials and institutionalise knowledge-sharing mechanisms related to DRR and CCA; *v)* enhance disaster response activities within DRRM; *vi)* build the DRR and CCA capacity of people and institutions.

Convergence between DRR and CCA remains a challenge, as conceptual and operational divides exist and institutional mechanisms have worked in isolation from each other. Mainstreaming DRR and CCA into development plans is further hampered by the fact that most agencies and communities still fail to view DRR and CCA as part of a sustainable development framework. There is a need to develop new information and campaign materials and institutionalise knowledge-sharing mechanisms in order to improve understanding of DRR and CCA. And as disaster risk reduction and response are actually complementary, disaster response activities should be continuously enhanced as part of the risk reduction approach. Finally, it is absolutely essential to build the capacity of the people and institutions involved.

In addition to the challenges identified by the NDRRMP, the Philippine Development Plan (PDP) 2011-16 also pinpoints the lack of technical expertise, capacity, and funding as just some of the major challenges to which disaster risk reduction must rise. It is important to budget DRR activities clearly so that extra resources – for instance in the form of international aid – can be used flexibly and efficiently in accordance with specific needs.

Last but by no means least, the uncontrolled and ever-faster pace of urbanisation is a major obstacle to disaster risk reduction. In order to mitigate its negative impacts on DRRM, the authorities must improve land use and planning and build preventive infrastructure, such as flood defence and early warning systems.

POLICY FOCUS

Improve agricultural productivity and transport infrastructure in Mindanao

While the development of the National Capital Region (NCR) – where Metro Manila is located – has been effective, the same cannot be said of rural areas in the other regions of the Philippines. Poverty there is widespread. In 2011, rural areas still accounted for 51% of the country's poor who tend to be employed in agriculture and fisheries. And income disparities at the regional level translate into a continuous cycle of significantly lower access to infrastructure services, persistent gaps in education and health outcomes, and lower investment and business activity in rural areas.

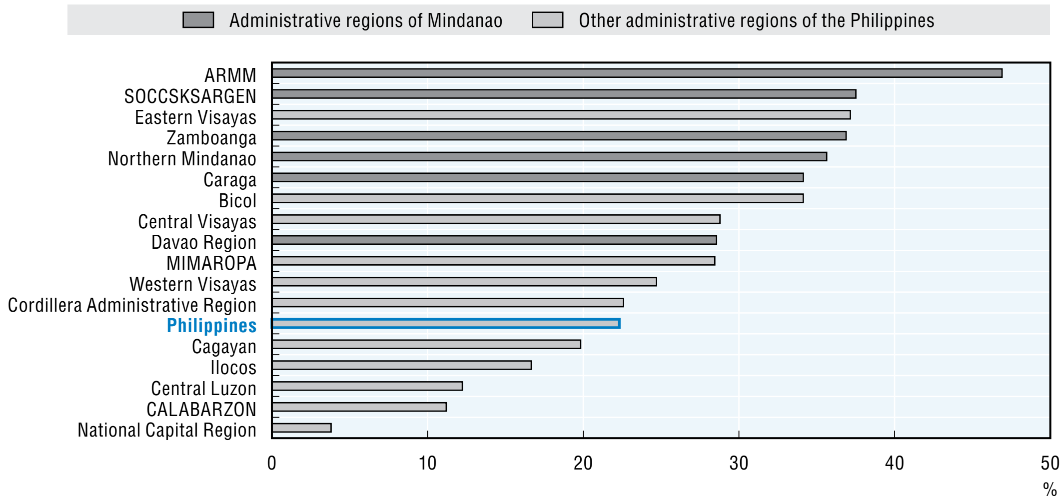
Mindanao's provinces are the poorest and most rural in the Philippines

Mindanao is divided into six administrative regions – Zamboanga Peninsula, Northern Mindanao, Davao Region, SOCCSKSARGEN,[4] Caraga Region, the Autonomous Region of Muslim Mindanao (ARMM). The island, which accounts for around 30% of the country's total land area and 24% of its population, relies heavily on agriculture with its share of local production ranging from 19% in Davao Region to 63% in ARMM. Yet Mindanao's share of total national output is smaller than that of the Luzon island group. In 2011, it contributed 14% to the country's gross domestic product (GDP), compared with Luzon's 73% and Visayas' 13%.

Despite the great potential of Mindanao's fertile, abundant land and resource-rich environment, its provinces are among the poorest and most rural in the country. Mindanao has the highest poverty incidence of all the three island groups with four of its regions in the Philippines' bottom five (Figure 2.7.6.). Similarly, Mindanao's provinces rank dismally in the Human Development Index (HDI).

The persistent rate of poverty in Mindanao is partly due to the fact that a substantial part of the population still depends on subsistence farming (NEDA, 2010). While agricultural productivity remains low and agri-industries underdeveloped, there are not enough employment opportunities outside of the agriculture sector. To invigorate Mindanao's economy and lift its people out of poverty, rural development needs to focus on improving agricultural productivity and transport infrastructure. It is also critical to develop transport infrastructure in order to further diversify the region's economy towards service-oriented sectors with high revenue and job-creation potential – e.g. information technology, business process outsourcing (BPO), and tourism.

Figure 2.7.6. **Poverty incidence among families in the Philippines, by region, 2012**



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Source: National Statistical Coordination Board (NSCB).

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Agricultural sector needs to be further developed

As Mindanao is the Philippines' main supplier of agricultural produce, there is a great potential for further agri-industrial development. Most of its regions are located outside the typhoon belt and its water supply is ample for irrigation (NEDA, 2010). As a result, Mindanao meets over 40% of the country's food requirements and contributes more than 30% to the national food trade.

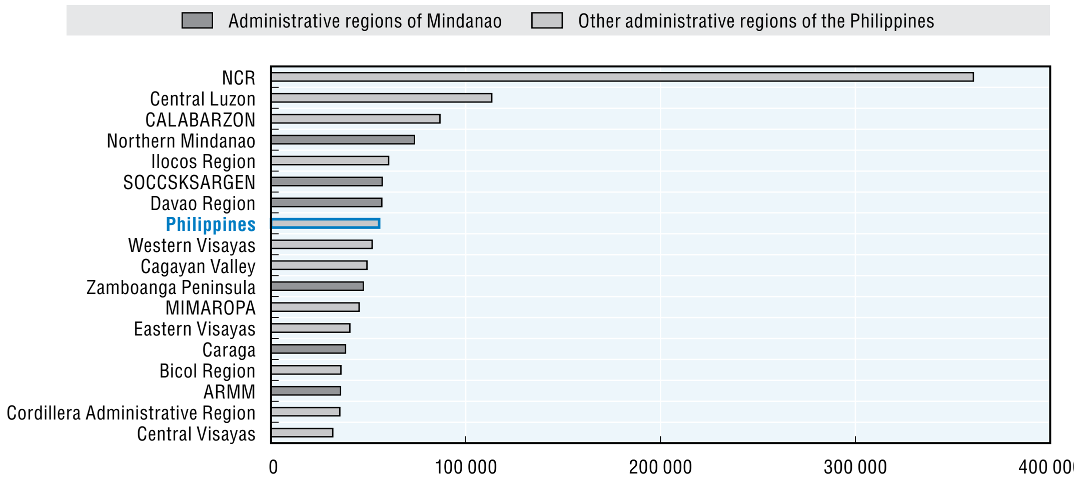
However, despite the bright prospects of Mindanao's agricultural sector, there is scope for improvement so as to exploit the full potential of its endowments. Agricultural productivity is low owing to its technology lag, high production costs, and shortage of skilled labour. Although labour productivity in Mindanao's agricultural sector varies from province to province, it is in particular need of improvement in Zamboanga Peninsula, Caraga, and the ARMM where it is below the national average (Figure 2.7.7).

Improved productivity and the broader development of the agriculture industry call for the adoption of new farming and processing technologies, an increase in related research and development (R&D), the establishment of new agri-industrial economic zones, and upgraded transport infrastructure. Improvements to farming and processing technologies also need to be supported by an expansion in credit facilities, the provision of post-harvest facilities, infrastructure, and irrigation systems (NEDA, 2010). As for the fishery and forestry industries, their sustainability needs to be strengthened through the rehabilitation and restoration of these natural resources.

R&D in the agricultural sector should focus on identifying the crops that meet certain parameters – e.g. the soil and terrain suitability and marketability – and on experimenting with climate-change-resistant food crops. It is also desirable that R&D should be better aligned with needs and spread evenly across the different organisations such as agricultural research institutions and universities.

Figure 2.7.7. **Labour productivity in the agriculture, fishery and forestry sector in the Philippines, by region, 2011**

PHP in constant 2000 prices



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Source: Bureau of Labour and Employment Statistics.

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The promotion of existing agri-industrial economic zones – in Lanao del Norte, Davao del Sur, Cagayan de Oro City, General Santos City and South Cotabato – needs to be strengthened and new ones established. Not only would access to modern agricultural technologies be facilitated through the inflow of foreign investment and know-how, there would be linkages with processing industries that would create local employment opportunities.

Mindanao has a large Muslim community, while its geographical location makes other Southeast Asian countries with Muslim populations easily accessible. These two assets could help it reinforce its share of the prosperous Halal industry. And with the certification framework for *halal* products already in place, Mindanao should step up its efforts to look for joint-venture opportunities and attract foreign direct investment (FDI) (NEDA, 2010).

A better developed transport infrastructure is also essential to improving the productivity of the agricultural sector. Its high production costs are in fact partly due to poor transport capacity. In that respect, irrigation systems, farm-to-market roads, and bridges are all examples of infrastructure developments that call for investment. They would improve the income and living conditions of rural households by reducing travel time and haulage costs as well as making basic social services such as schools and hospitals more easily accessible (Mangahas, 2010).

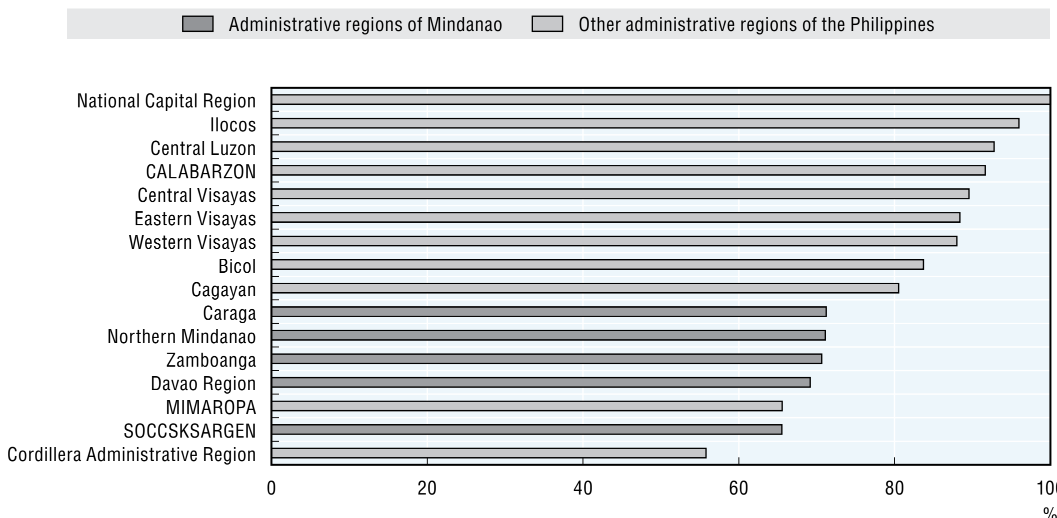
Develop transport infrastructure for overall rural development

Improving the tri-modal (road, sea, air) transport system in Mindanao is important not only for further development of the agricultural sector, but also for rural development as a whole. It would strengthen links between growth centres and the rural parts of

Mindanao, help diversify the region's economy, and the provision of basic services to the population.

Mindanao's development is seriously constrained by the poor overall state of its transport infrastructure. With the exception of Northern Mindanao, the region's provinces rank in the bottom half of all the Philippines' provinces with respect to road density. It has the worst road infrastructure conditions of the three island groups as measured by the percentage of paved roads to total road length. Some 30% of its roads are unpaved (Figure 2.7.8). As a consequence, the costs of cargo shipment and human transport from Mindanao to other parts of the Philippines are very high (NEDA, 2010).

Figure 2.7.8. **Proportion of the length of paved roads to total road length in the Philippines, by region, 2012**



Notes: 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. ARMM stands for Autonomous Region in Muslim Mindanao.

Source: Department of Public Works and Highways (DPWH), Road Data 2012.

StatLink http://dx.doi.org/10.1787/888932938346

Clearly, a more efficient transport network linking production areas to markets is essential if regional economic growth is to be boosted and disparities narrowed. While road improvement is a critical requirement, particularly to connect the provinces of Caraga, Northern Mindanao, and ARMM to Davao, developing a railway system would offer a more effective long-term solution.

Air transport infrastructure has undergone substantial development in recent years, so increasing air freight capacity and boosting exports. However, Mindanao's airports need to be further upgraded as air traffic is concentrated mostly in Davao International Airport,[5] which is one of just three international airports. Other strategically situated airports with large catchment areas also need to be expanded and upgraded.

However, over 90% of the goods that arrive or leave Mindanao are still transported by sea. Yet the cost of shipping is very high. Rates from Manila to China, for example, are less than one-third of the shorter Davao to Cebu route. Furthermore, maritime transport is further restricted by the fact that foreign-owned ships can anchor only in the few ports in Mindanao that have adequate facilities. There is an urgent need to develop and upgrade existing port facilities, while the authorities must act to create a regulatory environment that would encourage competition and so reduce high shipping costs.

This last point holds true for Mindanao's transport infrastructure as a whole. Hence, any development plan must include improvements to the institutional and regulatory framework. The authorities need to build the capacity of government departments and agencies tasked with developing transport infrastructure. Local government's limited access to financial resources and lack of capacity is coupled with frequent overlaps in many agencies' roles and responsibilities and issues related to land acquisition and resettlement.

Notes

1. Unemployment measures overlook underemployment which also contributes toward poverty.
2. Remarks made at a forum on 5 July 2013 organised by the Foreign Correspondents Association of the Philippines.
3. "Process or phenomenon of atmospheric, hydrological or oceanographic nature that may cause loss of life, injury or other health impacts, property damage, loss of livelihoods and services, social and economic disruption, or environmental damage." Definition taken from PreventionWeb, www.preventionweb.net/english/professional/terminology/v.php?id=490.
4. SOCCSKSARGEN is located in central Mindanao. Its name is an acronym that stands for the region's four provinces and one of its cities: South Cotabato, Cotabato, Sultan Kudarat, Sarangani and General Santos City.
5. Davao International Airport, inaugurated in 2003, was upgraded to international standards with the aim of making Mindanao a gateway to economic co-operation with the Brunei Darussalam-Indonesia-Malaysia-Philippines East ASEAN Growth Area.

Singapore

A. Medium-term economic outlook (Forecast, 2014-18 average)

GDP growth (percentage change):	3.3
Current account balance (% of GDP):	17.9
Fiscal balance:	3.9

B. Medium-term plan

Period: 2010-20

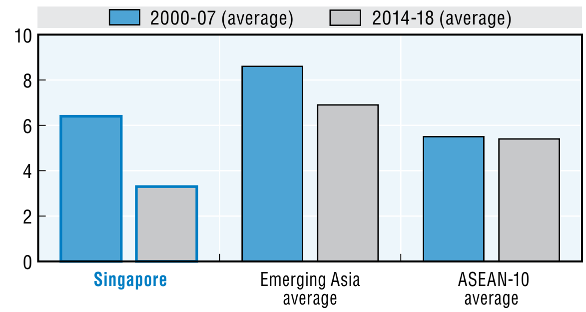
Theme: Highly skilled people, innovative economy, distinctive global city

C. Basic data (in 2012)

Total population:	5.4 million*
Population of Singapore	3.8 million (in 2010)
GDP per capita at PPP:	51 161 (current USD)**

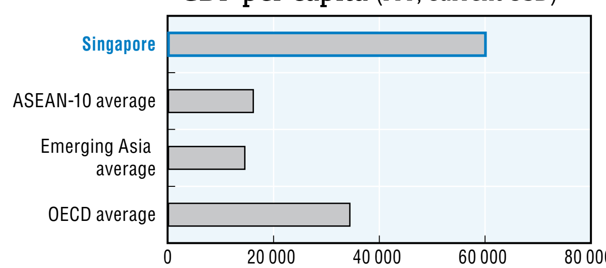
Note: * Total population data for 2012 are estimates.
** IMF estimate
Sources: OECD Development Centre, national sources and IMF.

GDP growth rates (Percentage change)



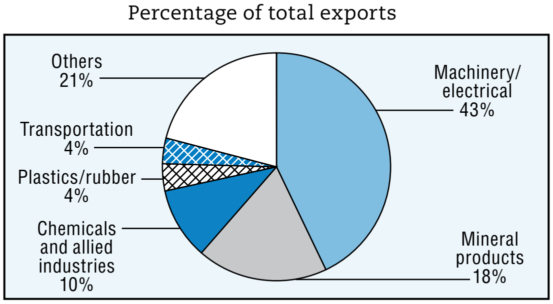
Source: OECD Development Centre, MPF-2014.

GDP per capita (PPP, current USD)



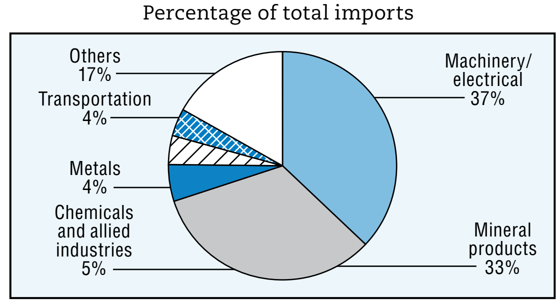
Source: IMF.

Composition of exports, 2012
Percentage of total exports



Source: Trademap.

Composition of imports, 2012
Percentage of total imports



Source: Trademap.

Singapore's priorities going towards 2020 are boosting skills in every job, deepening corporate capabilities to seize opportunities in Asia, and making Singapore a distinctive global city and endearing home.

To boost skills in every job, especially with an ageing population, the Singapore government has strengthened its adult learning provisions. The rationale behind lifelong learning is a pragmatic one in that there are economic benefits – higher wages, employment and labour productivity; more importantly, it also increases labour market flexibility. In fact, across the developed world, policies are increasingly being focused on vocational lifelong learning, which is seen as a driver of economic growth and competitiveness.

The Singapore government recognises this fact, and it has put in efforts to enhancing the productivity of SMEs. In Singapore, a multi-agency assistance provision offers SMEs a variety of schemes, ranging from tax cuts to loans and grants to help defray the costs of productivity improvements in areas such as R&D, automation, and capacity building.

A medium-term challenge facing Singapore in its efforts to make the city state a distinctive global city and an endearing home is the scarcity of land. There is competition for space, both for housing and for industrial and commercial uses, and property prices are high. There have been some concerns associated with congestion on the roads and with public transport. To help ease these concerns, it is useful to incorporate a green growth strategy.

Singapore's medium-term policy challenges and responses

- Optimise land use and allocation by incorporating a green growth strategy
- Raise SME productivity through well co-ordinated assistance programmes
- Strengthen life-long learning to increase labour market flexibility

POLICY FOCUS

Optimise land use and allocation by incorporating a green growth strategy

One of the medium-term challenges facing land-scarce Singapore if it is to support a growing population is how to allocate land optimally for different usages. There is a need to balance competing space demands for housing, transportation infrastructure, industrial and commercial uses, parks, reservoirs and community areas, while ensuring a liveable environment for all. The country's liberal foreign worker inflow policy of recent years has led to a situation where the existing housing and transport infrastructure has been unable to cope adequately with the large rise in the overall population. The result has been an increase in the negative externalities typically associated with urbanisation, such as congestion on the roads and high property prices.

One way to help ease such pressure would be closer co-ordination between planning agencies in order to pre-empt issues of inadequately met land demand before they arise. In keeping with its strategy of sustainable development, the government could also pursue green growth more proactively.

Singapore's land scarcity makes planning crucial

In 2013, to support its population projections, the government published a strategy document, the *Infrastructure Land Use Plan*, which outlines Singapore's land use and allocation strategy to 2030. It projects an increase in supply from 71 000 ha in 2010 to 76 600 ha by 2030, with the construction and development of housing and transport infrastructure being ramped up to offset the current mismatch in supply and demand (Table 2.8.1).

Table 2.8.1. **Infrastructure Land Use Plan: Singapore's land requirements**

Land use	Planned land supply (ha) 2030	New developments planned
Housing	13 000 (17%)	New housing estates in Bidadari, Tampines North, Tengah, former Bukit Turf Club, Kallang Riverside, Keppel and Bukit Brown; further development of Punggol
Industry and commerce	12 800 (17%)	New manufacturing areas at Woodlands, Sengkang West, Seletar, Lorong Halus, Pasir Ris, and Tuas Expand commercial areas at Jurong Lake District, North Coast Innovation Corridor, One-North, Paya Lebar Central, Southern Waterfront City
Parks and nature reserves	7 250 (9%)	More parks and park connectors, e.g. Jurong Lake Park, Coney Island Park New nature reserves at Jalan Gemla, and Beting Bronok & Pulau Unum
Community, institution and recreation facilities	5 500 (7%)	Increase in childcare facilities, and integrated hospitals
Utilities (e.g. power, water treatment plants)	2 600 (3%)	
Reservoirs	3 700 (5%)	Improve the attractiveness of Sungei Ulu Pandan and Rochor Canal
Land transport infrastructure	9 700 (13%)	More rail lines, e.g. Downtown Line, Thomson Line, Eastern Region Line, Tuas West Extension, North-South Extension, etc.
Ports and airports	4 400 (6%)	New low-cost-carrier airport terminal New transshipment port at Tuas, Pasir Panjang port expansion
Defence requirements	14 800 (19%)	
Others	2 800 (4%)	
Total	76 600 (100%)	

Source: Ministry of National Development (2013) *Infrastructure Land Use Plan*.

Optimise industrial, commercial and residential land use

As well as maximising land capacity through reclamation, the government also intends to pursue its focus on optimising the use of existing land. It is repurposing low intensity sites like old industrial facilities and golf courses to more productive ends, and consolidating activities that require space – e.g. military training, golf, and farming – so as to free up land for other usages. The government's recently launched Land and Liveability National Innovation Challenge seeks to foster and support research into ways of making land usage more cost-effective while keeping Singapore liveable.

The government believes that land use can be further optimised by intensifying new development projects. In manufacturing, different needs can be met by clustering shared industrial facilities in multi-stacked and plug-and-play factories. Efforts are also afoot to expand space underground. The Jurong Rock Caverns, for example, were hollowed out industrially as an oil storage facility.

The government is also offering further incentives to business owners to come up with solutions for maximising land productivity. In 2010, it introduced the Land Intensification Allowance scheme that gives businesses in nine manufacturing sectors tax allowances on their building costs if they meet or exceed the gross plot ratio[1] benchmarks for their specific sectors.[2]

The intensification of property development is also to be seen in residential and commercial areas. New real estate projects are building higher-density housing to minimise the space required. One example is the Pinnacle@Duxton residential complex, completed in 2010, consisting of seven connected 50-storey towers that boast a total of 1 848 units. The average public housing unit has also shrunk in size over the years to address land scarcity.

As for commercial properties, new growth poles – such as the Jurong Lake District – are being built away from central business districts in order to reduce congestion and provide employment opportunities and amenities closer to homes.

Close co-ordination among planning agencies

Despite planners' efforts to optimise the use and allocation of land, the demand for homes, transport infrastructure, and public amenities is tight as infrastructure takes time to build up. As a result, public dissatisfaction has risen alongside traffic congestion of public transportation system during peak hours.

Such negative externalities could affect Singapore's competitiveness in the long run. High land and housing prices may affect the decision of companies to relocate in or do business with Singapore, while local firms may have trouble recruiting highly qualified workers.

Recognising this, the 2013 Land Use Plan outlines the strategies to ensure that Singaporeans will continue to enjoy a high quality living environment and for Singapore to remain as one of the best cities in the worl to live in. There will be greater co-ordination between planning agencies to plan ahead and invest in infrastructure in a timely manner. The government will also invest in research, and explore and support innovative urban solutions which promote liveability.

Make green growth more proactive

In recent years, Singapore has recognised the importance of growth in a sustainable development context. Resource efficiency and improved environmental quality are two of the key priorities in its long-term integrated land use planning framework. While it has put in place funding to support green innovation technologies and designed standards in energy efficiency, the process has been more facilitative than proactive.

It may be useful for Singapore to incorporate a green growth strategy within its sustainable development framework. This would entail an operational policy agenda to help achieve concrete, measurable progress in green growth. Many OECD countries have adopted mechanisms to change mindsets and practices as part of their green growth strategies for sustainable development. Such mechanisms may be taxes and tradeable permit systems to control pollutant behaviour or subsidies to incentivise more environmentally sound products and manufacturing. One example comes from Germany, where the government introduced electricity taxes and subsidies for the use of renewable energy and energy technologies as part of its environmental fiscal reform measures over the period 1999-2005.

POLICY FOCUS

Raise SME productivity through well co-ordinated assistance programmes

Another medium-term challenge for Singapore is to help its businesses restructure and move up the value chain. The white paper on population (*A Sustainable Population for a Dynamic Singapore*) highlights how crucial it is for small and medium-sized enterprises (SMEs) – which account for more than 50% of economic output and 70% of employment – to place greater emphasis on productivity improvements. Doing so would help offset infrastructure constraints and the slowdown in the workforce growth rate, while ensuring that Singaporeans continue to enjoy access to better jobs, higher wages, and a higher standard of living. Although the government runs numerous support programmes to help SMEs develop their capabilities, it could do more to raise their awareness of the availability and value of such schemes. They should also incorporate an evaluation process that allows SMEs to assess the productivity benefits they bring.

Government is committed to help SMEs be more productive

Enhancing productivity in SMEs is a global theme. Globalisation compels firms to rely increasingly on the assets they create themselves, with the keys to success being building human capital and encouraging workers and unions to become actors in productivity (OECD, 2001). In Singapore, the National Productivity and Continuing Education Council oversees the productivity effort. The Council has invested SGD 2 billion (Singapore dollars) in a National Productivity Fund to champion initiatives in productivity and continuing education over the next ten years. The population white paper hopes that Singapore's productivity growth will be 2% to 3% between 2010 and 2020, but believes it will be between 1% and 2% for the 2020-30 period.

Broadly speaking, the government is committed to assist businesses in improving their innovation capacity and expertise through:

- sector-specific productivity improvement roadmaps
- stronger cross-sector support capacity.

The government has built a multi-agency assistance provision that offers SMEs a variety of schemes to to enhance productivity, innovation and capability upgrading. They range from tax cuts to loans and grants (Table 2.8.2) to help defray the costs of productivity improvements in areas such as R&D, automation, and capacity building. As of October 2012, the National Productivity Fund had disbursed almost one-half of its endowment (about SGD 950 million), with 5 700 SMEs benefitting from assistance programmes. These include schemes to support capacity building and to help companies develop their business internationally.

Table 2.8.2. **Assistance schemes for SMEs in Singapore to enhance productivity, innovation and capability upgrading**

Beneficiary	Programmes
Voucher	SGD 5 000 *Innovation & Capability Voucher (SPRING)* to defray costs when engaging approved consultants and service providers, capped at SGD 15 000 over three years from 2013-15
Tax incentive	*Productivity and Innovation Credit (IRAS)* – 400% tax deduction of up to SGD 400 000 and/or 60% cash payout of up to SGD 100 000 expenses in productivity improvements and innovation
Grant	*Capability Development Grant* supports up to 70% of cost of productivity improvements and capability development
	Land Productivity Grant (Spring) to help companies who intensify land use in Singapore
	Enterprise Training Support (WDA) to assist with holistic HR and training support packages
	WorkPro (WDA)
Loan	*Micro-loan Programme* that offers loans of up to SGD 100 000 for Singapore SMEs with ten or fewer employees
	Local Enterprise Finance Scheme offers loans up to SGD 15 million for all locally owned SMEs
Collaboration with industry players	*Collaborative Industry Projects (SPRING)* in six priority sectors to address sector-specific productivity challenges
	*Technology Adoption Programme (A*STAR)* to help link companies' technology needs to solution providers, with pilot in six sectors in July 2013
	SME Talent Programme to help SMEs recruit local talent from ITEs and Polytechnics over next five years

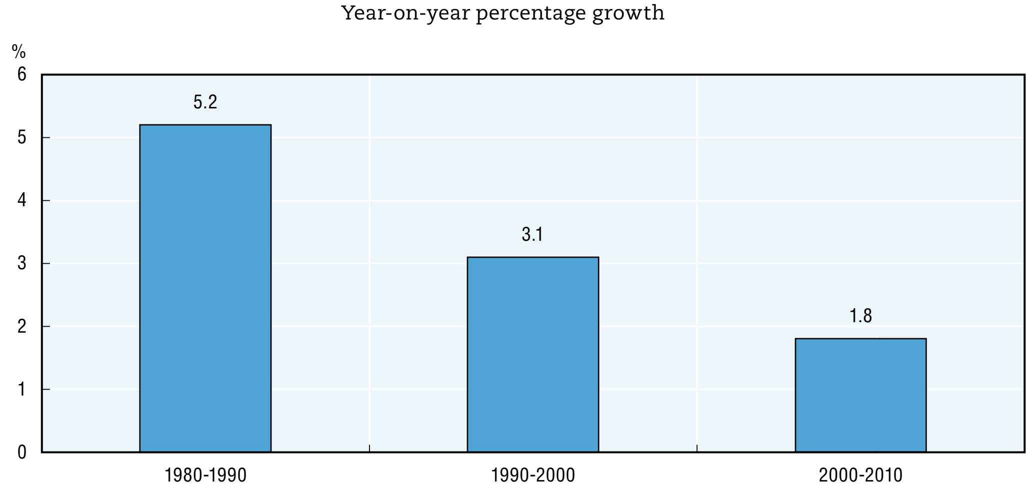
Sources: Singapore Workforce Development Agency (2011), *2011 Survey Findings on the Awareness and Adoption of WSQ and the Outcomes of WSQ Training on Employers and Workers*, Singapore; Spring Singapore; EnterpriseOne.

SMEs are gradually taking up the productivity drive

Despite the wide range of assistance schemes available, some small businesses have not embraced the productivity challenge. Partly because of Singapore's liberal foreign worker policy of the last few years, some SMEs have relied on foreign workers, which has fuelled employment rather than productivity growth. From 2000 to 2010, productivity growth was 1.8% *per annum* compared to 3.1% for the period 1990-2000 (Figure 2.8.1).[3] Although the figure was lower than other ASEAN countries, it was higher than other advanced economies in the OECD countries' 1.2% for the same period (Figure 2.8.2).

Figure 2.8.1. **Productivity growth rates in Singapore, 1980-2010**

Year-on-year percentage growth



Source: Singapore Department of Statistics.

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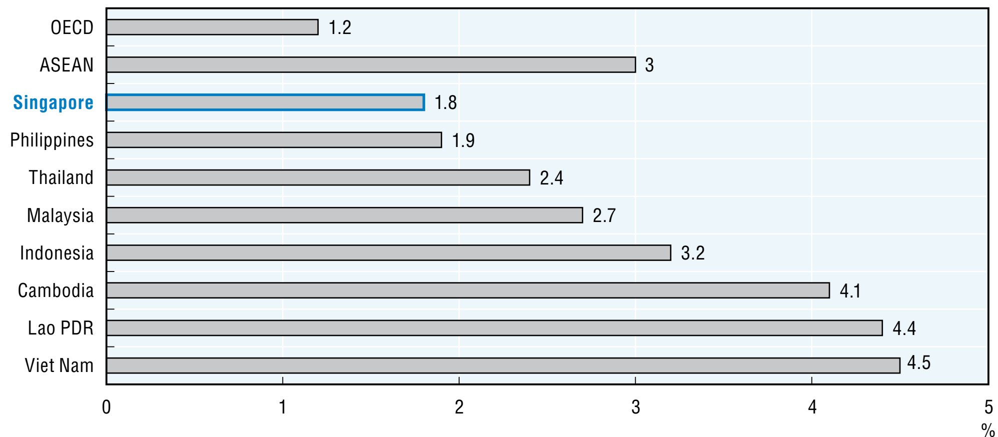
Figure 2.8.2. **Comparison of labour productivity growth for Singapore and other selected countries, 2000-10**

Average annual growth rate



Source: APO (2012), *APO Productivity Databook 2012*, Asian Productivity Organization,Tokyo; OECD.

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Raise SMEs' awareness of assistance

Although many assistance schemes are available, some SMEs may not know that. Others may have neither the resources nor the inclination to search for the specific type of support for which they can apply. To this end, the government is simplifying SPRING Singapore's assistance schemes for SMEs and developing existing Enterprise Development Centres (EDCs) into one-stop, integrated SME Centres. The government also recognises that more can be done to reach out to the SMEs and help them find ways to utilise the various productivity enhancing schemes. Indeed, a new government-led working group has been formed to lead and co-ordinate efforts to assist the SMEs in overcoming the challenges they face in restructuring and raising productivity.

The authorities should also further improve the effectiveness of schemes through evaluation mechanisms that would properly assess whether they are beneficial to particular SMEs. Many are of limited duration and are designed to support SMEs in building their business capacity in the short term. SMEs that are unable to increase their productivity should be allowed to exit or consolidate, which would lead to gains at industry level. In this regard, the newly formed work group by the government to lead and co-ordinate efforts to raise awareness of these productivity-enhancing schemes and to assist the SMEs cope with difficulties faced in economic restructuring and raise productivity is a step in the right direction

Another way of boosting SMEs' productivity is to design schemes that would assist them more effectively in accelerating the process of internationalising their business in global markets. Because the domestic market is small, Singaporean SMEs should be encouraged to venture abroad to secure more business opportunities. Those that do so will inevitably have to streamline their processes and become more productive to hold their own against international competition.

Over the years, the Singapore government has provided extensive support to SMEs to upgrade their capabilities. It already supports the internationalisation of SMEs through loans, grants, tax incentives and equity financing administered mainly by two government agencies – International Enterprise Singapore and SPRING Singapore.

SMEs can also tap into the new Market Readiness Assistance Grant, which SMEs with international growth plans may use to seek advice from pre-approved consultants in areas such as market assessment.

To further assist SMEs doing business abroad, the government has also introduced enhanced assistance programmes to help SMEs internationalise as well as promote collaboration between SMEs and larger enterprises though the enhanced Partnerships for Capability Transformation (PACT) scheme. However, the government should consider leveraging existing programmes to partner with non-governmental organisations (OECD-APEC joint survey). Partnerships should encourage large local companies to work with less experienced SMEs and use them as subcontractors or suppliers for overseas projects, for example, in order to give them footholds in foreign markets.

Raise SMEs' profiles as attractive places to work

Although Singapore's SMEs employ a majority of the country's workforce, many young graduates entering the labour market set their sights on established domestic firms and multinational companies for the mobility opportunities and depth of learning that they offer. To enable SMEs to attract more capable young talent, there should be more and closer collaboration between SMEs and tertiary institutions in offering internships and job attachments. That is precisely what the new SME Talent Programme attempts to do.

It is designed to enable SMEs to attract and recruit able students early from local institutes of technical education and polytechnics by sponsoring so-called "study awards" that cover students' fees and guarantee them a two-year job upon graduation. There is certainly scope to extend this scheme to students from local universities should it prove successful. As a final thought, SMEs would do well to design more well-rounded positions that offer wider, more attractive ranges of skill that local graduates could learn.

POLICY FOCUS

Strengthen lifelong learning to increase labour market flexibility

With its ageing population, a key medium-term priority for Singapore is to support lifelong personal development as a means to enhance workers' competitive advantage and sustain their employability. The 2013 white paper on population – *A Sustainable Population for a Dynamic Singapore* – noted that in a rapidly changing business environment, Singaporeans need to constantly upgrade and refresh their knowledge and expertise to cope with changing job demands. Singapore actually has a wide range of government co-financed training programmes in place to support adult learning. Their delivery and quality control, however, require strengthening. In addition, policies should be directed at changing workplace norms and practices, particularly the employment of older workers.

Government strengthens adult learning provision

Many countries offer their workforces a wide range of non-formal adult learning resources.[4] Across the OECD, policies have been increasingly focusing on vocational lifelong learning, seen as a driver of economic growth and competitiveness (OECD, 2000). In Singapore, non-formal adult learning measures are co-ordinated by public bodies such as the Workforce Development Agency (WDA), SPRING Singapore, the Institute of Adult Learning and the Council for Private Education. Under the Continuing Education and

Training (CET) Masterplan (2008), the government aims to partner with these agencies to establish a high-quality, sustainable CET infrastructure that will support lifelong learning and skills upgrading in the workforce.

Some training schemes are tailored to groups of workers, such as those who are older, low-skilled and particularly vulnerable to displacement if they fail to upgrade or pick up new skills. The government heavily subsidises training, which is geared towards improving workers' abilities to meet sectoral needs. The Workforce Training Support (WTS) scheme, for example, encourages low-wage workers to attend training courses to upgrade their skills and employability. The government funds up to 95% of accredited course fees and absentee payrolls. Workers also receive a monetary incentive when they commit to attending a training course and receive further additional income through the Workfare Income Supplement (WIS) as they continue to be employed. Since the WTS was introduced in July 2010, more than 90 000 low-wage workers have undergone training to improve their skills and employability.

Table 2.8.3. **Non-formal adult learning assistance schemes in Singapore**

Areas targeted	Programmes
Low-wage and mature workers	WTS complemented by WIS (mentioned above)
Capacity-building	*Productivity Initiatives in Services & Manufacturing (PRISM)* offer cross-sectoral and industry-specific verticals for services and manufacturing personnnel *Skills Training for Excellence Programme (STEP)* for professionals, managers, executives and technicians offering industry and occupational-specific skills, "horizontal" skills such as business management and human resource
Back-to-work	*WorkPro* offers job search assistance for mature and/or back-to-work locals, fully funded job-preparation workshops to help them get ready for work, and incentives such as a one-time transport allowance and retention bonus to remain at work
During the economic downturn	*Skills Programme for Upgrading and Resilience (November 2008-November 2010)* offers employers higher course fee support to keep jobs and retrain workers *Professional Skills Programme Traineeships (March 2009-March 2010)* offered traineeships to participating companies to allow them to gain industry experience and develop national skills base in growth sectors

Source: Singapore Workforce Development Agency.

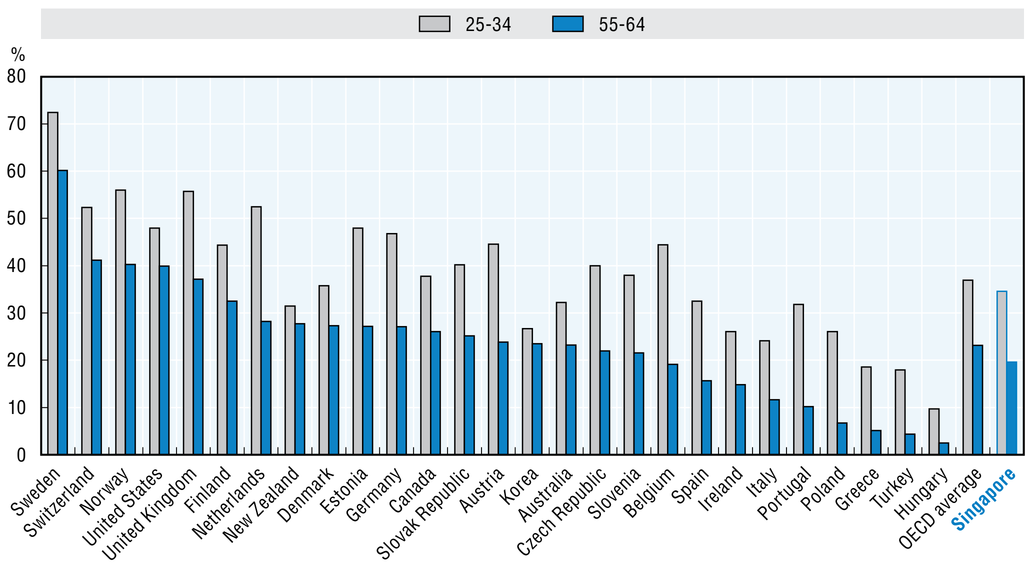
Employers and workers positive about lifelong learning outcomes despite misgivings over income

In 2011 the WDA conducted a survey which found that most companies were positive about sending their employees on accredited training courses under the Workforce Skills Qualification (WSQ) system.[5] Seventy percent of respondent companies reported that training had led to higher productivity and service quality. Among trainees, 92% said they were able to apply the skills they had learned, while 90% that their work performance had improved.

However, employers and trainees were more divided on other fruits of training. Less than half (49%) thought it thought it benefitted employees' wages, 46% said it did not improve promotion opportunities, and 40% felt it failed to enhance deployment flexibility.

External studies, however, have found that adult education and training have a significant impact on earnings. Ang et al. (2006) argue that in Singapore training is more likely to have a positive effect on pay rises and promotion among workers in low pay brackets. Given that the participation rates in non-formal education among mature (and therefore less skilled) workers are lower in Singapore than the average OECD rate, more should be done to encourage them to engage in non-formal learning (Figure 2.8.3).

Figure 2.8.3. **Participation in non-formal education in Singapore and OECD countries, by age group, 2007**



Notes: Countries are ranked in descending order of the participation rate of 55-64 year-olds (2007).
Year of reference 2005 for Sweden and the United States; year of reference 2006 for Finland, the United Kingdom, New Zealand, Denmark, Italy, Poland and Hungary; year of reference 2008 for the Netherlands, Canada, Czech Republic, Belgium and Ireland; and year of reference 2009 for Switzerland.
Singapore: proportion of economically active residents aged 20-39 years and 50-64 years who had engaged in some form of job-related structured training in 2005.

Source: OECD (2012e), *Education at a Glance 2012: OECD Indicators*, OECD Publishing, Paris; Singapore Ministry of Manpower (2006), *Adult Training 2005*, Ministry of Manpower, Singapore.

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Raise awareness and the profile of adult learning

The sheer number and many types of training programmes can be confusing both for employees and employers. In this respect, the two new CET campuses are valuable in that they provide a one-stop shop service that brings together career advice and services, training and assessment. More could be done to publicise the campuses and the range of services they offer employers and employees alike. It is also important to ensure that CET provisions should be flexible enough to translate into widely recognised qualifications that are useful for lateral movements in employment. However, the experience of other countries points to a drawback of the one-stop shop approach that Singapore should bear in mind – namely, the risk of competition between providers and of conflict between education and labour programmes (OECD, 2005).

The rationale behind lifelong learning in Singapore is a pragmatic one that seeks to emphasise economic benefits – higher wages, employment and labour productivity. Government agencies and employers champion CET as a way for employees to acquire important sector- and industry-specific skills. However, it has non-economic benefits, too, such as greater self-esteem and social interaction, which Singapore could use to entice employees to take up training opportunities.

Another avenue it could explore is that of subsidy schemes – such as individual learning accounts and grants (i.e. allowances and vouchers) – which a number of OECD countries have used effectively to promote adult learning among the low-skilled. The US, for example, has a system of individual training accounts whereby individuals are given vouchers they use to pay for training courses in the occupational skills they need to find gainful employment.

Box 2.8.1. **Adult vocational learning : Examples from OECD countries**

In OECD countries, adult learning takes many forms – from second-chance programmes to language courses for immigrants and workplace training. Below are some examples of workplace learning schemes generally put in place by the government or employers.

In **Germany**, low-skilled adults can acquire vocational qualifications through a programme of "differentiated pathways to receiving vocational degrees". Its approach mixes assessment and the recognition of prior learning, as well as a modular system for assessing qualifications. For low-skilled workers without a vocational degree, there are also a number of local projects for "obtaining certified skills while working"("*berufsbegleitende Nachqualifizierung*").

Mexico created its "Learning for Life and Work Model" to deliver adult basic education with a focus on vocational preparation and job requirements.

In the **UK**, Employer Training Pilots enable employees to acquire basic skills and NVQ2-level skills, with the financial incentives of paid time off for the employee and wage subsidies for employers.

In **Austria**, car manufacturer Magna Steyz trains non-skilled workers for skilled positions through a one-year programme which delivers the *Facharbeiter* qualification (equivalent to an apprenticeship programme).

Source: OECD (2005), *Promoting Adult Learning*, OECD Publishing, Paris, http://dx.doi.org/10.1787/9789264010932-en.

ANNEX. Population White Paper – Sustainable population for a Dynamic Singapore

Towards inclusive, cohesive growth for all Singaporeans

In January 2013, the Singapore government published a white paper, *A Sustainable Population for a Dynamic Singapore*,[6] to address the demographic challenges of an ageing workforce and declining birth rate. The paper sets out key medium-term considerations and a roadmap for population policies designed to:

- maintain a strong, cohesive society with a sustainable Singaporean core,
- regulate the number of new Singapore citizens and permanent residents accepted in the country,
- create good jobs and opportunities for Singaporeans,
- build a high-quality living environment,
- strengthen Singaporean identity and society.

To those ends, the white paper advocates a number of measures such as encouraging marriage and parenthood among the young, increasing the productivity of SMEs, and accelerating infrastructure development to cope with a larger population.

Table 2.8.A1. **Population White Paper: Key statistics and estimated projections in Singapore, until 2030**

	Current available year	2020 (estimated)	2030 (estimated)
Economy			
GDP growth rate (compound annual growth rate [CAGR], %)	6.8 per year (average, 1980-2010)	3.0-5.0 per year (average, 2010-20)	2.0-3.0 per year (average, 2020-30)
Labour productivity growth rate (%)	-2.6 (2012)	2.0–3.0 per year (average, 2010-20)	1.0-2.0 per year (average, 2020-30)
Workforce growth rate (%)	3.3 per year (average, 1980-2010)	1.0-2.0 per year (average, 2010-20)	1.0, per year (average, 2020-30)
Demography			
Resident population (million) (includes citizens and permanent residents)	3.82 (as of June 2012)	4.0-4.1	4.2-4.4
Non-resident population (million)	1.49 (as of June 2012)	1.8-1.9	2.3-2.5
Total population (million)	5.31 (as of June 2012)	5.8-6.0	6.5-6.9
Land and infrastructure			
Planned land supply (ha)	71 000 (2010)		76 600
Rail length (km)	178 (2012)	~280 (by 2021)	~360
Rail density (km/mil pop)	34	47	54
Public housing (housing units)	1.2 million		700 000
SMEs			
Citizens in PMET* jobs	850 000 (50%, 2011)		1 250 000 (67%)
Citizens in non-PMET jobs	850 000 (50%, 2011)		650 000 (33%)
Lifelong learning			
Two new CET campuses	+50 000 trained adults per year		

Note: PMET, defined as Professional, Managerial, Executive and Technical, describes a category of jobs that require a higher level of skills and educational qualifications. CET stands for continuing education and training.

Source: Singapore National Population and Talent Division (2013), *A Sustainable Population for a Dynamic Singapore: Population White Paper*, Singapore National Population and Talent Division, Singapore Government.

Notes

1. Gross plot ratio is the the ratio of a building's total floor area to the size of the plot of land upon which it is built. Other countries use different terms, such as "site ratio", "floor space ratio", or "plot ratio".
2. The nine manufacturing sectors are pharmaceuticals, petrochemicals, petroleum, specialities, other chemicals, semiconductor-wafer fabrication, aerospace, marine and offshore engineering, and solar cell manufacturing.
3. From 2000 to 2010, productivity growth contributed 31.7% to GDP growth, while labour force growth contributed 68.3%. The actual figures are real average GDP growth at 5.6%, productivity growth of 1.8%, and labour force growth of 3.8% (Singapore Department of Statistics).
4. The OECD defines non-formal learning as professional development programmes (outside schools and colleges of the formal education system) that equip workers and professionals with new knowledge and skills.
5. The WSQ system is a national qualification system that trains adult workers and delivers certified, nationally recognised, industry-relevant qualifications.
6. The Population White Paper can be downloaded from the National Population and Talent Division website (www.population.sg/).

Thailand

A. Medium-term economic outlook (Forecast, 2014-18 average)

GDP growth (percentage change):	4.9
Current account balance (% of GDP):	2.0
Fiscal balance:	-2.89

B. Medium-term plan

Period: 2012-16

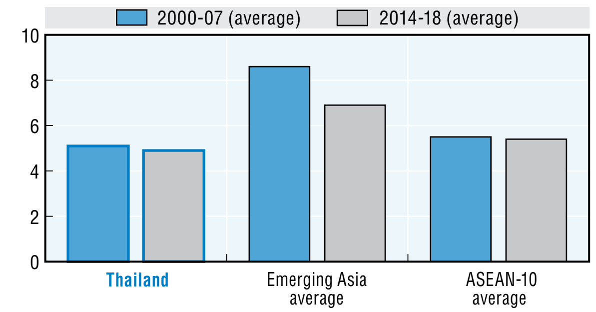
Theme: A happy society of equity, fairness and resilience – the vision of the Philosophy of a Sufficiency Economy

C. Basic data (in 2012)

Total population:	64 million*
Population of Bangkok	5.7 million (in 2010)
GDP per capita at PPP:	10 125 (current USD)**

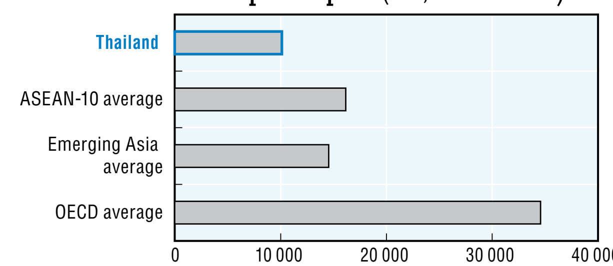
Note: * Total population data for 2012 are estimates.
** IMF estimate
Sources: OECD Development Centre, national sources and IMF.

GDP growth rates (Percentage change)



Source: OECD Development Centre, MPF-2014.

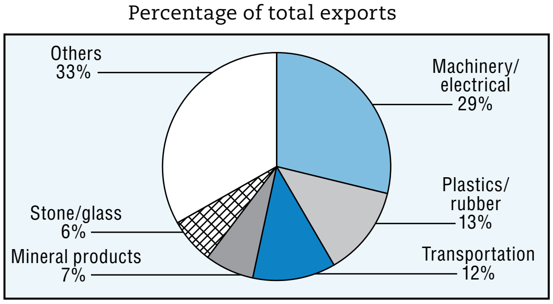
GDP per capita (PPP, current USD)



Source: IMF.

Composition of exports, 2012

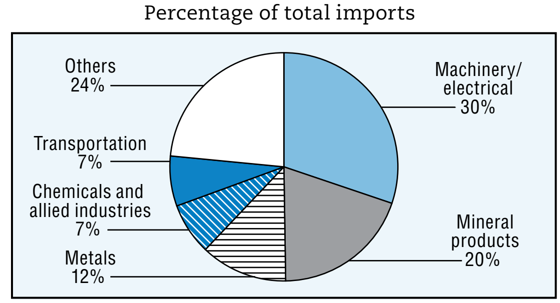
Percentage of total exports



Source: Trademap.

Composition of imports, 2012

Percentage of total imports



Source: Trademap.

"Philosophy of Sufficiency Economy" – a happy society that is equitable, fair and resilient

Thailand will need to address several medium-term challenges identified in its 2012-16 Eleventh National Economic and Social Development Plan (NESDP) before it can achieve its vision of becoming an economy that is balanced, stable and sustainable. Although the country has carried out some reforms in the two years since the plan was initiated, it needs to do more – specifically to upgrade educational quality, strengthen the agriculture sector, and restructure the economy with an emphasis on green growth.

In education, there needs to be a co-ordinated effort to elevate the quality of learning and teaching if outcomes are to be improved. As for agriculture, meeting the challenge of greater productivity and income and employment security requires further efforts to modernise and to educate farmers in the use of technology. As regards green growth, Thailand can make its national strategy more effective by strengthening institutional co-ordination and raising levels of public awareness of the benefits of a green lifestyle.

Thailand's medium-term policy challenges and responses

- Upgrade human capital by improving the national curriculum and teaching standards
- Improve agricultural productivity through modernisation and education
- Improve institutional co-ordination to achieve green growth

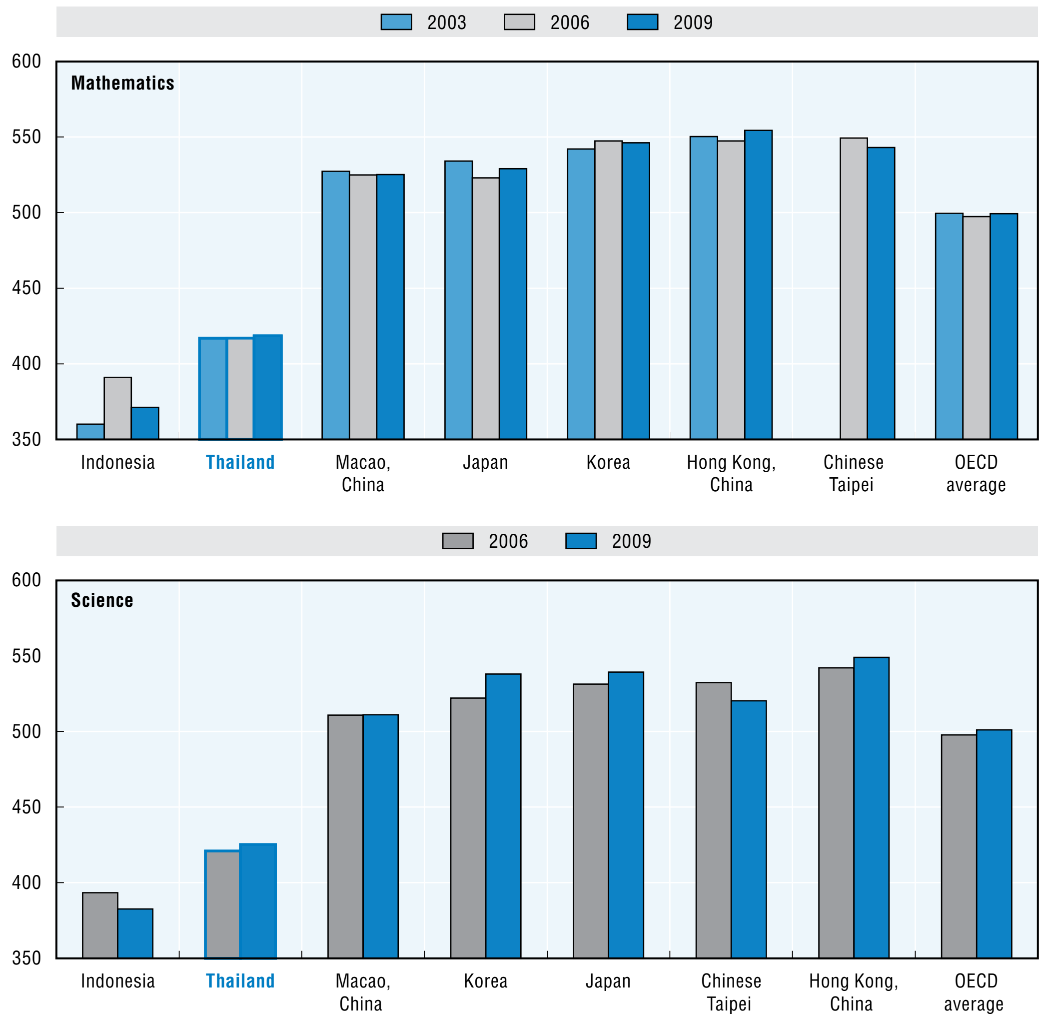
POLICY FOCUS

Upgrade human capital by improving the national curriculum and teaching standards

Thailand's educational system has seen a significant increase in access and enrolment levels at primary, secondary, and tertiary levels. Yet overall learning outcomes have remained stationary and even deteriorated over time – a trend reflected in Thai students' poor showings in national and international tests. In 2009, their scores in the mathematics and science tests of the Programme for International Student Assessment (PISA) were either similar or only marginally better than in previous assessments. Thailand lags behind other Asian countries, with the exception of Indonesia, and lies well below the OECD average in PISA performance levels (see Figure 2.9.1).

Figure 2.9.1. **PISA scores in mathematics and science in Thailand and other selected economies**

Mean 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.

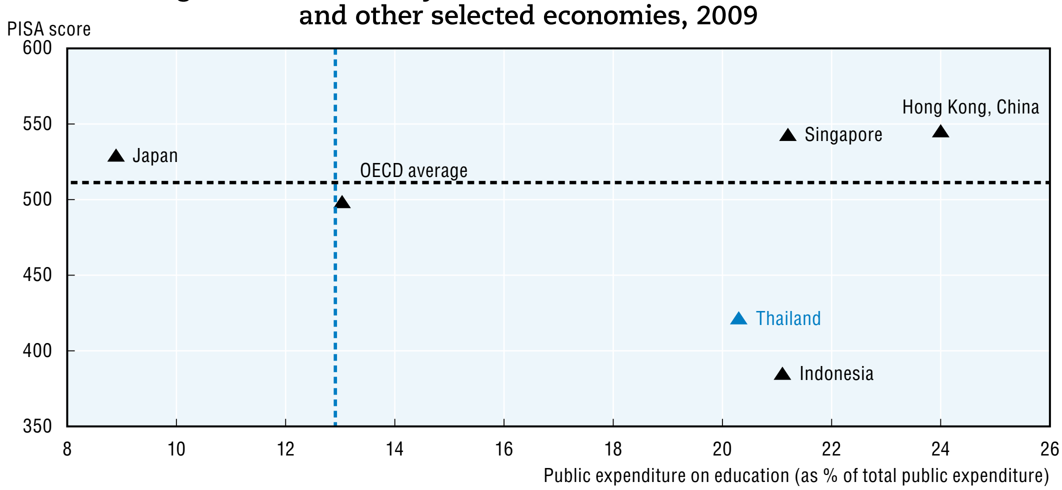
Source: OECD (2011b), *PISA 2009 Results: Learning Trends: Changes in Student Performance since 2000* (Volume 5), OECD Publishing, Paris.

StatLink http://dx.doi.org/10.1787/888932938422

The Thai educational paradox

Thailand's educational outcomes are relatively weak even though the percentage of the national budget devoted to education is consistently higher (20% in 2009) than in other countries that belong to the Association of Southeast Asian Nations (ASEAN). Indeed, some analysts speak of the "Thai educational paradox" (see Figure 2.9.2). The paradox shows that merely increasing financial resources cannot in itself raise standards of education, particularly when expenditure focuses on expanding education quantitatively – i.e. building infrastructure (Fry and Bi, 2013).

Figure 2.9.2. **Efficiency of the education sector in Thailand and other selected economies, 2009**



Source: OECD Pisa database and national sources.

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Revamp national curriculum and performance assessment system to raise academic standards

A closer look at Thailand's weak educational outcomes reveals an inward-looking curriculum that emphasises rote learning. The current national curriculum has been described as "hierarchical, top-down, with a systematic lack of critical thinking" that does not prepare students for work in the 21st century (Ahuja, 2011).

What is needed is a revamped curriculum that provides for project-based learning, teamwork and the use of information technology (IT) resources for e-learning purposes, while affording teachers some flexibility in the classroom. While current Prime Minister Yingluck Shinawatra's "one tablet per child" pledge is a step in the right direction of encouraging information and communication technology (ICT) in the classroom, it should be complemented with a change in curriculum that puts the focus of learning on student needs in the present global environment.

Changes to the curriculum should be supported by a performance assessment system that effectively measures students' academic abilities and is aligned with international standards. Thailand's existing system has often been described as lacking in credibility.

At present, students are assessed through two sets of standardised national tests administered by the National Institute of Educational Testing Services (NIETS): the Ordinary National Education Tests (O-Net) at grades 6 and 9, and the Advanced National Education Test (A-Net) at grade 12. Although passing O-Net and A-Net is a requirement for university admission, it is reported that average scores are inconsistent and have declined over time. Many educators and independent researchers have called for O-Net and A-Net to be replaced by standardised tests that take international standards of academic performance as their benchmarks. Such tests could further serve to hold teachers and schools accountable for their students' performance, especially if schools' average test scores were released publicly.

Improve teaching standards

Another decisive factor in educational outcomes is the standard of teaching. A large and growing body of research convincingly shows that the quality of teachers is the single most important schooling-related factor in student achievement (OECD, 2009c). In Thailand, improving the quality of teachers and learners and making the school management system more efficient were among the recommendations of the 2008 Commission on Second Decade of Educational Reform.

Consequently, teachers became the focus of educational reform under former Prime Minister Abhisit Vejjajiva's government, which sought to raise pay and respect for the profession. To that end, the government introduced two schemes:

In 2009 it approved a project known as "Khru Pan Mai" ("New Breed of Teachers"). The project sought to create 300 000 positions for a new breed of teachers who would have high qualifications, knowledge and versatility. They would replace retiring teachers and help raise the profile of the teaching profession.

In 2004 the government introduced a new salary scheme that not only doubled the minimum salary at each teaching level (with the exception of the first level), it also provided bonuses for teachers whose students achieved good results (Table 2.9.1). Consequently, teachers' pay – especially in the public sector – has increased over time (Figure 2.9.3).

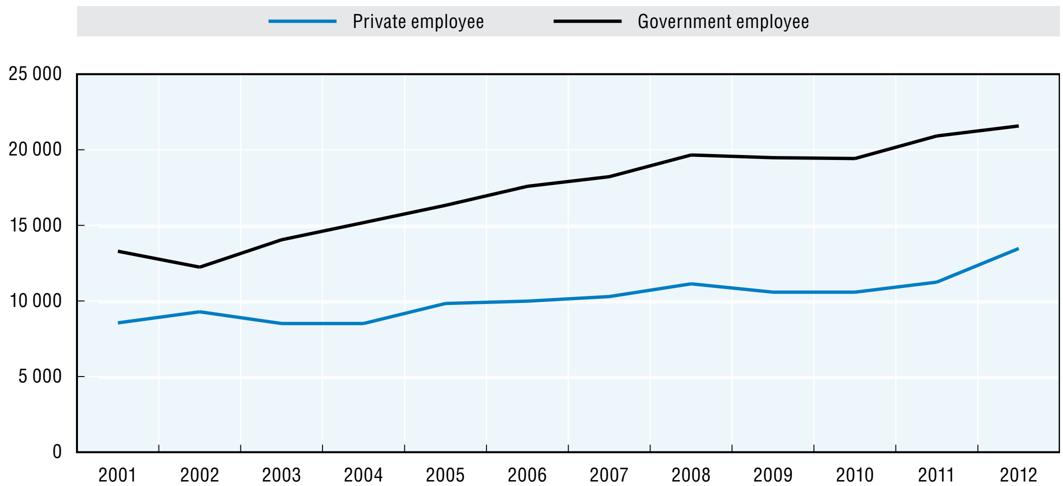
Table 2.9.1. **Comparison of old and new salary schemes in Thailand**

Old scheme (prior to 2004)		New scheme (2004)		
Level	**Salary (THB)**	**Level**	**Salary (THB)**	**Extra allowance**
Teacher 1	4 230 ~ 13 550 (USD 124 ~ 399)	Assistant teacher	8 360 (USD 246)	
Teacher 2	5 050 ~ 16 650 (USD 149 ~ 490)	Teacher	11 470 ~ 26 440 (USD 337 ~ 778)	
Instructor 1	6 210 ~ 20 340 (USD 183 ~ 598)	Experienced teacher	14 810 ~ 32 250 (USD 436 ~ 949)	3 500 (USD 103)
Instructor 2	9 320 ~ 25 180 (USD 274 ~ 741)	Highly experienced teacher	18 180 ~ 45 620 (USD 535 ~ 1 342)	5 600 (USD 165)
		Expert teacher	22 330 ~ 48 600 (USD 657 ~ 1 430)	9 900 (USD 291)
Instructor 3	11 340 ~ 43 440 (USD 334 ~ 1 278)	Specialised teacher	24 450 ~ 61 860 (USD 719 ~ 1 819)	13 000 (USD 382)

Source: Atagi (2011), *Secondary Teacher Policy Research in Asia: Secondary Teachers in Thailand*, UNESCO, Bangkok.

Figure 2.9.3. **Average monthly wage for an employee in Thailand, by sector of education (i.e. private and government), 2001-12**

In Thailand baht



Source: National Statistical Office, *Labour Force Survey* and CEIC.

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Merit-based incentives

Although teachers are now better renumerated, there remains room for improvement in using incentives to improve standards. Because the quality of teachers is so important to student learning outcomes, education systems are increasingly assessing teachers performance according to students achievement (OECD, 2009c). In this regard, Thailand should consider a merit-based incentive framework – one that ties teacher recruitment and promotion to students' educational outcomes.

The current incentive system places a greater premium on administrative duties than on student performance and does little to promote good teaching or teacher training. In addition, promotion is determined by how long a teacher has been in the profession, not by his or her students' performances. There could also be incentives for teachers willing to teach in rural areas and in such shortage subjects as science and mathematics. However, before a merit-based reward system can work, a framework for fair, systematic teacher appraisals across schools must be in place (see Box 2.9.1).

Better teacher training

Thailand's teacher-training programmes have been criticised for their poor quality. Teachers report such failings as courses that are too short, low-standard lectures, and the inapplicability of material taught (Atagi, 2011). Courses also fail to emphasise the transmission of new knowledge or innovative teaching strategies. To improve its current system, Thailand should offer a wide range of accredited teacher-training programmes to support teachers and educators in new learning strategies, assessment and evaluation, ICT competency and mentoring skills.

More rigorous teacher licensing

Further improvements are also called for in Thailand's teacher licensing system.[1] Currently, a licensed teacher may teach all subjects at all levels. A first step in the right direction could be to grant more specialised teacher licences, especially in subjects that require more technical ability, such as science and mathematics. In addition, when the system was first implemented, nearly all teachers were awarded their licences by meeting such minimum requirements as merely attending training programmes. A stringent, demanding evaluation of applicants' qualifications should be considered as the next step in reforming the system.

Educational reform should be supported by closer co-ordination across related agencies

Finally, as reforms for teacher appraisal, student assessment, and school evaluation cut across several education agencies, such agencies should discuss and agree on any existing policy changes before implementing them. At present, the Teachers Council of Thailand, the Office of National Education Standards and Quality Assessment (ONESQA), NIETS, and other related education agencies act independently of one another. A centralised agency tasked with monitoring, evaluating and accounting for reform could strengthen overall improvements to educational quality.

Box 2.9.1. **Examples of incentives to enhance teacher performance in OECD countries**

Many countries have initiated incentive systems that will attract and retain highly effective teachers in schools. On the other hand, there is also evidence that incentives can improve the quality of teaching among incumbent teaching personnel. Educational sectors in various OECD countries show that incentive programmes generally take two forms – financial and non-financial – and rewards may be individual or collective. Many countries use a combination of both programmes. For financial incentives, the critical issue is to determine the appropriate mix of payments that will attract and retain teachers while also encouraging them to improve their knowledge and skills.

Knowledge and skills-based incentives. Teachers are required to demonstrate their skills either through external examinations or teacher evaluations based on a school-system-selected model of teacher effectiveness. Such programmes focus on the continuing improvement of teacher competencies that are likely to lead to improved student outcomes. In some states in **Germany**, teachers are able to climb the salary levels faster if their performance evaluations are good. In some regions of **Switzerland**, teachers must successfully complete self-evaluations and external assessments before they can move up to the next pay scale.

Incentives for hard-to-staff schools. These schemes create an opportunity to staff schools in remote areas or which serve students in disadvantaged neighbourhoods. In **Australia**, the Queensland Remote Area Incentive Scheme provides teachers with cash awards of up to AUD 5 000 (Australian dollars) to cover the cost of transport from the remote areas where they work to metropolitan areas for shopping or visiting relatives. The awards come on top of retention stipends, also of up to AUD 5 000 per year.

Box 2.9.1 (contd.)

Incentives for shortage subjects. Such incentives usually take the form of additional compensation for teaching certain subjects, such as mathematics, science, technology, foreign languages and special education. In the **UK**, the Shortage Subject Support Scheme provides up to GBP 5 000 (British pounds) for students studying a secondary subject that is identified nationally as a shortage subject. Loan forgiveness programmes for teachers of mathematics, science, special education and technology offer up to GBP 16 000 in teacher training tuition expenses over ten years of teaching.

Pay-for-performance incentives. These include incentives based on a school's performance and improvements in test scores and on its attendance and drop-out rates. They may also target individual teachers' performances and improvements in their test scores. For instance, schools in **Brazil** are rewarded for meeting and exceeding targets for teacher attendance and retention and for student achievement, enrolment, graduation, and low drop-out rates. Teachers in schools that meet all their targets receive up to three months' additional salary, with pay proportional to their school's level of achievement.

However, these kinds of incentive schemes are often deemed controversial. Not only may there be great differences in the effectiveness of teachers, but such schemes may actually create disincentives in schools with low-achieving students.

Non-financial incentives. They usually take the form of recognition and prestige, job stability and favourable working conditions with adequate support and resources.

Source: OECD (2009c), *Evaluating and Rewarding the Quality of Teachers: International Practices*, OECD Publishing, Paris. http://dx.doi.org/ 10.1787/9789264034358-en

POLICY FOCUS

Improve agricultural productivity through modernisation and education

Agriculture, which employs 35% of the workforce, is a key sector of the Thai economy. Even though its contribution to GDP has declined to 12% over time, it is still one of the world's top exporters of commodity crops such as rice, sugar cane and rubber.[2] It exported 20% (in value) of its rice exports to Asian countries in 2012. In recent decades, Thai agriculture has shifted towards higher-value crops with increased mechanisation in order to remain competitive and raise farmers' incomes.

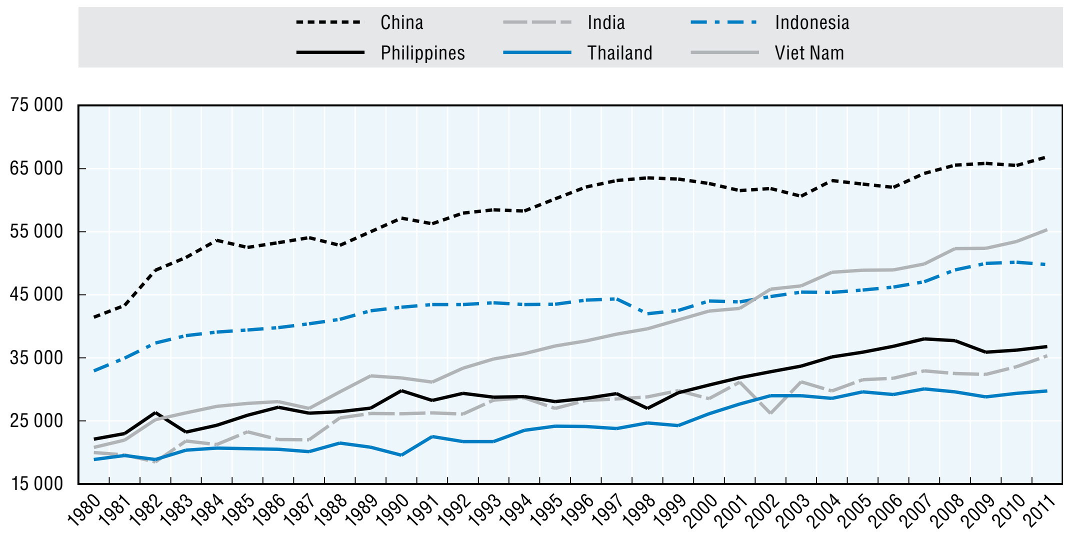
Despite reform, productivity is still relatively low and there is a shortage of farmers

In spite of increased mechanisation and industrialisation, Thailand continues to lag behind its Asian neighbours in agricultural productivity. Rice yields, for example, have been lacklustre by regional standards even though they have increased modestly over time (see Figure 2.9.4).

Forssell (2009) reasons that lower productivity is due to the production of low-yield, higher-quality rice and a low percentage of irrigated farming areas that leaves farmers unable to diversify into more profitable crops. Some analysts also believe it is the result of the widely scattered ownership of land that prevents small farmers from benefitting from economies of scale. Further contributory factors include the limited use of technology, inadequate research into and development of better farming methods, and the slow transfer and take-up of new knowledge and technologies among local farmers.

Figure 2.9.4. **Rice yield in Thailand and other Asian countries, 1980-2011**

Hectogram per hectare



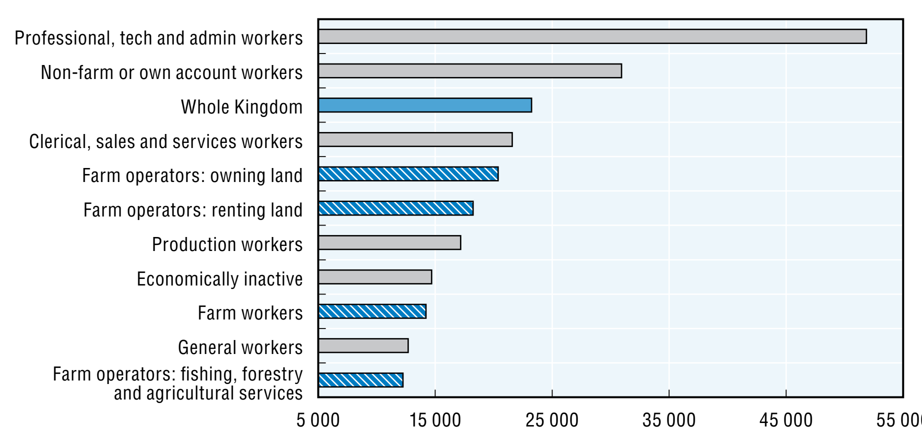
Source: FAOSTAT.

StatLink http://dx.doi.org/10.1787/888932938479

In addition, the Thai agricultural sector is experiencing a labour shortage as farmers move into the better-paid manufacturing and services sectors and those who remain get older. Incomes are below the national average and below those of professional, technical, and administrative workers (Figure 2.9.5). According to government statistics, the average age of farmers jumped from 31 years old in 1985 to 42 in 2010. Only 12% were under 25, compared to 34% in 1985.

Figure 2.9.5. **Average monthly household income in Thailand, by type of occupation, 2011**

In Thailand baht



Source: National Statistical Office, *Household Socio-Economic Survey* and CEIC.

StatLink http://dx.doi.org/10.1787/888932938498

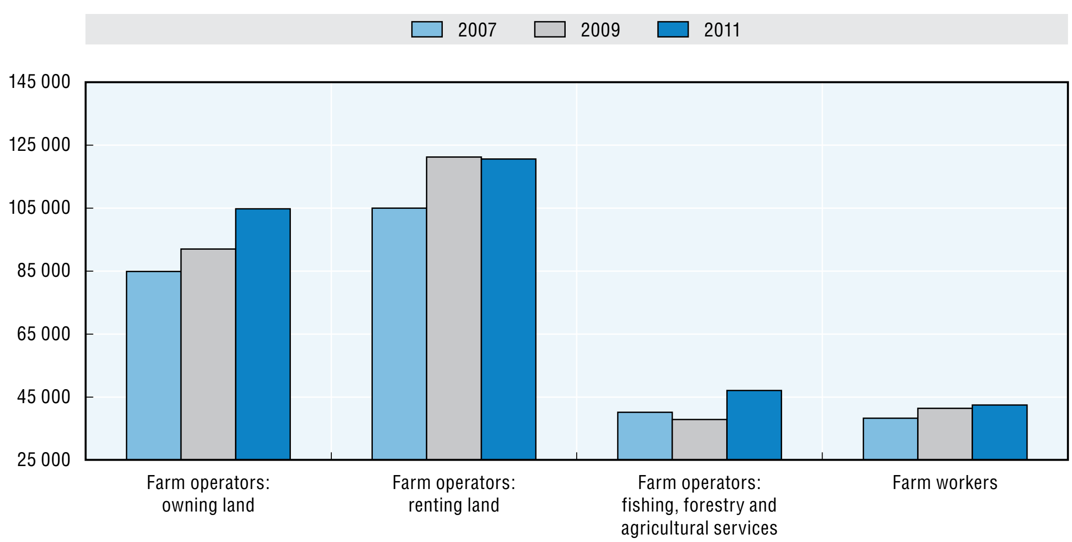
Contract farming, agribusiness development and farm subsidies bring farmers income security

Since the 1980s, the government has encouraged contract farming as a way of providing farmers with a stable income.[3] To make Thailand the "kitchen of the world", farmers, contract companies and agri-industrial firms have worked with financial institutions like the Bank for Agriculture and Agricultural Cooperatives (BAAC) to produce processed food such as canned fish, tomato products, and poultry – primarily for export markets. Contract farming has allowed small farmers to become part of the global food chain, bringing them a degree of market certainty, price stability, access to technical knowledge in farming methods and ease of access to loans.

Nevertheless, small-scale farmers are seldom able to negotiate fair contracts with large agri-businesses. Nor do they have any control over production methods, and many have had to bear the costs of initial investment and expensive machinery and equipment. Farmers also have to contend with the risk of natural disasters and crop failures (Delforge, 2007). As a result, they are increasingly indebted, with smallholders owing an average of THB 105 000 (Thailand baht) in 2011 – equivalent to five months of their average monthly income (see Figure 2.9.6).

Figure 2.9.6. **Average household debt in the farming industry in Thailand, by type of occupation, 2007-11**

In Thailand baht



Source: National Statistical Office, *Household Socio-Economic Survey* and CEIC.

StatLink http://dx.doi.org/10.1787/888932938517

With the rise of contract farming in Thailand, there is a need for a dispute settlement mechanism to ensure the fairness of contracts and so improve working relationships between farmers and contract companies or agri-businesses. The Senate Committee on Agriculture and Co-operatives identified the lack of such an agency as a problem in 2003. But efforts to put one in place have not borne fruit.

In the agriculture sector as a whole, some progress has been made towards improving farmers' welfare and social protection. In 2011, the Department of Rice in the Ministry of Agriculture and Co-operatives set up the Farmers' Welfare Fund to provide old age pensions and disability compensation.[4] With the dynamics of the Fund now in place, it should be easier to extend welfare coverage to crop insurance for farmers affected by natural disasters and health insurance for those whose health has been damaged by pesticide poisoning.

In addition to the Farmers' Welfare Fund, the government has put in place price intervention programmes for rice, cassava, red onion, garlic, pineapple and rubber. The programmes serve as income insurance for farmers. The rice price guarantee scheme, for instance, pays local farmers at rates that are higher than market prices for unlimited output, with the taxpayer and exporters footing the bill.[5] Since the inception of the schemes, farmers have reported a doubling of their monthly incomes.

Although subsidies have benefitted local farmers, they are not necessarily the right way forward. Experience from OECD countries indicate that, while price policies are a convenient lever for the government in the short term, they address income concerns inefficiently and often prove to be fiscally unsustainable (OECD, 2012f).

At a time when rice production from countries such as China and India has increased, there are concerns that the farm subsidy scheme has made Thai rice uncompetitive in the global market, giving rise to anti-dumping fears over the government's large rice stockpiles and farmers' lack of incentive to improve their productivity. Rather than using the added income to improve their productivity, farmers have reportedly spent it on fertilisers to increase rice production.

The government needs to decide whether to pursue its intervention scheme by weighing its costs and benefits against the pros and cons of a policy that tackles the underlying causes of poor productivity and low farmers' incomes.

Focus on further modernisation and education focus to raise productivity and farmers' incomes

Instead of using price and market interventions, policy makers should encourage rural incomes to grow through productivity gains. Their efforts to that end could include increased mechanisation, the use of new technologies in farming methods, and the transfer of the resulting knowledge and experience to agricultural communities. It is precisely in that direction that Thailand has gone with its moderately successful Smart Farm scheme.

Launched in 2008, Smart Farm was intended to boost agricultural sector productivity by applying knowledge and technology to conventional farming methods – first at farm level and, subsequently, across agricultural supply chains and logistics. State agencies under the aegis of the National Science and Technology Development Agency worked with the private sector to introduce farmers to equipment such as sensors to evaluate soil acidity, fertiliser mixing machines, sugar cane water management tools, and shrimp farm monitors.

However, the main challenge in using ICT to improve farming efficiency is insufficient investment in such technology on a nationwide level – Thailand's existing broadband network reaches only 33% of its total population (Pornwasin, 2012). To that should be added the difficult tasks of convincing farmers to use ICT in their farming methods, educating them to that end, and addressing the inadequate capacity of qualified IT support personnel. For the successful implementation of Smart Farm projects, extending Internet coverage to rural farms should be complemented by the training and recruitment of qualified IT professionals.

In the meantime, farmers' communities could be organised to share best practices in and understanding of technology utilisation, yield management, harvesting techniques, and disease and disaster management. Thailand has established community rice centres to share ICT knowledge and know-how, with more capable farmers teaching and counselling others (Sangbuapuan, 2012).

POLICY FOCUS

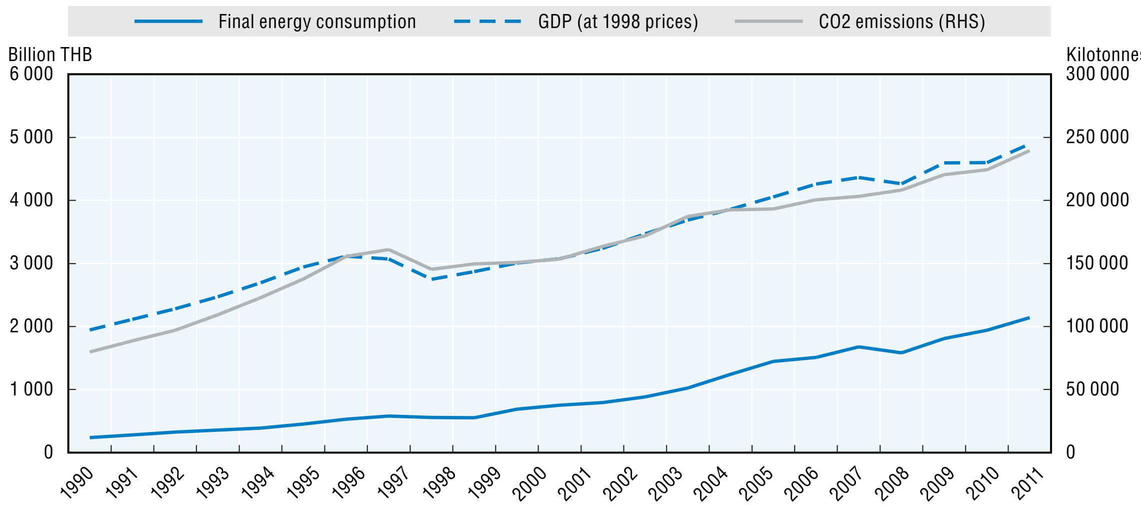
Improve institutional co-ordination to achieve green growth

Many Asian countries have become more mindful of green growth development strategies to address the issues of climate change, the depletion of natural resources, and energy security. Thailand is no exception, with the government making the goal of green growth in a low-carbon society a central theme in its 11th NESDP. Since then, its efforts have been supported by both national and sector-specific local policies to promote a clean, green economy that does not preclude growth.

Economic growth increases resource consumption and environmental pollution

The Thai government's recent commitment to the green growth imperative was prompted by concerns over the country's energy use – particularly as it has not decoupled economic growth from its consumption of raw material resources and the resulting greenhouse gas emissions (Figure 2.9.7). Indeed, even during the 2009 global financial crisis, growth and energy consumption continued to be closely coupled. Greenhouse gas emissions in Thailand ranked 20th in the world and 5th in East Asia, according to the World Bank in 2011. Thailand was also the third most energy-intensive ASEAN economy after Brunei and Singapore in 2010, as Figure 2.9.8 shows, which suggests that it has a great deal of room for energy efficiency improvement.

Figure 2.9.7. **Final energy consumption, GDP (at 1998 prices) and CO_2 emissions in Thailand, 1990-2012**



Source: National Economic and Social Development Board (NESDB), Bank of Thailand (BOT), Energy Policy and Planning Office, Ministry of Energy (EPPO); and Department of Alternative Energy Development and Efficiency, Ministry of Energy (DEDE).

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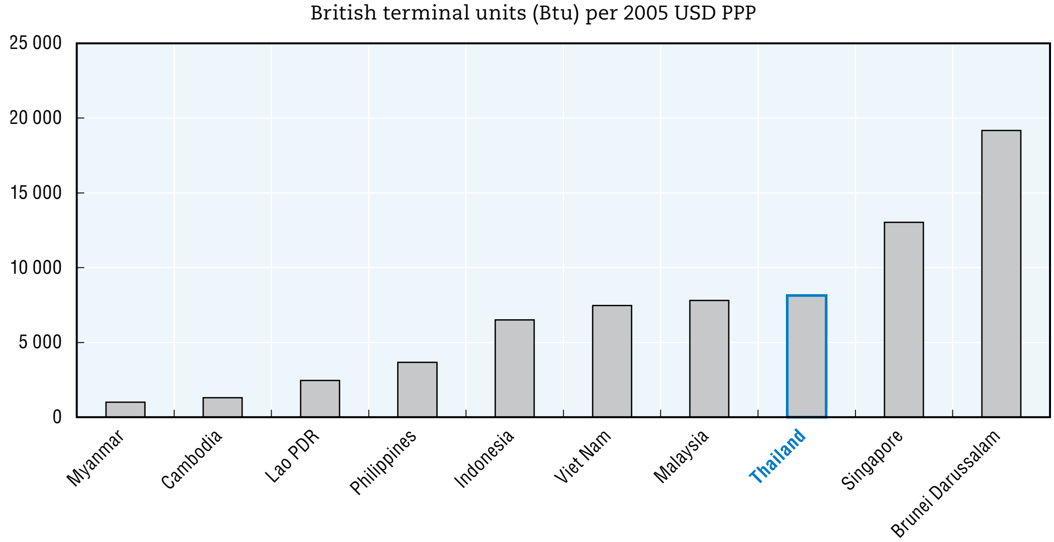
Figure 2.9.8. **Energy intensity in Thailand and other Southeast Asian countries, 2010**

British terminal units (Btu) per 2005 USD PPP



Note: Energy intensity is defined as total primary energy consumption in British terminal units (Btu) per 2005 USD PPP.

Source: U.S. Energy Information Administration (EIA).

StatLink http://dx.doi.org/10.1787/888932938555

Government departments take action as Thailand rolls out its green economy policy

The Thai government has now set a number of national targets in order to improve environmental quality and reduce greenhouse gas emissions (Table 2.9.2).

Table 2.9.2. **Climate change mitigation targets for Thailand**

	Emissions	Energy efficiency	Renewable energy	Deforestation
National plan	Energy Efficiency Development Plan (2011-2030)		Renewable and Alternative Energy Development Plan (2012-2021)	-
National targets	Reduction of 30% energy emissions below BAU* by 2020 (base year 2005)	Reduction of 15% energy intensity by 2020, 25% by 2030 (base year 2005)	20% of final energy demand from renewable energy by 2021	Forest cover to be 40% of total land mass by 2020 (target introduced in 1991, level is 37% in 2010, up from 25% in 1998)

Note: *BAU refers to business-as-usual.

Source: ADB and ADB Institute (2012), *Study on Climate Change and Green Asia: Policies and Practices for Low-Carbon Green Growth in Asia: HIGHLIGHTS,* Asian Development Bank Institute, Philippines; Department of Alternative Energy Development and Efficiency, Ministry of Energy.

In addition, multiple ministries and agencies have developed their own environmental policies and action plans for the sectors for which they have responsibility. For businesses and SMEs, there is a range of government assistance programmes in the areas of certification, loans, tax and non-tax incentives to coax companies into producing eco-friendly materials and reducing their environmental impacts (Table 2.9.3). To improve environmental quality on an industrial level, five eco-industrial estates have been built to help companies operating there reduce their environmental footprint and energy consumption.

Table 2.9.3. **Green growth initiatives enacted for companies operating in Thailand, by ministry**

Agency-in-charge	Initiatives and areas targeted
Ministry of Industry	Green Industry Initiative to promote green production in 30 industries
	Training courses for industries, businesses and SMEs on green curriculum
National Science and Technology Development Agency	The Company Directed Technology Development Programme (CD)
	Industrial Technology Assistance Programme (iTAP)
Board of Investment	Special tax and non-tax (e.g. import duty exemption) privileges to enterprises related to energy conservation, renewable energy and production of environmentally friendly products
Department of Alternative Energy Development and Efficiency	Feed-in tariffs e.g. the Adder programme for small power producers and very small power producers
	Training courses aimed to promote green skills (with the Bureau of Energy Human Resource Development)
Ministry of Tourism and Sports	Green Leaf Programme certifies hotels according to the level of energy efficiency (Board of Environmental Promotion of Tourism Activities)
	Training courses on eco-tourism
Ministry of Energy	Investment grants for design, consultant and partial investment to support renewable energy (biogas, municipal waste and solar hot water) projects
Thai financial institutions	Green Loans to support environmentally-friendly projects
	ENCON Fund - ESCO Fund and the Energy Efficiency Revolving Fund to provide financial support for energy conservation-related activities
Federation of Thai Industries	Training courses on clean technology, application of value engineering approach in energy conservation and environmental standards

Source: OECD Development Centre compilation from various sources.

Effective institutional co-ordination a prerequisite for successful green growth

The key to the successful implementation of green growth and energy conservation measures in any country is effective institutional co-ordination across the key sectors and between central and local government (World Bank and NESDB, 2011).

In Thailand, despite efforts by public and private sector agencies to push for environmental reform, researchers and policy experts state that there is a lack of focus, enforcement, and policy co-ordination at national, local, and sectoral levels. The challenge for policy makers is to implement green growth strategies in a more integrated manner across those different levels. One way could be through a green-growth inter-ministerial committee with the mandate, authority, and resources required to lead efforts across sectors and regions. Singapore, for instance, set up an inter-ministerial committee on sustainable development in 2008 to formulate a clear national framework and strategy with goals and targets for the next 10 to 20 years. Co-chaired by the Minister for National Development and the Minister for the Environment and Water Resources, its members include ministers from relevant government departments.

Besides effective institutional co-ordination across public agencies, the successful implementation of a green growth policy also requires the participation and awareness of the general public and, as a consequence, a shift towards greener consumption practices. The Thai government's approach to environmental and green policies is generally top-down, with little participation from local communities. The general public therefore tends to be unaware of the benefits of such policies or the costs of environmental degradation and is not supportive of green policy efforts. It is clear, then, that the Thai government should include public consultation and feedback in the formulation of future green growth strategies. Korea actively promotes a green, low-carbon lifestyle by offering incentives, supplying practical information, and including the environment in its educational curriculum at elementary and secondary school levels (Sang In, Jin-gyu and Hongseok, 2012).

Notes

1. The teacher licensing system was established in 2003 after the passing of the Teachers and Education Personnel Council Act. Applicants and teachers have to adhere to the Education Performance Standards – for professional knowledge and experience, performance and conduct – before they can apply or renew their existing licenses. Attending approved training programmes is a major factor for renewal for teachers, but the current process involves self-reporting paper work only (Atagi, 2011).
2. 2012 data.
3. According to the Food and Agriculture Organization of the United Nations (FAO), "contract farming can be defined as an agreement between farmers and processing and/or marketing firms for the production and supply of agricultural products under forward agreements, frequently at predetermined prices. The arrangement also invariably involves the purchaser in providing a degree of production support through, for example, the supply of inputs and the provision of technical advice".
4. Members of the Fund will reportedly contribute to it, with their contributions being matched by the Thai government. The government will offer an endowment of at least 150% of members' contributions, with a committee chaired by the Permanent Secretary for Agriculture setting out benefits and membership criteria.
5. The rice subsidy policy was first introduced in 2001. It functioned as a mortgage programme in which farmers were able to get a fixed minimum price for their rice, which was slightly higher than the market rate. It was reintroduced in 2008 under the Samak government (Forssell, 2009). Current Prime Minister Yingluck Shinawatra continued the programme in 2011 as a way of winning the support of farmers. His government pledged to buy unlimited quantities of rice from farmers at a 40-50% premium over the market price. The government has spent THB 300 billion on the scheme and will channel in an additional THB 100 billion by the end of 2013. It is conducting a similar pledging programme for rubber following protests against falling global rubber prices.

Viet Nam

A. Medium-term economic outlook (Forecast, 2014-18 average)

GDP growth (percentage change):	5.4
Current account balance (% of GDP):	4.5
Fiscal balance:	-3.9

B. Medium-term plan

Period: 2011-20

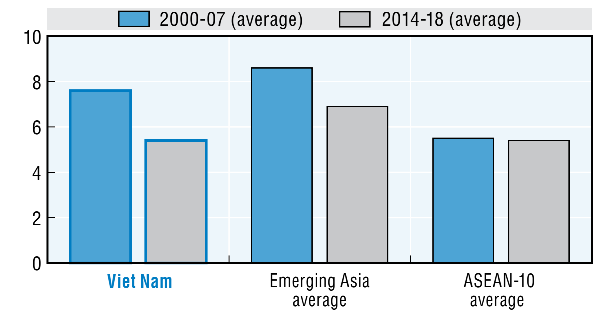
Theme: A modern, industrialised country by 2020

C. Basic data (in 2012)

Total population:	90 million*
GDP per capita at PPP:	3 547 (current USD)**

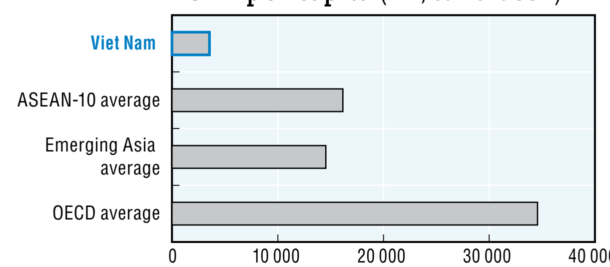
Note: * Total population data for 2012 are estimates.
** IMF estimate
Sources: OECD Development Centre, national sources and IMF.

GDP growth rates (Percentage change)



Source: OECD Development Centre, MPF-2014.

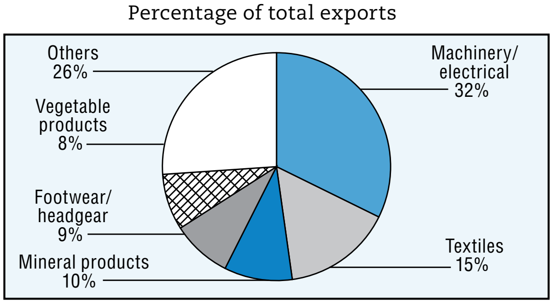
GDP per capita (PPP, current USD)



Source: IMF and national sources.

Composition of exports, 2012

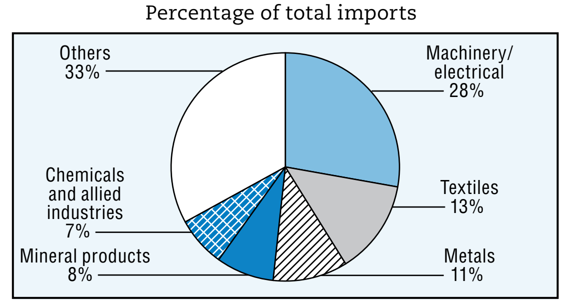
Percentage of total exports



Source: Trademap.

Composition of imports, 2012

Percentage of total imports



Source: Trademap.

Since Viet Nam initiated its *Doi Moi* Policy of economic reform in 1986, it has successfully modernised its economy and produced impressive growth and poverty reduction. However, economic growth has slowed in the last five years.

Continuing economic development requires new skills and labour structure. Viet Nam urgently needs to improve schooling and technical and vocational education and training (TVET) if it is to rectify the mismatch between skills supply and demand.

Viet Nam's private sector is crucial to its economic growth. Non-state enterprises (NSEs) account for more than 50% of gross domestic product (GDP) and create 60% of all new jobs. Yet they do not compete on an equal footing with state-owned enterprises. Viet Nam needs to foster an equitable, stable business environment, reduce transportation costs for NSEs, and afford them equal access to credit. Only then will it be able to harness NSEs' valuable, growing economic input.

Viet Nam needs to revisit its monetary policy. The country's priority today is to ensure macroeconomic stability and its monetary policy needs to meet that priority effectively. In the medium and long term Viet Nam should build a framework within which monetary policy is geared to controlling inflation and macroeconomic fluctuations.

Viet Nam's medium-term policy challenges and responses

- Increase access to education and strengthen TVET to improve the quality of human capital
- Ease access to credit and lower transport costs to develop the private sector
- Restructure the financial system to enhance the effectiveness of monetary policy

POLICY FOCUS

Increase access to education and strengthen TVET to improve the quality of human capital

Although Viet Nam enjoys relatively favourable population structure in which the working age population is nearly double the dependent population, labour productivity is low. According to the Asian Productivity Organisation (APO, 2012), Viet Nam's labour productivity in 2010 was 23.3% of Malaysia's and 37% of Thailand's. Not only does it lag behind its regional neighbours, its annual productivity growth rate fell from 5% during the period 2002-06 to 3.4% in 2007-11 according to the Ministry of Planning and Development.

Weak labour productivity and labour market outcomes are often attributed to inadequate human capital or workers having limited training opportunities to enhance their skills and productivity. It is a challenge to which Viet Nam must rise in its efforts to become more competitive in the global economy. It has therefore made education and training a priority area for development intervention.

Improve access to education

Successful economic reform in Viet Nam during the period 1990-2012 resulted in an impressive human capital development performance. Life expectancy rose by nearly ten years; the average number of years spent in schooling by people aged 25 and older lengthened by 1.5 years; gross national income (GNI) in constant USD 2005 purchasing power parity (PPP) increased more than 3.5 times; and Viet Nam's human development index (HDI) value increased 40.55%, the highest rise within ASEAN-5 (Indonesia, Malaysia, the Philippines, Thailand and Viet Nam).

Despite its dramatic improvement Viet Nam's HDI value is still very low. In 2012, Viet Nam ranked 127th out of 187 countries. It was in fact the last of the ASEAN-5 countries (Table 2.10.1), although Inequality Adjusted HDI (IHDI)[1] puts it above Indonesia and the Philippines. The inference is that, while Viet Nam's potential HDI is the lowest within ASEAN-5, its actual human development is better than some within the group.

Table 2.10.1. **Human Development Index in Viet Nam and other Southeast Asian countries, 2012**

	Human Development Index (HDI)	Inequality adjusted HDI	Life expectancy at birth (years)	Expected years of schooling	Mean years of schooling	Growth HDI 1990-2012 (%)	Rank out of 187 countries
Indonesia	0.63	0.51	69.8	12.9	5.8	31.32	121
Thailand	0.69	0.54	74.3	12.3	6.6	21.27	103
Philippines	0.65	0.52	69.0	11.7	8.9	12.56	114
Malaysia	0.77	n.a.	74.5	12.6	9.5	21.10	64
Viet Nam	0.62	0.53	75.4	11.9	5.5	40.55	127

Note: Expected years of schooling for children of school-entrance age, which is the total number of years of schooling a child of school-entrance age can expect to receive if prevailing patterns of age-specific enrolment rates stay the same throughout the child's life.

Source: UNDP (2013), *Human Development Report 2013 – The Rise of the South: Human Progress in a Diverse World*, United Nations Development Programme, New York, http://hdr.undp.org/en/reports/global/hdr2013/.

Significantly, average schooling in Viet Nam – as measured by mean years of schooling (MYS) – is the lowest in ASEAN-5 and school enrolment rates over the last three years have remained almost unchanged. As a consequence, the gap between its MYS and those of the other ASEAN-5 countries has widened and there has been no improvement in the country's expected years of schooling (EYS).[2]

In order to improve access to education, Viet Nam is implementing a four-pronged strategy:

1. expand schooling and training systems by concentrating on infrastructure and teachers to cover all education needs;
2. improve the standard of schooling and training to help more young people into higher education;
3. subsidise education in remote areas and for the disadvantaged (the poor, the disabled, ethnic minorities, etc.);
4. widen distance education to all areas of the country.

The plan is that by 2020 the enrolment rate should be 99% in primary schools, 95% at lower secondary level, 80% in higher secondary schools, and that 70% of disabled children should be schooled.

More vocational education and training to enhance labour force quality

The structure of the labour market in Viet Nam changed rapidly after its accession to the World Trade Organization (WTO) in 2007. For example, the proportion of unskilled jobs – described as "elementary occupations" in Table 2.10.2 – dropped sharply from 61.7% in 2007 to 39.98% in 2012. While demand for unskilled labour has declined quickly, it has risen for all other kinds of occupations. The numbers of workers with basic and medium skills ("service workers and shop and market sales workers"), skilled agricultural and fishery workers, and plant and machine operators and assemblers have grown at much faster rates than occupations that require higher skills.

Table 2.10.2. **Structure of labour market in Viet Nam, by type of occupation, 2007-12**

Percentage

	2007	2010	2011	2012
Legislators, senior officials and managers	0.60	0.90	1.10	1.05
Professionals	4.50	5.10	5.30	5.52
Technicians and associate professionals	2.90	3.70	3.60	3.48
Clerks	1.20	1.40	1.50	1.67
Service workers and shop and market sales workers	7.30	14.60	14.90	16.07
Skilled agricultural and fishery workers	5.70	15.50	13.90	12.74
Craft and related trade workers	12.50	12.60	12.10	11.96
Plant and machine operators and assemblers	3.30	7.10	7.00	7.27
Elementary occupations	61.70	39.10	40.40	39.98

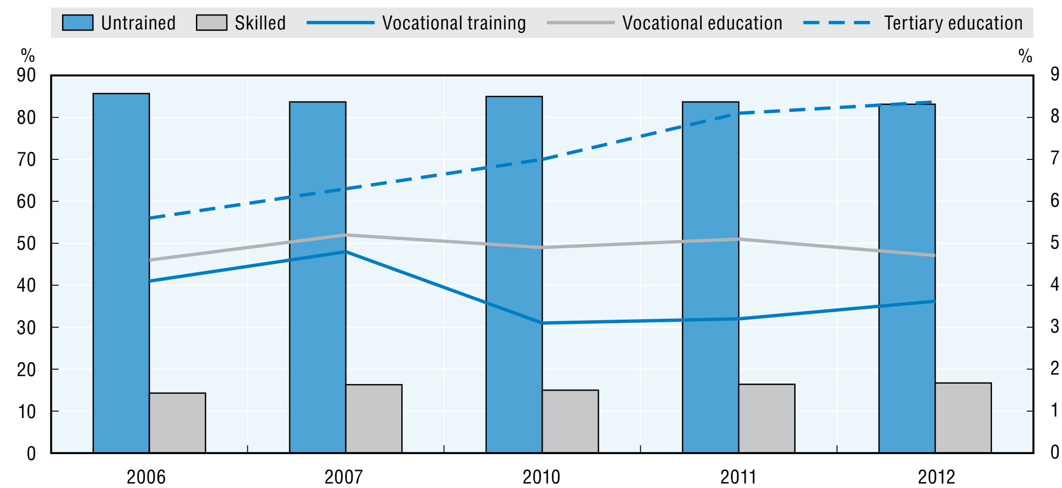
Source: GSO (2011, 2012, 2013), *Reports on the 2010, 2011, and 2012, Viet Nam Labour Force Surveys*, General Statistics Office of Viet Nam, Ministry of Planning and Investment, Hanoi.

However, the rapid change in demand for skilled labour is not being met by the market supply. During the 2007-12 period, the proportion of untrained workers hardly changed from 83.7% to 83.15% (Figure 2.10.1). The apparent contradiction with the change in the structure of occupation in Table 2.10.2 can be explained by the fact that a high proportion (30.7%) of unskilled workers are trained at work by employers themselves. The inference is that official education and training institutions have not been producing workers who meet the requirements of employers. In other words, they have had to recruit unskilled workers and then train them at work themselves.

However, employers can provide only training that builds simple skills, is short-term in nature, and can be carried out cheaply and on a large scale. They are not willing to provide training in complex skills that requires comprehensive syllabuses, costly facilities and customised learning situations. The reason for their reluctance is the high cost of such training and the risk of learners quitting their jobs on completion of training. The failure to supply medium-level skills by formal education and training institutions may be an obstacle to Viet Nam achieving its economic growth goals.

The unchanged numbers of workers completing vocational training courses[3] and graduating from vocational education[4] institutions also supports the argument set out above (Figure 2.10.1). The share of workers who have certified training qualifications has not increased since 2007. Fortunately, however, this trend is offset by the rise in the proportion of workers with tertiary education qualifications. They have steadily increased to fill the growing demand for professional workers, legislators, senior officials and managers, technicians, etc.

Figure 2.10.1. **Structure of labour force in Viet Nam, by skill, 2006-12**
Percentage of total labour force



Source: GSO (2011, 2012, 2013), *Reports on the 2010, 2011, and 2012, Viet Nam Labour Force Surveys*, General Statistics Office of Viet Nam, Ministry of Planning and Investment, Hanoi

StatLink http://dx.doi.org/10.1787/888932938574

The results of the Viet Nam STEP Employers Survey[5] – conducted in 2012 by Viet Nam's Central Institute for Economic Management (CIEM) with the support of the World Bank – point to mismatches between supply and demand of skills. Around 47% of firms claimed that the education system failed to meet the skill needs of the workplace. Of international firms, 66% stated there was a mismatch, while 36% of local firms made the same claim. The survey also reveals that well educated and highly trained workers and white-collar workers are more likely to think that their education is useful for their jobs. Indeed, a general finding is that the higher the level of education, the more relevant to the workplace it is seen to be. However, since more than 83% of workers in Viet Nam are still untrained, very few of them believe that education is useful.

To increase its TVET provision, the Vietnamese government has stepped up investment in public education and training institutions. It is also offering such generous incentives as low-cost land, credit subsidies, and tax holidays to encourage domestic and foreign private sector investment in TVET, while subsidising firms that provide inhouse training.

Increase and improve job-related and cognitive skills

Employers highly appreciate job-specific, problem-solving and leadership skills among white-collar workers. Such skills scored more than 2.5 out of 5 in the 2012 CIEM-World Bank STEP Survey. Nearly 87% of professional respondents stated that they had to interact with people from outside their company, 79% have to make presentations at work, and 72% have to supervise others. The figures for technicians are 84.6%, 66.7% and 53% respectively. Such abilities require high cognitive and inter-personal skills, a trend underlined by studies into the demand for managers, professionals, technicians and other skilled personnel in Viet Nam's labour market. Such a demand can only grow over time.

Theoretically, technical skills are imparted by TVET and higher education establishments or, in part, by on-the-job training. Cognitive abilities – such as leadership, problem-solving and communication – are acquired at primary and secondary education levels. To narrow the mismatch between skills supply and demand, Viet Nam needs to focus on improving TVET and higher education establishments and enhancing the teaching of cognitive abilities in secondary and primary schools.

TVET establishments have failed to meet the growing demand from employers for job-related skills. Viet Nam needs to raise their awareness and understanding of the skills the market requires. They need to work closely with firms to continuously update new skills and increase their capacity to meet demand. Similarly, it is important to help workers understand that skills pay off in order to persuade them to take up technical and vocational education and training.

Furthermore, to enable TVET education and training institutions to meet the fast-changing market demand for skills, they should enjoy greater freedom in determining syllabuses, recruiting personnel, and setting fees. The authorities should not interfere, but supervise quality and support learners with financial assistance.

In short, Viet Nam's successful policy reforms have effectively built human resources. However, the country started from a low base, and its human capital now urgently needs to be further upgraded and updated. Current education and training institutions and facilities fail to meet the requirements of the labour market and enterprises bear the burden of training workers. But relying on employers to train employees will not, in the long run, help Viet Nam to make the transition to a competitive, productive economy. It needs to comprehensively improve its education and vocational training system to rectify the mismatch between labour supply and demand and deliver the job-related and cognitive skills the market requires.

POLICY FOCUS

Ease access to credit and lower transport costs to develop the private sector

The private sector was officially acknowledged as an economic force in 1986 when, at its Sixth National Congress, the Communist Party of Viet Nam asserted: "[F]rom now on, [private capitalists] are allowed to use capital, technical and managerial knowledge for doing businesses in some industries."

Since then, legal frameworks and institutions have been put in place to enable the private sector to develop. In 1990, the Private Enterprises Law established a legal basis for sole proprietorships while the 1991 Company Law ushered in limited liability and joint-stock companies. However, private ownership – the fundamental prerequisite for a private sector to operate – was officially recognised and enshrined in the Constitution only in 1992 and not incorporated in the Civil Code until 1995. This tardy recognition echoes the trial and error approach of the *Doi Moi* economic reform policy. In other words, private ownership was recognised only once it had proved that it was necessary to the economy. However, even today the private sector still plays second fiddle to state-owned enterprises (SOEs) which have been assigned the lead role in the economic development of Viet Nam.

In parallel to its removal of trade barriers in the domestic market, Viet Nam has progressively opened up to the international market by signing bilateral and multilateral agreements that have helped NSEs[6] to develop rapidly. An important turning point came in late 2000 when the Enterprise Law significantly simplified business registration. In the same year, Viet Nam also signed a bilateral trade agreement with the United States, so securing its exports access to the world's largest market. These moves prompted a dramatic increase in the number of registered private enterprises in subsequent years.

In 2005, to prepare for WTO accession, Viet Nam substantially modified its legal framework to make it compliant with international rules and provisions. Of particular significance was the passing of the 2005 Enterprise Law which unified the previously fragmented and discriminatory legal framework that governed business. Up to 2005, the Law on Enterprise (1999) governed non-state enterprises, the Law on State-Owned Enterprises (2003) regulated SOEs, and the Law on Foreign Investment in Viet Nam (1996) governed the business of foreign-invested enterprises (FIEs).

To further support the private sector, Viet Nam has gradually developed its two-tier banking sector and monetary, capital, labour, land and services markets. It has also passed laws to regulate those markets and their institutions.

Steady increase in private sector's economic contribution

Improvements to the legal and institutional system have helped the private sector in Viet Nam to develop rapidly. From to 2000 to 2011, SOEs' contribution to GDP steadily shrank from 38.52% to 33.03%, while the private sector's steadily grew.

Private enterprises have demonstrated their entrepreneurship by rapidly growing in number. Since 2000, they have expanded nationwide, although they are concentrated in Ho Chi Minh City and Hanoi. In 2011 the number of NSEs doing business was nine times higher than in 2000. They account for over 61% of the total workforce in all types of enterprises – a share that has more than doubled since 2000. And they are playing an increasingly important role in accumulating capital: their share of the total capital of enterprises of all types rose from 35% in 2000 to more than 50% in 2011. In fact, they are growing in size and number faster than any other kind of firm. In 2007 there were only 103 among Viet Nam's 500 biggest enterprises (which include FIEs). By 2012 there were 225.

Changes in business structure beneficial to NSEs

The development of private businesses in Viet Nam is reflected in changes in types of enterprises. In their initial stages of development – between 1990 and 2000 – most NSEs were small or micro enterprises concentrated mainly in the southern part of the country and chiefly producing consumption goods such as food, garments, detergent and other staples. They were primarily family-owned and control stayed within the family. Indeed, relatives and personal acquaintances were their lenders as they were denied access to bank credit.

Modern structures, more attuned to modern business, have replaced the simple, traditional, and increasingly obsolescent ones. In 2002 "private enterprise"[7] was the most widespread structure and accounted for 39.41% of all registered companies. By 2011 only 14.3% of business entities were "private enterprises". In contrast, limited liability companies expanded sharply from 37.33% of firms to 57.22% by 2011. The growth of the joint stock structure was even more spectacular – from 4.5% to 20.1% over the same period. And with the rapid emergence of joint stock commercial banks, NSEs have gained greater access to loans and are more easily able to expand their business.

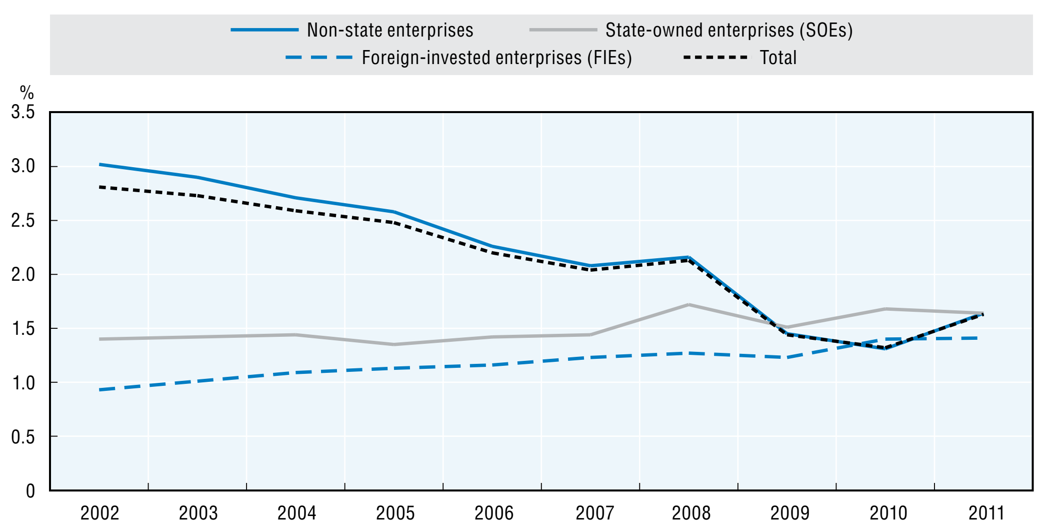
Non-state enterprises more capital-intensive than labour-intensive

As NSEs multiplied and grew between 2001 and 2011, they also became gradually more capital-intensive. By 2011 their average capital was over ten times higher than in 2000, while average workforce numbers had fallen by more than nine employees. Clearly, NSEs are gradually moving into more capital-intensive fields. The increasingly low volatility of capital supports this argument.

At the beginning of the new millennium, NSEs generally operated in labour-intensive fields, which made their capital volatility much higher than in SOEs and FIEs. As they got involved in projects that required more capital, their investment horizons grew longer and their capital volatility dropped. Recent data show that the volatility of capital in NSEs steadily converged towards the volatility levels of capital in SOEs and even FIEs (Figure 2.10.2). This suggests that NSEs are increasingly investing in long-term projects which are generally more capital- and technology-intensive.

Figure 2.10.2. **Capital volatility of enterprises in Viet Nam, 2002-11**

Ratio of total revenue to total capital



Source: OECD calcuation based on General Statistics Office of Viet Nam (GSO), *Enterprise Surveys*, 2001 to 2011.

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Access to credit has increased but still lags behind that of SOEs

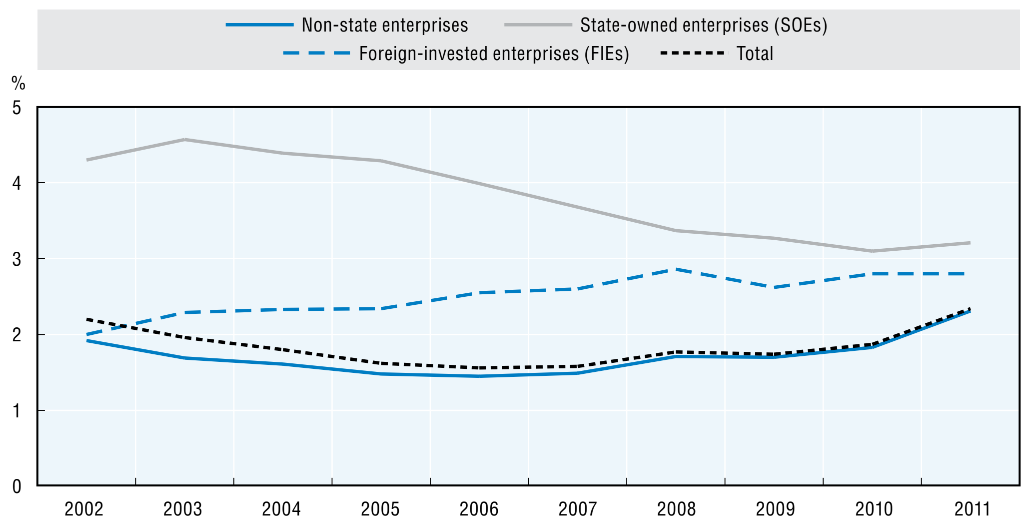
Credit accessibility may be measured by the debt index – a ratio of total debt over total owner's capital. The higher the ratio is, the better credit accessibility is. Figure 2.10.3 shows that SOEs' debt index, though gradually declining, remained much higher than NSEs and FIEs' indices from 2002 to 2011. Nevertheless, the tendency suggests that, while SOEs still enjoy easier access to loans than NSEs, their favoured status is gradually dwindling.

There are two clear trends in NSE debt indices: downward from 2002 to 2006 and steadily upward from 2006 to 2011. During the downward period, the banking sector was dominated by state-owned commercial banks which have long had a close relationship with SOEs. These banks tend to lend to familiar clients and are reluctant to grant loans to NSEs which are short on historical credibility.[8] NSEs survived on their own capital or on personal loans from relatives and friends.

From 2006, ahead of Viet Nam's WTO accession, it passed and amended numerous laws. From the new legislation joint stock commercial banks emerged. They supplied the missing channel of credit to the private sector and, as a result, the NSE debt index has risen steadily and businesses have expanded.

Figure 2.10.3. **Debt index of enterprises in Viet Nam, 2002-11**

Ratio of total debt to total capital



Source: OECD calculation based on General Statistics Office of Viet Nam (GSO), *Enterprise Surveys*, 2001 to 2011.

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NSEs an engine of growth, but persistent constraints are poor access to credit and high transaction costs

In 2012, the General Statistics Office (GSO) conducted a survey into business environment factors that impact negatively on company performance. It identified six factors:

1. high lending rates
2. high inflation with uncertain fluctuation
3. difficulty of access to credit
4. high cost of transportation
5. uncertain supply of electric power
6. unstable policies.

The government has made these concerns part of its economic policy and has gone some way towards mitigating them. Since early 2011, it has consistently applied policies to stabilise macroeconomic fluctuations. Indeed, stability has been its highest priority. Inflation has slowed and is under control and the exchange rate has been almost unchanged since March 2011. The trade balance and balance of payments have strongly improved with significant increases in foreign reserves,[9] while the lending rate fell from around 14% at the end of 2012 to 10.5% in July 2013.

The most problematic issues for NSEs, however, remain poor access to credit and transport costs. The high cost of transport is a result of Viet Nam's sorely inadequate transport infrastructure and fragmented logistics sector. It is an issue that can be addressed only by a long-term plan and will take time to improve.

Difficulty in accessing bank loans is a direct consequence of high non-performing loans in the banking sector. Although the advent of joint stock commercial banks has made it easier for NSEs to access credit, Viet Nam needs to take swift, radical action to ease this persistent strain on the private sector which plays such an increasingly crucial part in national economic development.

Private companies now contribute more than 50% of GDP and create over 60% of all new jobs. They are quite simply crucial to the economy. In last 11 years their number and their quality have development rapidly. Even though times are hard, there were twice as many NSEs in Viet Nam's 500 biggest enterprises in 2012 as in 2007 – figures that attest their vitality.

If Viet Nam maintains its efforts to stabilise the business environment and level the playing field so that NSEs can compete on equal terms, the could soon be playing the lead role in Viet Nam's economic development.

POLICY FOCUS

Restructure the financial system to enhance the effectiveness of monetary policy

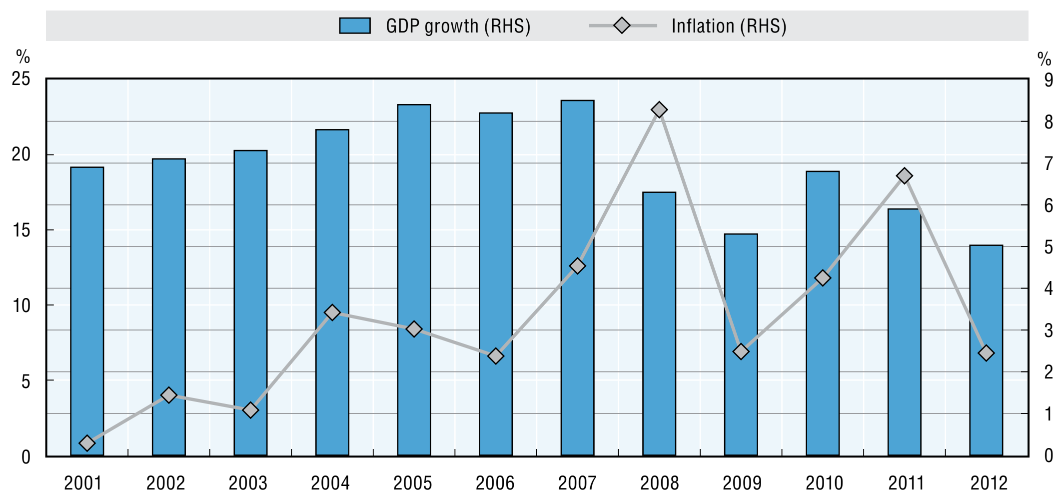
Monetary policy's broad mandate

Viet Nam's monetary policy seeks to facilitate fast growth, create jobs, reduce unemployment and improve living standards for all citizens. It also aims to control prices and inflation, stabilise the value of money, and ensure the sound development of the banking system and financial institutions. However, because monetary policy's mandate is so broad, it tends to be inconsistent over time and may contribute to macroeconomic instability.

Inflation control and economic growth

The Law on the State Bank of Viet Nam does not clearly define the prime objective of monetary policy. As one of the government's most important economic and financial management instruments, monetary policy targets both intermediate goals (the interest rate and exchange rates) and final objectives (the control of inflation and economic growth). As a consequence, there are times when the trade-off between inflation control and economic growth becomes a significant challenge. Indeed, since 2007 Viet Nam has had to contend with high inflation, the devaluation of the domestic currency, and the economic downturn. Recently, however, monetary policy management has actually improved and been relatively effective in controlling inflation and maintaining economic growth, although it still falls short of expectations. Figure 2.10.4 shows that the government did not pursue the objective of inflation control decisively enough.

Figure 2.10.4. **Inflation rate and GDP growth in Viet Nam, 2001-12**



Source: General Statistics Office of Viet Nam (GSO) and annual resolution of the National Assembly on socio-development.

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Developments in monetary policy in recent years

Viet Nam's monetary policy framework is not mature. From 2006 to 2011, the State Bank of Viet Nam (SBV) conducted monetary policy in a passive manner, keeping only loose control of the money supply as it had not caused high inflation. However, when headline inflation affected people's income, the SBV did an about-turn and tightened monetary policy. The result was macroeconomic instability (Table 2.10.3).

In early 2011, Viet Nam recognised that macroeconomic instability harmed the business environment, encouraged speculation in real estate and other non-productive sectors, and seriously discouraged long-term investments in the real economy. Macroeconomic indicators were bad and getting worse: soaring inflation, severe balance of payment and budget deficits, an escalating interest rate, dwindling foreign reserves, and bad loans piling up fast in the banks. In order to avert even worse damage, Viet Nam applied policies to tighten the money supply: it raised the lending rate to 18%, slashed public investment, and froze foreign exchange and gold markets.

The government has used these consistently and firmly since 2011 and they have helped to stabilise the economy. The most recent tightening of monetary policy reflected the government's determination to deal with high inflation. However, it also led to economic growth falling well short of official targets – 5.9% vs. 7.5% in 2011 and 5.03% vs. 6.5% in 2011 and 2012.

Table 2.10.3. **Overview of the developments of monetary policy in recent years in Viet Nam**

	Economic conditions	Monetary policy
2004-mid 2007	Mild inflation, high economic growth	Loosening monetary policy and expanding fiscal policy
	Officially entering WTO 2007, a large amount of foreign exchange flew in	Absorbing capital inflows without sterilising, hence boosting credits and money supply to record level
Mid 2007-mid 2008	High inflation	Open market operations (OMO) to withdraw money from circulation
	Sharply increasing interest rate	Interest rates (i.e. policy rate, rediscount rate and refinancing rate) adjusted upwards
	Increasing dollarisation	Implementation of a floating but controllable foreign exchange rate regime to prevent the appreciation of VND and restricting the fluctuation range of VND/USD exchange rate
	Slowing down economic growth	Selling compulsory SBV's promissory notes to commercial banks
		Consecutively increase required reserve ratio (RRR)
Second half of 2008-09	Global financial crisis and economic recession	Interest rates adjusted to create more favourable conditions for financial institutions to lower lending rate
	Easing pressure from inflation	Consecutively reducing RRR
	Capital started flowing out, FDI and capital inflow declining	Trading band of VND/USD exchange rate continuously expanded, and interbank exchange rate followed the upward trend.
	Economic growth slow down further	OMO and refinancing operations applied to control money supply in order to secure the payment system and stabilise monetary market
		Buying in SBV's compulsory promissory notes
		Subsidising 4% of interest rate on loans made in VND
First half 2010	High inflation and dollarisation	Tightening monetary policy to target of lowering inflation
Second half 2010	Easing pressure of inflation	Loosening monetary policy again
	Economic growth was under expectation	Credit and real money balance in second half increased almost twice the level in first half
2011	High inflation again	Interest rates (i.e. policy rate, rediscount rate and refinancing rate) adjusted upwards to help banks solve shortage of liquidity
	Sluggish economic growth	Overshooting devaluation to break circle of foreign exchange speculation
	Severe deficit in balance of payment and budget	Suppressing parallel foreign exchange market and gold market
	Escalating interest rate	Hard restriction on credit for real estate and stock investment
	High pressure for devaluation of foreign exchange	Tightening supervision on commercial banks' operations
	Exhausting foreign reserves	Setting ceiling for growth of credit and money supply for all banks
	Bad loans building up quickly in banking sector	Stabilising exchange rate
	Increasingly high inventory	
2012 to present	Inflation gradually declined to normal level	Keep on cautionary manner in managing monetary policy with highest priority of maintaining macroeconomic stability.
	Improved balance of payment and trade balance	Gradually removing ceiling on growth of credit
	Building up foreign reserves to more than 12 weeks	Consecutively cutting down interest rates (deposit rate, basic rate, refinancing rate, discount rate…) to level that is lower than those in good period of 2004-06.
	Declining interest rate	Conducting restructure of commercial banking sectors.
	Bad loans stopped increasing	Keep on stabilising exchange rate
	Sluggish growth of credit	
	Economic growth declined under expectation	
	Capital inflow has not improved yet	

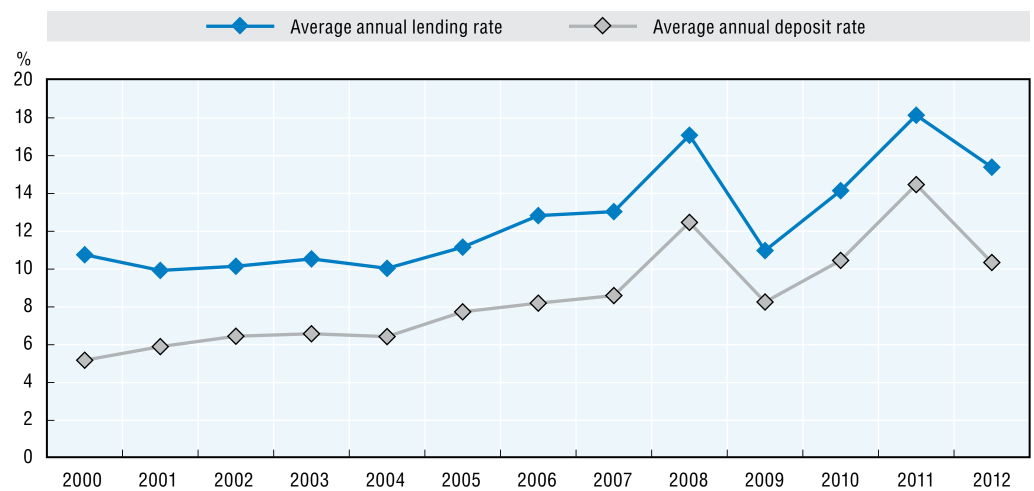
Source: Authors' compilation.

In summary, monetary policy has become gradually more effective and lends significant support to the attainment of targeted objectives. Policy implementation has gradually shifted to instruments such as the reserve requirement ratio (RRR), open market operations (OMOs), rediscount loans, refinancing, etc.

Credit restriction measures to avoid a real estate bubble

The SBV has intervened on policy interest rates (basic rate, rediscount rate, refinancing rate), and adjusted lending and deposit rates accordingly (Figure 2.10.5). Annual average deposit and lending rates increased steadily in the 2000-08 period, but fluctuated dramatically between 2009 and 2012.

Figure 2.10.5. **Average annual lending and deposit interest rates in Viet Nam, 2000-12**



Source: State Bank of Viet Nam (SBV).

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In the mid-2000s, the government took measures – including monetary policy to keep loans under strict control – to regulate the real estate market and prevent a real estate bubble from forming. Consequently, after an overlong period of prosperity, the market slipped into stagnancy in 2008 and remained that way.

In 2011, in a context of high inflation, the government promulgated Resolution No. 11/NQ-CP of 24/2/2011 on inflation control and macro stabilisation. It capped credit growth at under 20% and limited loans for non-productive activities to 16% to the end of 2011. As a result, the real estate market froze. In 2012, there was a 65% slump in new apartments for sale (equivalent to over 8 600 apartments) against the previous year and 28 000 apartments in the Ho Chi Minh City found no buyer.

In early 2013, the government approved an economic stimulus package of VND 30 000 billion (Viet Nam dong) to revive the real estate market. Although it is viewed as an optimistic signal, its implementation will face many challenges.

The effectiveness of monetary policy is also affected by the fact that Viet Nam's financial market is underdeveloped. The result is that stakeholders tend to over react in response to adjustments in the monetary policy – clearly reflected in the interest rate race among commercial banks when the SBV tightened monetary policy in 2008 and 2011, which in turn led to liquidity unrest in the market. Moreover, restrictions on financial instruments also affect the capacity to raise capital for the state budget as well as for businesses. That in turn affects Viet Nam's economic growth, since it depends heavily on bank lending.[10] The banking system is thus under constant pressure to provide capital for the economy even in the context of tight monetary policy aimed at controlling inflation. And as short-term deposits still dominate, Viet Nam's banking system is always faced with the risk of maturity mismatches, a problem that may be mitigated only if the capital market is improved.

Measures to enhance monetary policy

Maintaining macroeconomic stability must be the highest priority and monetary policy should be conducted to that end. In the medium and long terms, Viet Nam should conduct its monetary policy within an inflation-targeting framework in order to anchor macroeconomic fluctuations. To further enhance the effectiveness of monetary policy, it needs to rid the economy of dollarisation and make the Vietnamese dong the only currency in use.

Because Viet Nam is a bank-based economy, the effectiveness of monetary policy depends closely on the quality and development of the banking system. Successfully restructuring it so that it is modern and internationally compatible is essential to enhancing effective monetary policy. The government should go about restructuring cautiously but in a timely manner, too, as the longer the process is the costlier it will be to the economy.

Finally, the SBV and the government need to win public confidence in their policies and statements by keeping their promises and maintaining credible policies.

Policy makers need to strengthen their ability to stress test financial risks and their likely impacts on the financial and monetary situation and the economy. To that end, a valuable tool would be an improved database of serial macroeconomic and monetary variables. It would enable comprehensive research into and analysis of how these variables interact and affect the economy as a whole.

Notes

1. IHDI takes into account inequality in all three dimensions of the human development index (HDI) by "discounting" each dimension's average value according to its level of inequality. The HDI can be viewed as an index of "potential" human development and the IHDI as an index of actual human development.
2. Expected years of schooling for children of school-entrance age, which is the total number of years of schooling a child of school-entrance age can expect to receive if prevailing patterns of age-specific enrolment rates stay the same throughout the child's life.
3. Under the management of the Ministry of Labour, Invalids and Social Affairs.
4. Under the management of the Ministry of Education and Training.
5. STEP stands for Skills Toward Employment and Productivity. STEP studies measure skills demanded by the labour market.
6. The private sector in Viet Nam includes individual farming businesses and private economic units. Private economic units encompass NSEs, non-farming individual business, and co-operatives. On 31 July 2012 there were 4 971 206 private economic units out of a total of 4 983 979 economic units in total – a proportion of 99.74%. NSEs account for only 6.61% the number of private economic units but 45.66% in terms of employment. This report focuses mainly on NSEs when discussing the private sector.
7. Private enterprise is a firm owned by an individual who is its legal representative. The owner has total discretion in making business decisions, and is liable for its operations to the extent of all his or her assets.
8. It should be noted that, in 1997, Tang Minh Phung, the owner of a private company in Ho Chi Minh City together with numerous senior managers of the Vietcombanks and the Viet Nam Industry and Commerce bank were arrested on defrauding charges. Six people were sentenced to death (some were executed in 2003) while others received long jail terms. The case has a powerful impact on banks and private owners. Banks were reluctant to do business with private enterprises and loans to private enterprises were always carefully scrutinised.
9. Foreign reserves increased from around 4 weeks of imports at the beginning of 2011 to more than 12 weeks' imports in June 2013.
10. By the end 2012 total banks credit was more than 110% of GDP

China

A. Medium-term economic outlook (Forecast, 2014-18 average)

GDP growth (percentage change):	7.7
Current account balance (% of GDP):	1.6
Fiscal balance:	-1.6

B. Medium-term plan

Period: 2011-15

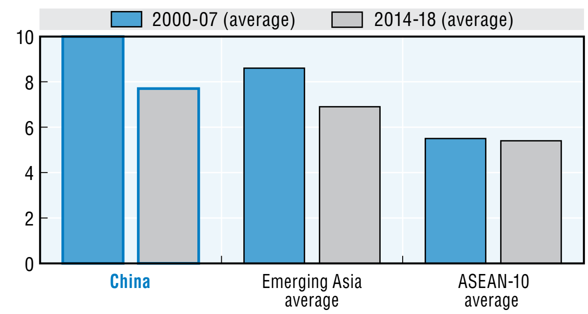
Theme: Rebalancing the economy, ameliorating social inequality, and protecting the environment

C. Basic data (in 2012)

Total population:	1 354 million
Population of Beijing	19.6 million (in 2010)
GDP per capita at PPP:	9 161 (current USD)

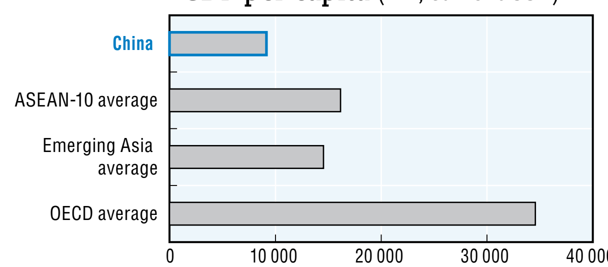
Sources: OECD Development Centre, national sources and IMF.

GDP growth rates (Percentage change)



Source: OECD Development Centre, MPF-2014.

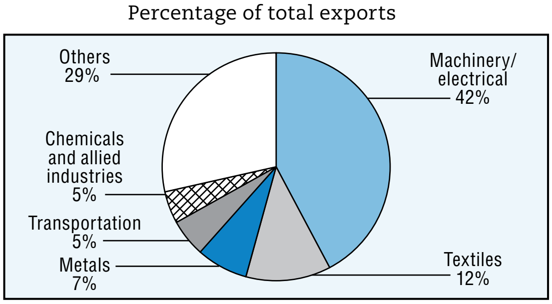
GDP per capita (PPP, current USD)



Source: IMF.

Composition of exports, 2012

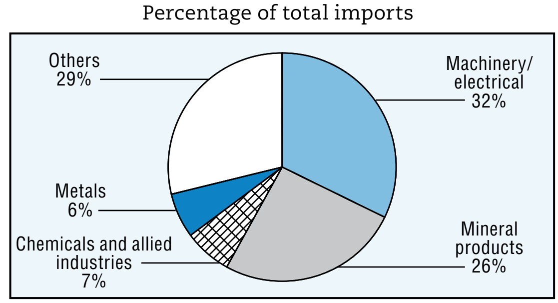
Percentage of total exports



Source: Trademap.

Composition of imports, 2012

Percentage of total imports



Source: Trademap.

China's 12th Five-Year Plan – focusing on "inclusive growth"

China has made significant progress in the last decade with regard to its economic development, living standards, and status in the international community. Its gross domestic product (GDP) reached RMB 51.9 trillion (Chinese renminbi) in 2012 and is now the world's second largest after the US. The key themes of the ongoing 12th Five-Year Plan (12th FYP) 2011-15 are rebalancing the economy, improving social inequality, and protecting the environment so that the fruits of economic growth can be shared more widely.

One policy direction laid out in the 12th FYP towards achieving those goals is to improve the provision of basic public services – e.g. public education, health care and social security – by undertaking more effective institutional reform and defining more clearly the responsibilities of different levels of government. The FYP goes on to state the government's intention of deepening fiscal reform through improvements to transfer payments, budget management and tax systems. While China has made progress in these areas, it can do more to streamline administrative efficiency and accelerate budgetary reform.

China's medium-term policy challenge and response

- Improve fiscal efficiency through institutional reform

POLICY FOCUS

Improve fiscal efficiency through institutional reform

China's fiscal challenges are institutional in nature

In its transition towards a market economy, the Chinese central government sought to decentralise its system of fiscal management between 1979 and 1993 through various fiscal contracting systems. Its objective was to give local authorities greater responsibility for local economic development and more autonomy in the fiscal measures they took to that end, while ensuring it kept a suitable degree of fiscal control.

However, although it fostered growth in many regions, its action also produced such unintended consequences as regional inequality, inadequate public services delivery, rising local government debt and weakened budget management. These challenges were exacerbated by subsequent fiscal policies, such as the 1994 tax assignment system that recentralised revenues and the 2000 rural tax reform that phased out agricultural taxes and instituted fiscal transfers.[1]

The result of those policies was uneven fiscal decentralisation marked by a mismatch between local governments' expenditure mandates and the funds allocated to them by central government. Their fiscal resources could not meet their expenditure needs. In 2011, local governments accounted for 85% of all spending (especially in such big budget items as education, social security and health care) despite receiving only 51% of government revenues (Tables 2.11.1 and 2.11.2).

Table 2.11.1. **Central and local revenue assignment in China, 2011**

Percentage

	Central	Local
Central revenues		
Domestic consumption tax	100	
VAT and consumption tax from imports	100	
VAT and consumption tax rebate for exports	100	
Tax on ship tonnage	100	
Vehicle purchase tax	100	
Tariffs	100	
Local revenues		
Resource tax		100
Urban land use tax		100
Land appreciation tax		100
Tax on vehicles and boat operation		100
Farm land occupation tax		100
Deed tax		100
Tobacco leaf tax		100
House property tax		100
Shared revenues		
Domestic value-added tax	75.3	24.7
Business tax	1.3	98.7
Corporate income tax	59.8	40.2
Individual income tax	60.0	40.0
City maintenance and construction tax	6.1	93.9
Stamp tax	40.8	59.2
Other tax revenue	72.0	28.0
Special programme receipts	11.8	88.2
Charge of administrative and institutional units	10.0	90.0
Penalty receipts	3.0	97.0
Other non-tax receipts	33.0	67.0
National government revenue	**49.4**	**50.6**

Source: National Bureau of Statistics of China, *China Statistical Yearbook 2011*.

Table 2.11.2. **Central and local expenditure assignment in China, 2011**
Percentage

Area of expenditure	Central	Local
General public services	8.2	91.8
Foreign affairs	99.1	0.9
National defence	96.7	3.3
Public security	16.4	83.6
Education	6.1	93.9
Science and technology	50.7	49.3
Culture, sport and media	10.0	90.0
Social safety net and employment effort	4.5	95.5
Medical and health care	1.1	98.9
Environment protection	2.8	97.2
Urban and rural community affairs	0.2	99.8
Agriculture, forestry and water conservancy	4.2	95.8
Transportation	4.4	95.6
Affairs of exploration, power and information	11.6	88.4
Affairs of commerce and services	1.9	98.1
Affairs of financial supervision	63.8	36.2
Post-earthquake recovery and reconstruction	0.0	100.0
Affairs of land and weather	15.2	84.8
Expenditure for affairs of housing security	8.6	91.4
Expenditure for affairs of management of grain and oil reserves	42.5	57.5
Interest payment for domestic and foreign debts	76.3	23.7
Other expenditure	2.6	97.4
National government expenditure	**15.1**	**84.9**

Source: National Bureau of Statistics of China, *China Statistical Yearbook 2011*.

In general, local governments have little say in spending and tax policies. Central government generally sets tax rates and bases alongside norms for the provision of local public goods and specific unfunded spending mandates. Local authorities are, for example, responsible for supporting workers laid off from state-owned enterprises (OECD, 2006d). Local governments' limited fiscal powers are further weakened by the overall lack of clear guidelines for financing, delivering, or regulating goods and services. Each province determines tax-sharing arrangements within its jurisdiction at its own discretion. Consequently, with the lack of guidelines and transparency, the lowest tiers of governments (county and town councils) are the ones that receive the least funding to meet their needs.

Performance monitoring and evaluation mechanisms need to be improved. In the absence of formal accountability mechanisms, local officials do not usually have to answer to citizens for their actions. Most merely perform tasks allotted to them top-down by central government and it may also be inferred from the inadequacy of oversight mechanisms that funds are weakly and inefficiently allocated to such usages as infrastructure projects.

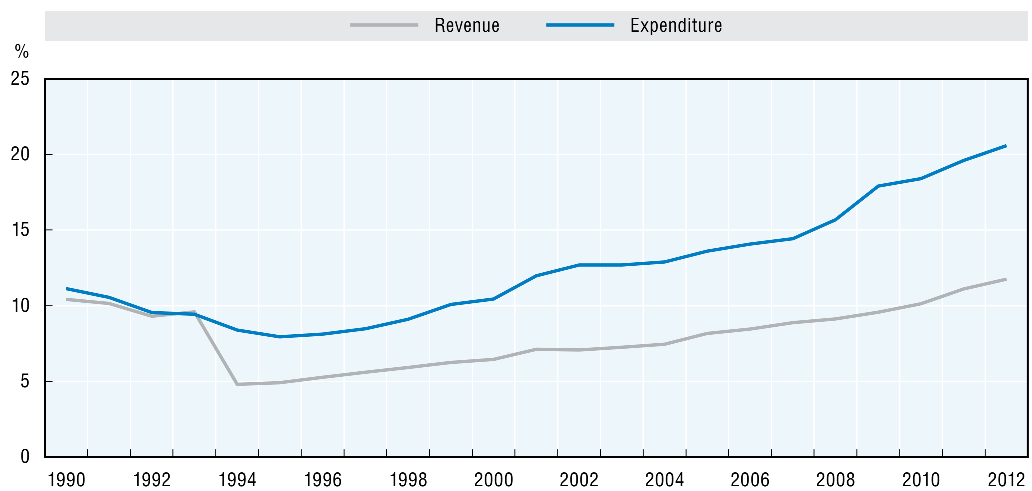
Finally, there is room to improve efficiency of the fiscal system, both "vertically" and "horizontally" (OECD, 2006d). Vertical inefficiency occurs in regions where there are too many layers in the system: the middle tiers (prefectures) absorb funding, causing shortfalls in the much-needed transfers to counties and townships. As for horizontal inefficiency, in particular, overlapping responsibilities need to be improved.

Previous fiscal policy has worsened regional financing and inequality

To address funding shortfalls, central government provides fiscal transfers to local governments. There are persistent financing shortfalls which vary widely both within and between regions and point to worsening regional inequality, primarily due to the lack of a monitoring mechanism for ensuring the effective use of funds or of any clear transfer criteria within the provinces (Figures 2.11.1 and 2.11.2).

Figure 2.11.1. **Local government revenue and expenditure in China, 1990-2011**

Percentage of GDP



Source: CEIC.

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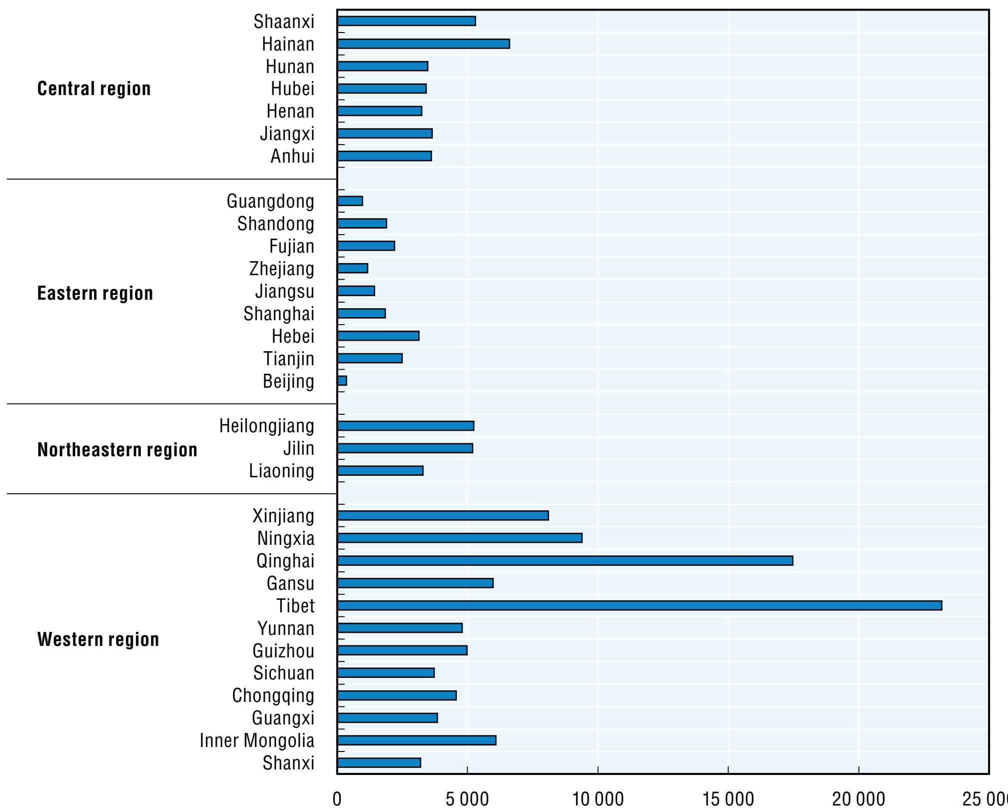
Figure 2.11.2. **Financing gaps in China, by province (before transfers), 2012**

CNY per capita



Source: CEIC and OECD Development Centre calculations.

StatLink http://dx.doi.org/10.1787/888932938688

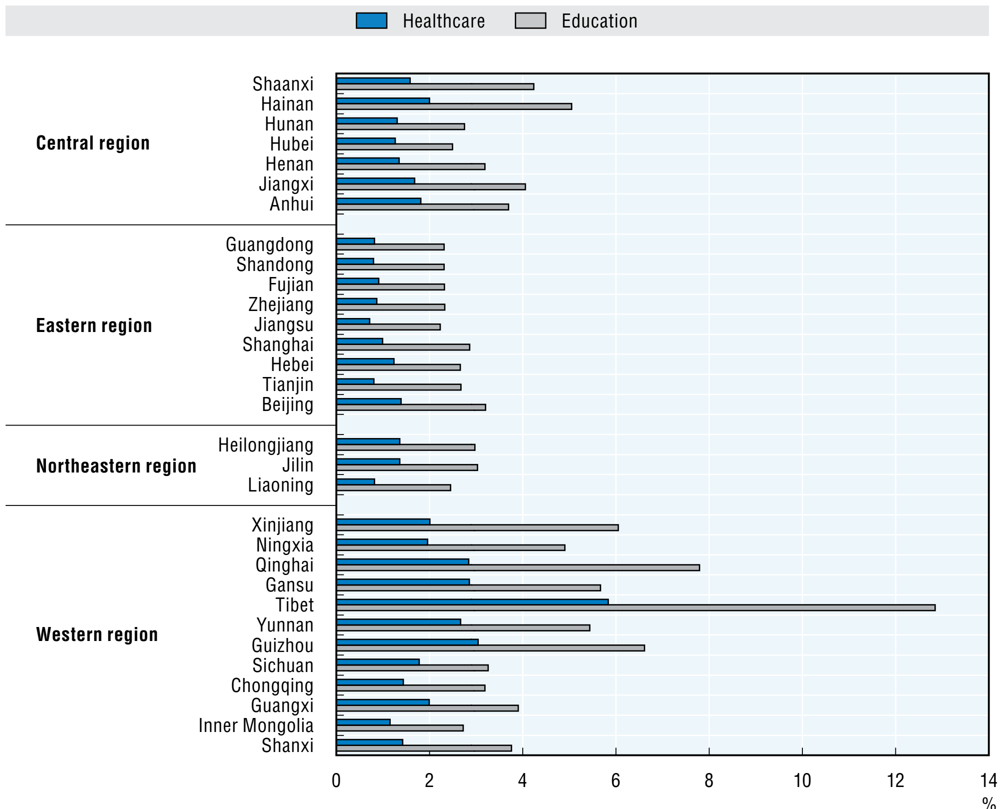
As a result, core public services delivery in areas like education, public health care and social security is deficient and unequally spread across regions, as local governments are forced to reallocate scarce funds in order to balance their budgets at the end of each year. Lower tiers of government, poorer provinces and rural areas are particularly underfunded, while sharp variations in the distribution of spending across regions produce stark inequalities in educational and health outcomes (Figure 2.11.3). China's public spending on education (3.7% in 2010) and health care (5.2% in 2011) as a share of GDP is significantly below the OECD averages of 6.2% for education and 9.8% for health care in 2009 (National Bureau of Statistics; OECD Health Data, World Bank).

Local governments driven to extra-budgetary and off-budget activities

Persistent funding gaps, inadequate fiscal transfers, poor fiscal transparency, and the daunting infrastructure and development commitments faced by local governments are increasingly driving expenditure into extra-budgetary and off-budget accounts, nearly all of which are controlled by local governments.[2] While extra-budgetary funds and fees are stipulated by laws and regulations, off-budget expenditure is illegal and not always accounted for in official statistics.

Figure 2.11.3. **Government expenditure on education and health care in China, by province, 2011**

Percentage of GDP



Source: CEIC and OECD Development Centre calculations.

StatLink http://dx.doi.org/10.1787/888932938707

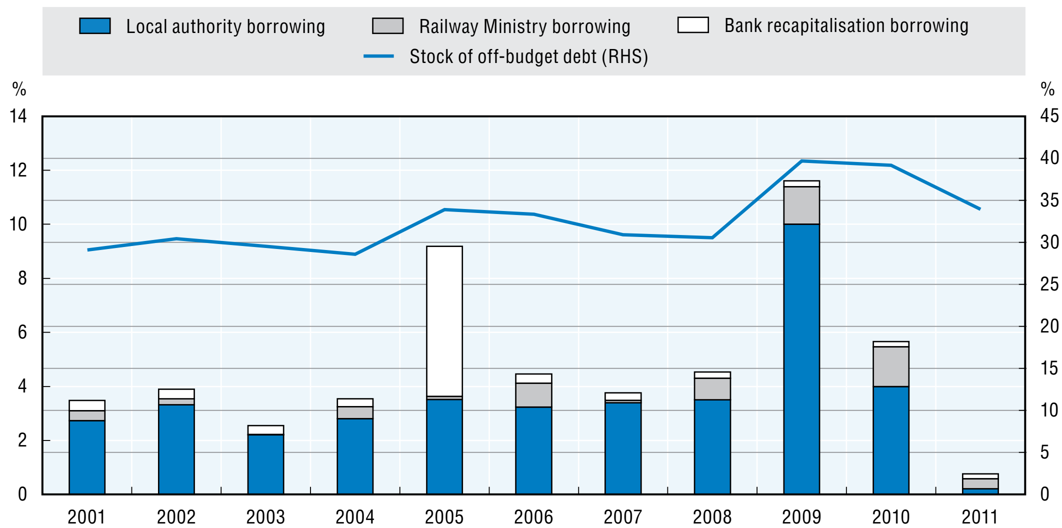
Of greater concern is the growth of illicit local government-guaranteed debt, which could fuel growth in contingent liabilities and jeopardise financial stability. Much of it is in the form of bank borrowing by local government financing vehicles (LGFVs). LGFVs are entities that use government guarantees and publicly provided collateral (such as land) to acquire credit for construction projects, since local authorities are barred from directly borrowing from banks or selling debt – which includes debt incurred by local government public service units that fund hospitals, schools and universities. The central bank estimated that, in 2011, local governments had set up more than 10 000 LGFVs to fund construction projects.

Already, the reported debt build-up has affected China's credit worthiness, with Fitch downgrading China's sovereign rating by one notch to A+ in April 2013. Former Finance Minister, Xiang Huaicheng, reportedly stated that local government-guaranteed debt could be as high as RMB 20 trillion (or almost 40% of GDP) in 2012. That amount is double the figure of RMB 10.7 trillion officially acknowledged at the end of 2010 by the National Audit Office.[3]

Estimates by the OECD (2013d) put the stock of off-budget debt at 34% of GDP in 2011, with local government borrowing peaking at 10% of GDP in 2009 (Figure 2.11.4). A breakdown of off-budget debt in 2011 indicated that local government agencies accounted for a significant 67% of the total.

Figure 2.11.4. **Off-budget borrowing in China, by entity, 2001-11**

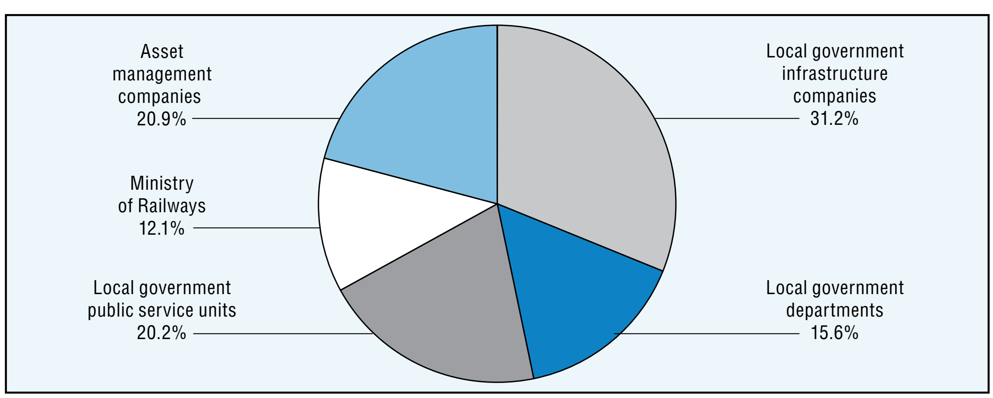
Percentage of GDP



Source: OECD (2013d), *OECD Economic Surveys: China 2013*, OECD Publishing, Paris.

StatLink http://dx.doi.org/10.1787/888932938726

Figure 2.11.5. **Off-budget debt composition in China, 2011**



Source: OECD (2013d), *OECD Economic Surveys: China 2013*, OECD Publishing, Paris.

StatLink http://dx.doi.org/10.1787/888932938745

Local government debt management

The management of local government debt was also tightened. Each debt was identified and put under standardised supervision. It was clarified who the parties responsible for payment were and the assurance was given that all local government bonds due in 2012 would be redeemed on time.

Government officials have also talked about pilot programmes that allow local governments to issue bonds directly, which could bring off-budget liabilities back on-budget. Amid concerns over rising bad assets, the National Development and Reform Commission was toughening approval processes for bond issuance by LGFVs. In addition, the Jiangsu Asset Management Company,[4] created by the Jiangsu Provincial Government in April 2013, is expected to purchase and restructure non-performing loans, reportedly in the photovoltaic cell industry and steel trading companies. The central government is also trying to reconcile government's financial accounts with those of the LGFVs, so that the latter's borrowing can be monitored more accurately.

More still needs to be done to improve institutional and budget reform

The Chinese government could also consider further simplifying tax administration, both vertically and horizontally, to improve fiscal efficiency. At present, the four-tier hierarchy of province, prefecture, county, township applies across the country, even though some provinces have relatively few counties. To ensure that fiscal transfers reach the counties and townships more effectively, central government could consider bypassing the prefecture tier, especially for densely populated counties where a province's population is concentrated (given that prefectures control relatively few counties). This would apply to provinces such as Anhui, Shandong, Henan, Jiangsu and Guangdong (OECD, 2006d). Several provinces such as Zhejiang and Hainan already have counties that report directly to the provincial government, even where a prefecture might exist.

In addition, moves to merge townships and villages could enable economies of scale and the reduction of administrative costs, especially if there are overlapping or conflicting responsibilities. Provincial pooling of resources has already begun in pensions and unemployment insurance at the provincial level, though not for industrial accident insurance and maternity insurance. Progress is slow and contribution rates, administrative efficiency and management practices still vary widely. An agency set up to co-ordinate pooled resources could further assist in addressing inequality within provinces.

Clearer guidelines as to roles and responsibilities across the tax administration hierarchy, more transparency, and greater accountability in budgetary finances should be considered. Tax officials should be elected and assessed against criteria that include performance and accountability for their management of budgetary funds. While the overall fiscal transfer system has been improved to provide funding to country-level jurisdictions, more can be done with regard to the system of special-purpose transfers designed as short-term fixes to deal with emerging issues without a review.

Central government could also consider conducting a needs assessment that used international standards as a guideline to review and determine levels of expenditure in the priority areas of education, health care and social security. Such assessment could help central government channel funds more effectively into meeting its development goals. Although central government has implemented a basic budget system framework statewide, it could further consider the use of standardised benchmarks for spending efficiency and effectiveness evaluation for its next stage of reform.

Box 2.11.1. **Budget transparency and the OECD experience**

OECD member countries are at the forefront of budget transparency practices. At the 1999 annual meeting, the OECD Working Party of Senior Budget Officials asked the Secretariat to draw up a set of member countries' best practices in the field.

The guidelines set out in *OECD Best Practices on Budget Transparency* are designed as a reference tool for member and non-member countries to help them improve budget transparency at home. There are three categories.

Part 1 lists the principal budget reports that governments should produce and their general content – the budget, a pre-budget report, monthly reports on budget implementation, a mid-year report, a year-end report, a pre-election report, and a medium-term report.

Part 2 describes specific disclosures to be contained in the reports – economic assumptions, tax expenditure, financial liabilities and assets, non-financial assets, employee pension obligations and contingent liabilities.

Part 3 highlights practices for ensuring the quality and integrity of reports – accounting policies, systems and responsibility, audits, and public and parliamentary scrutiny.

For example, medium-term budget frameworks (MTBFs) have been used successfully in Germany, the United Kingdom and Australia. They are mechanisms for controlling the introduction of new policies and tracking budget implementation beyond a single year. MTBFs provide a transparent basis for the accountability of the executive branch and are a necessary foundation for more detailed results-oriented budgeting. In the United Kingdom and Australia, the introduction of a strong forward-estimates process within the medium-term framework has been associated with agencies enjoying much greater flexibility in their uses of resources within aggregate and programme ceilings.

Source: OECD (2002), *OECD Best Practices for Budget Transparency*, OECD Publishing, Paris, http://dx.doi.org/10.1787/budget-v1-art14-en.

Notes

1. The 1994 comprehensive tax reform package sought to replace the fiscal contract system by redefining the sources of revenue for central and local governments as central government revenues, local government revenues and shared revenues. This was done to increase central government revenues which could then be used as fiscal transfers to the poorer central and western provinces.

2. Extra-budgetary funds and fees comprise surtaxes, levies and user charges that are collected, allocated or arranged by government agencies or other institutions and social organisations that perform duties delegated to them by the government. Off-budget expenditure comprises unauthorised fees and charges and is often ad hoc (OECD, 2006d).

3. "China local government debt may top estimates, former Minister says", Bloomberg, 7 April 2013. The figure given by Xiang Huaicheng is also higher than figures given by other official public agencies such as the People's Bank of China (RMB 14.4 trillion at the end of 2010) and the Central Bank Regulatory Commission (RMB 9.3 trillion at the end of 2012) (Bloomberg News, 2013).

4. The Ministry of Finance and the Chinese Banking Regulatory Commission allowed local governments to set up asset management companies (AMCs) from February 2012 onwards. The Jiangsu AMC will be registered in Wuxi City of southern Jiangsu with an initial capital of RMB 5 billion. Its controlling shareholder is Wuxi Guolian Development (Group) Co., a local state-owned enterprise funded by the Wuxi City government. The Jiangsu AMC is reportedly supervised by the provincial banking regulatory commission, the state-owned asset supervisor and the government financial office (Caixin Online, 30 May 2013).

India

A. Medium-term economic outlook (Forecast, 2014-18 average)

GDP growth (percentage change):	5.9
Current account balance (% of GDP):	-3.9
Fiscal balance:	-8.0

B. Medium-term plan

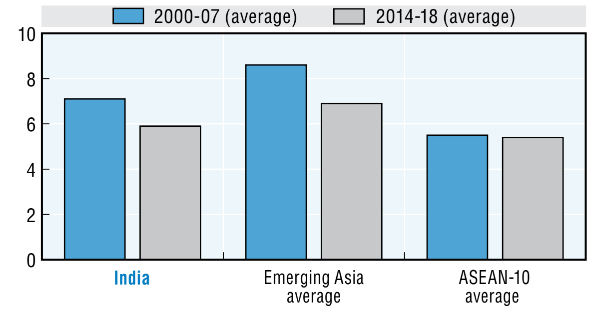
Period: 2012-17
Theme: Faster, more inclusive and sustainable growth

C. Basic data (in 2012)

Total population:	1.223 million*
Population of New Delhi	16.8 million (in 2011)
GDP per capita at PPP:	3 829 (current USD)**

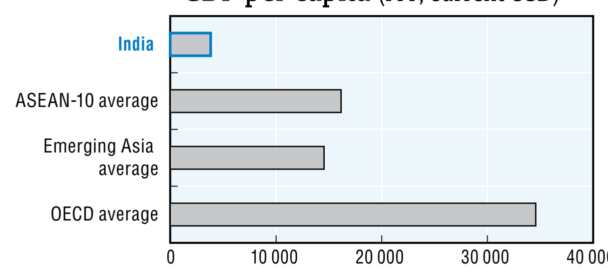
Note: * Total population data for 2012 are estimate.
** IMF estimate
Sources: OECD Development Centre, national sources and IMF.

GDP growth rates (Percentage change)



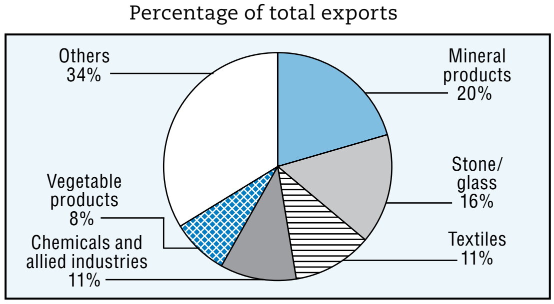
Source: OECD Development Centre, MPF-2014.

GDP per capita (PPP, current USD)



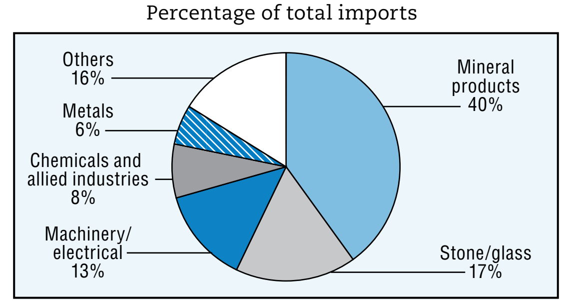
Source: IMF.

Composition of exports, 2012
Percentage of total exports



Source: Trademap.

Composition of imports, 2012
Percentage of total imports



Source: Trademap.

India's 12th Five Year Plan – growth that is faster, more inclusive and sustainable

India's economy has developed quickly in the last decade, improving living standards and experiencing strong growth in such sectors of the economy as information and communication technology (ICT). Real gross domestic product (GDP) growth averaged 8.5% in the years leading up to the global financial crisis (2006-10) and poverty rates declined significantly. In recent years, however, circumstances have become less conducive to growth: macroeconomic conditions in the developed economies point to a prolonged external slowdown, while domestic constraints such as high inflationary pressure and rising fiscal and current account deficits have emerged. The result was a 5% growth rate for 2012-13, the lowest in ten years.

In recognition of the downturn, the country's 12th Five Year Plan (12th FYP) puts the onus on inclusion and sustainability, while seeking to meet the immediate issue of reversing the recent decline in growth and the structural challenge of restoring medium-term real growth potential. The educational focus of the 12th FYP is on teacher training, evaluation, and accountability. It also stresses the need for higher quality in research, infrastructure, teachers and curriculum content.

India's medium-term policy challenge and response

- Improve teaching and national assessment systems to raise education standards

Access to education has expanded rapidly

India's educational system has seen significant progress, primarily thanks to the strategic programmes initiated by central government (see Box 2.12.1). One such scheme, the Right to Free Education (RTE), has led to an increase in enrolments in many Indian states. Over 90% of children are now registered in primary school in most states, indicating that the country is close to achieving universal elementary school participation. Drop-out rates have fallen and literacy has risen – it stood at 74% in 2011. There has also been an increase in the number of public and officially recognised private schools at elementary and secondary levels.

Table 2.12.1. **Educational schemes initiated by the Indian government**

Target groups	Programmes	Year of launching	Objective	Outcomes
All	Saakshar Bharat (SB)/Adult Education		Target of the 11th FYP was to achieve 80% literacy nationwide. Target of the 12th FYP is to raise the overall literacy rate to over 80% and reduce gender gap in literacy to less than 10%	As per Census 2011, 74% literacy has been achieved. By March 2012, the programme has reached 372 districts in 25 states.
Elementary education	Right to Free Education (RTE), extension of the Sarv Shiksha Abhiyan (SSA) programme	April 2010	Building on the SSA, every child between the ages of 6 and 14 has a right to free and compulsory education, and a commitment to ensure access to a neighbourhood elementary school throughout the country by 2013. One of the key elements of the RTE Act is the provision of 25% seats in schools to weaker sections and disadvantaged groups in the neighbourhood.	By September 2012, 334 340 new primary and upper primary schools were opened, 284 032 school buildings were constructed, 1 642 867 additional classrooms, 217 820 drinking water facilities and 618 089 toilets, supply of free textbooks to 8.32 crore children, appointment of 12.46 lakh teachers and imparting of in-service training to 18.64 lakh teachers.
Elementary education	Midday Meals (MDM)	2001	Raise the level of nutrition of children and enable them to develop in a healthy manner, cooked meals are provided to all children attending Classes 1-8 in government, local body, government-aided, and National Child Labour Project schools. Expected to enhance enrolment, retention, attendance of children in schools apart from improving their nutritional levels.	The scheme provides lunch to about 120 million children every school day, and as such, is the largest school meal scheme in the world. Although no rigorous evaluations of the impact of this scheme on children's school enrolment and attendance and on nutritional and health status, several micro studies suggest major increases in enrolment immediately after the introduction of MDMs.
Secondary education	Rashtriya Madhyamik Shiksha Abiyan (RMSA)	March 2009	Aim to achieve universal lower secondary enrolments (up to and including grade 10) by 2017 and universal retention by 2020.	Under the 11th FYP, 9 636 new schools were sanctioned, 34 311 existing schools were strengthened, 49 356 additional classrooms were built, 59 000 teachers were added, in-service training for all teachers were conducted, 75 394 schools received annual grants, and 62 221 schools had minor repairs.
Other centrally sponsored schemes	1. Model Schools Scheme	November 2008	Scheme to set up 6 000 high quality model schools to provide quality education to talented rural children.	By December 2012, 2 266 model schools in 22 states have been approved for construction. -
	2. Girls' Hostel Scheme			
	3. ICT@Schools			
	4. Inclusive Education for Disabled at Secondary Stage			
	5. Scheme of Vocational Education			
	6. National Means-cum Merit Scholarship Scheme		To award 100 000 scholarships each year at Grade 9 stage.	
	7. National Incentive to Girls			
	8. Appointment of Language Teachers			
Vocational education	National Vocational Qualification Framework (NVEQF)	September 2012	Provide a common reference framework for linking various vocational qualifications and setting common principles and guildelines for a nationally recognised qualification system and standards.	NVEQF pilot project was implemented in 2 states (Haryana and West Bengal).

Sources: Government of India (2011a), *Twelfth Five Year Plan* (2012-2017): *Faster, More Inclusive and Sustainable Growth*, Planning Commission, India; Government of India (2011b), *Economic Survey 2012-13*, Department of Economic Affairs, Ministry of Finance, India; OECD (2011c), *OECD Economic Surveys: India 2011*, OECD Publishing, Paris.

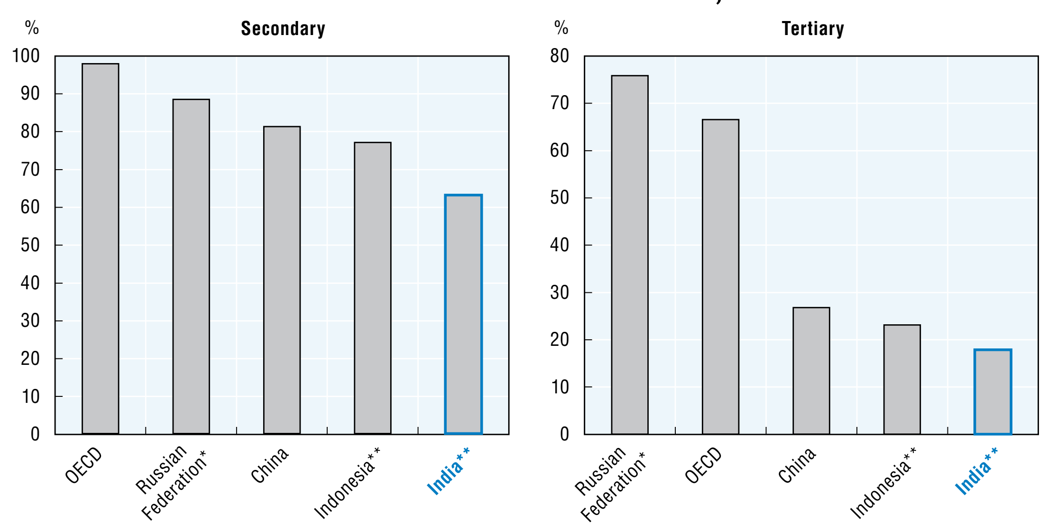
Overall educational quality still low and disparities persist

Despite the government's efforts to increase enrolment and the provision of schooling, there is much room for improvement in other aspects of education – particularly access to secondary school, persistent disparities, inadequate basic facilities, and low academic standards.

Access to secondary and tertiary education

First, the government should seek to further stimulate access to secondary and tertiary education, where Indian enrolment rates lag behind those of other countries, which includes China (see Figure 2.12.1). There are also wide gaps between enrolment and attendance. In Bihar, for example, only 65% of the children enrolled in primary school in 2009 actually attended and of that 65% only 40% attended school regularly (Kingdon and Banerji, 2009). Drop-out rates at upper primary and secondary levels are high, too, rising from 27% at the end of primary school (grade 5) to 41% at the end of the upper primary level (grade 8) and 49% in secondary school (grade 10). The reasons were, reportedly, the cost of education, a lack of interest in schooling, and the need to work at home or outside to supplement the family income (Govinda and Bandyopadhyay, 2008). Drop-out rates, especially among disadvantaged groups such as scheduled castes (SCs) and tribes (STs), are higher than the national average.

Figure 2.12.1. **Gross enrolment rates in secondary and tertiary education in India and other selected countries, 2011**

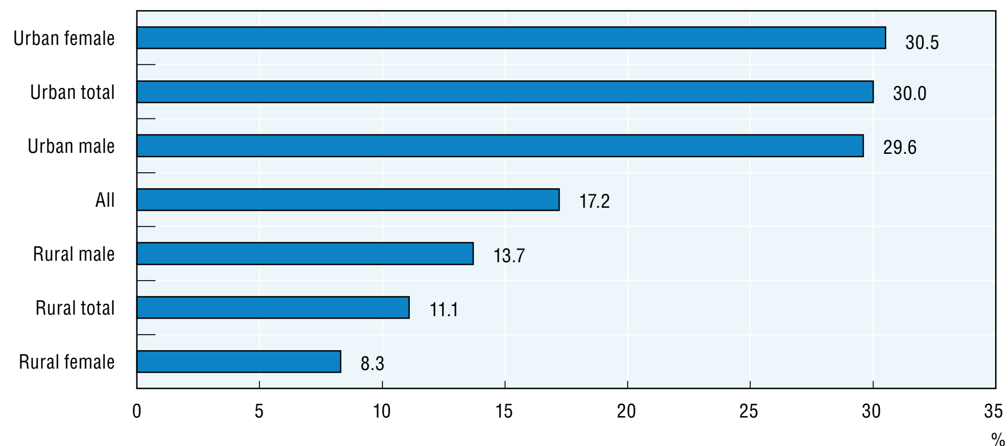


Note: *2009 figures; **2010 figures.
Source: World Bank, *World Development Indicators*.
StatLink http://dx.doi.org/10.1787/888932938764

Persistent disparities in access to education

Access to education in India is unequal. Disparities occur at all levels – between states, urban and rural regions, genders, and communities. The World Bank (2009) reports that there is a 40 percentage-point gap in secondary enrolment rates between students from the highest (70%) and lowest (30%) expenditure quintile groups; a 20 percentage-point gap between urban and rural secondary enrolment rates; and a persistent 10 percentage-point gap between secondary enrolment rates of boys and girls. In higher education, enrolment rates demonstrate similar discriminatory trends across gender, urban-rural density (Figure 2.12.2), and socio-religious groups. With limited access to schooling, disadvantaged groups continue to lag behind in educational progress, which further restricts their earning ability and wealth.

Figure 2.12.2. **Gross attendance ratio (GAR) in higher education in India, by urban and rural areas and by gender, 2007-08**



Source: Government of India (2011a), *Twelfth Five Year Plan (2012-2017): Faster, More Inclusive and Sustainable Growth*, Planning Commission, India.

StatLink http://dx.doi.org/10.1787/888932938783

Inadequate basic facilities

Supply-side constraints account for the large number of schools that do not have the minimum basic facilities, despite the expansion in school capacity. Over 63% of rural schools, for example, have no usable toilet facilities, which may make it difficult to retain girls (Government of India, 2011a). In higher education, 48% of universities and 69% of colleges are reported to be deficient in infrastructure (Ernst & Young, 2012). Furthermore, except for a few top-level institutions – such as India's Institutes of Technology and the University of Delhi – many colleges are deemed to be below standard. As of March 2010, only 159 universities (32.3%) and 4 094 colleges (13.1%) had been accredited by the National Assessment and Accreditation Council (NAAC). Of the NAAC-accredited institutions, it was estimated that 62% of universities and 90% of colleges were average or below average (Ernst & Young, 2012).

The demand for better quality education has led to the proliferation of private schools, many of which tend to be concentrated at the tertiary level. Teacher attendance rates, teaching quality and student performance are generally found to be higher in private schools despite the better pay and superior teaching credentials of public school teachers (Hill and Chalaux, 2011).[1] The private-public school divide with regard to learning outcomes could be another factor that contributes to socio-economic disparities, especially as private schools generally cater to more affluent students.

Low academic standards

Academic standards are another cause for concern. Not only does the out-of-date curriculum emphasise rote-learning, educational abilities remain low by international standards. Kingdon and Banerji (2009) cite the SchoolTells (Teacher Effectiveness and Learning Level of Students) survey of 160 sample schools in Bihar and Uttar Pradesh for the 2007-08 school year. It revealed that only 50-58% of children could write a simple sentence (with mistakes) by the end of grade 4. What's more, the results of the OECD Programme for International Student Assessment (PISA) in 2009, together with scores from the additional PISA 2009 Plus survey,[2] ranked the Indian states Tamil Nadu and Himachal Pradesh 73rd and 74th out of 75 countries.

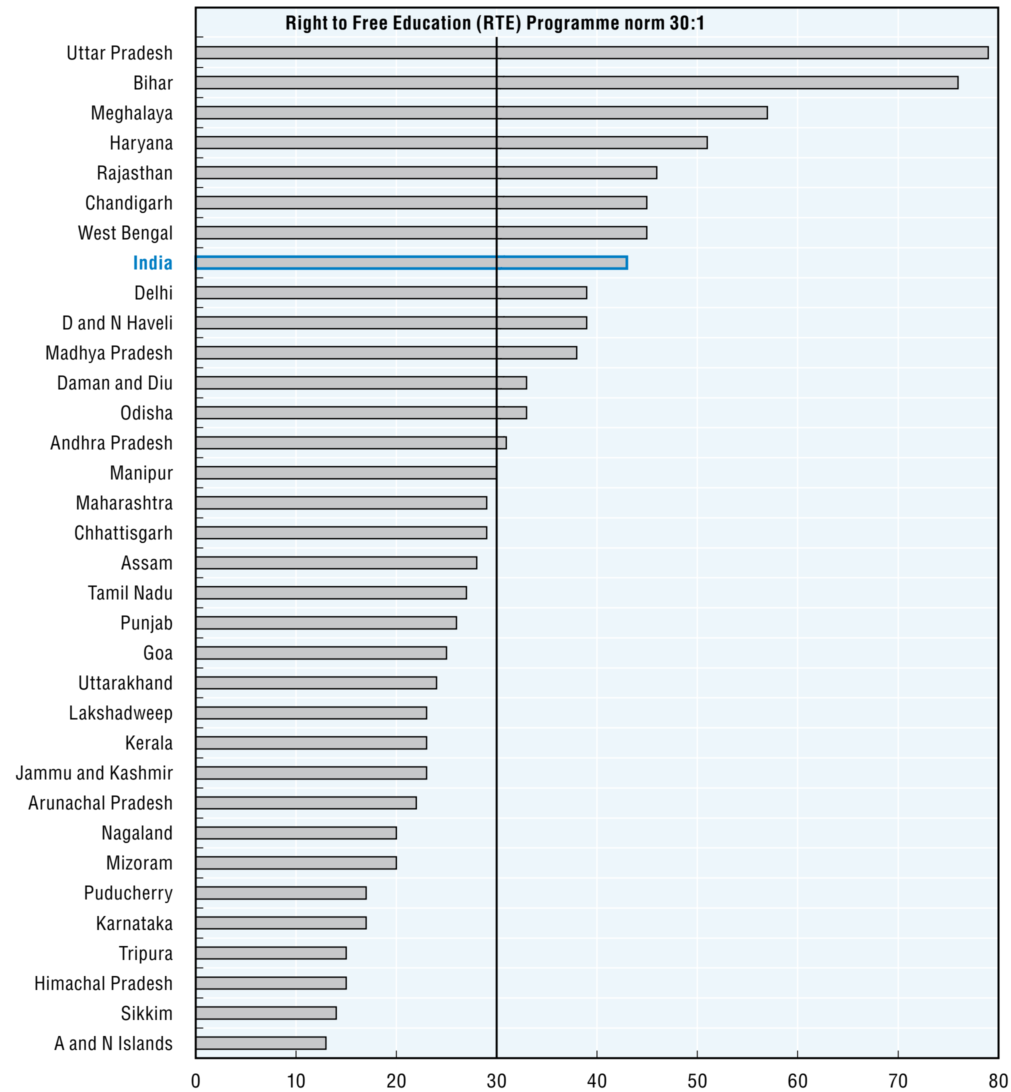
In addition, daunting challenges that worsen the low academic standards are the insufficient numbers and poor quality of teachers. Teacher shortages are especially acute in secondary schools and in the critical subjects of mathematics, science, and foreign languages (Government of India, 2011a).

The problem is further compounded by the slow recruitment process of teachers by state governments for both new and existing positions. The result is a backlog of teaching vacancies in all states and teacher-pupil ratios that exceed the limits stipulated by the RTE and RMSA norms of 1:30 and 1:35 in many state schools at all levels. As a consequence, incumbent teachers often have to teach multiple grades (Figure 2.12.3).

State schools have also turned to employing teachers who do not have the qualifications required by the National Council of Teacher Education which oversees standards, procedures and processes in India's education system. These teachers, known as contract or "para-teachers", are generally low-paid and untrained. Gelda et al. (2013) reported that 45% of rural primary education teachers had not studied beyond grade 12.

Indeed, teaching standards need to improve. Teachers often do not receive the pre-service or in-service training that allows them to deliver quality education. Their lack of accountability for schooling outcomes to either parents or the state further contributes to the problem. As a result, teachers are frequently absent. In the 2002-03 school year it was reported that 25% of primary school teachers in rural India were absent on any given day, aggravating the already severe understaffing in primary schools where there were, on average, no more than three teachers per establishment (Gelda et al., 2013).

Figure 2.12.3. **Pupil-teacher ratio in primary schools in India, by state, 2011**



Source: Ministry of Human Resource and Development.

StatLink http://dx.doi.org/10.1787/888932938802

Improving the quality of education is of the utmost concern

India's educational system continues to face the multiple challenges of access, equity and quality. It needs to improve on all three counts – particularly in the standard of education, so that young adults graduating from school may find good jobs and so contribute to economic growth and poverty reduction. The current picture is particularly stark as the country's workforce is expected to grow exponentially over the next five years. The Indian government has estimated that the proportion of the working-age population between 15 and 59 years old is likely to rise from approximately 58% in 2001 to more than 64% by 2021. In other words, approximately 63.5 million new entrants from that age group will swell the labour market, between 2011 and 2016. The bulk of them will be in the younger 20-35 year-old age bracket (Government of India, 2011b).

Numerous industry reports cite the lack of market-ready skills and – therefore – the low employability of Indian graduates from higher education establishments. Employer surveys point to shortages of skilled workers in the fields of information technology, financial services, telecommunications, tourism, retail and skill-intensive manufacturing – all sectors in which there has been employment growth over the past decade. Yet, because of the skills shortage, new private sector investment and growth is now faltering in these sectors (World Bank, 2009). Moreover, skills mismatches in technical and vocational areas have also forced Indian graduates into jobs other than those for which they have trained.

The inequality of educational outcomes among socio-religious groups is accompanied by occupational stratification. The upper castes continued to dominate in professional jobs, while the lower castes and tribes are engaged primarily in agricultural labour (Sethi and Somanathan, 2010), which in turn perpetuates social and economic inequalities.

Measures have been taken since the 11th FYP

Despite the dire shortcomings of India's educational system, the government has demonstrated its commitment to improving access, equity and quality in previous five year plans. Under the 11th FYP, for example, changes to upgrade educational practices were introduced, while a number of bills were proposed to improve the quality and transparency of the education system. One such bill was the Higher Education and Research Bill (2011), designed to be the sole regulator of norms and standards for academic quality. The National Accreditation Regulatory Authority for Higher Education Institutions Bill (2010), for its part, aims to make accreditation and rating of all higher education institutions mandatory in India. Both bills are yet to come before Parliament.

In line with the 12th FYP's target of improving educational standards, the Indian Institutes of Information Technology (IIT) Bill was introduced in 2013 to create "20 more Indian IITs in various parts of the country". The 2013-14 budget speech also emphasised vocational training and development, stating that it is to be spearheaded by the National Skill Development Corporation, which will set the curriculum and standards for training in different skills that any institution may then offer.

A stronger quality assurance system to improve educational outcomes

The challenge for the Indian government today is to build on the considerable progress made in increasing school participation. Equally, if not more, important, it must improve the quality of educational outcomes (OECD, 2011c). A comprehensive policy on the governance and role of education, followed by clear articulation of learning goals, is a crucial first step. The 12th FYP acknowledges the need for a clear, comprehensive policy as part of its intended strategy to provide quality schooling. Although the FYP focuses on elementary education, the effort to improve outcomes can be extended to all levels of education.

The next stage is to put in place a system for setting standards of quality and institutions to enforce them. At present, a two-tier quality assurance framework exists in India: two main quality assurance agencies – the National Accreditation and Assessment Council and the National Board of Accreditation – evaluate and accredit new institutions and/or programmes (usually at the tertiary level) on a purely voluntary basis. The government intends to overhaul the system with strategies it proposes in the 12th FYP that would make regular assessments (and possible accreditation) of educational institutions mandatory. It plans to introduce the practice in elementary schools and at secondary level with the School Quality Assessment and Accreditation System. It also intends to revamp the national accreditation system for higher educational institutions at the tertiary level. These systems would then be monitored by a national education agency or quality assessment regulator so as to better align quality standards across a student's time in schooling. Should a school fail to meet minimum requirements, there would be follow-up procedures involving mandatory corrective actions.

Strengthening educational quality assurance may also have beneficial knock-on effects on teacher quality. Compelled to improve their accountability and meet assessment requirements, schools may hire more teachers, recruit and promote better ones, and penalise those who are frequently absent. To further raise teaching standards, schools may also conduct diagnostic tests of student performance.

To evaluate school performance, two-thirds of OECD countries have regulations that require lower secondary schools to be inspected regularly, while a slightly smaller number require schools to conduct periodic self-evaluations. In around three-quarters of OECD countries, school inspections and self-evaluations also strongly influence assessments of school governance and individual teachers. In more than half of all OECD countries, school inspections are also used to make decisions about whether or not to close schools. Periodic standardised assessments of students in compulsory education are conducted to obtain information on student performance in two-thirds of OECD countries, while in nearly half national examinations have a real impact on lower secondary school students, i.e. determining whether or not they may proceed to a higher level of education. Only a few countries, such as Belgium (in its Flemish Community), Chile and the Czech Republic reported that school inspections influenced decisions as to whether to financially reward or sanction a school (Schleicher, 2012).

A final point is that the 12th FYP's proposed action to improve access to education and raise standards require greater public spending. Public expenditure on education in India was 3.3% of GDP in 2010. It has been stood around that level since the late 1980s, with the government failing to increase spending despite widening access to a larger number of students. Goswami (2012) estimates that the result has been a 20% reduction of expenditure per student over the 2003-06 period, which in turn suggests that the overall quality of education has in fact declined.

Box 2.12.2. **National quality assurance systems in tertiary education in selected OECD countries**

Quality assurance systems serve two main purposes: *i)* accountability, or to inform the public of educational establishments' academic performance; and *ii)* improvement, with criteria and procedures aimed at promoting better future performance. The following summarises the approaches and key features of national systems of tertiary education quality assurance within the OECD area.

Quality assurance systems in tertiary education in selected OECD countries

Country	Agency	Approach and level					Use of performance indicators	Public report	Links with funding
		Programme assessment	Institutional assessment	Institutional audit	Programme accreditation	Institutional accreditation			
Australia	Austalian Universities Quality Agency			x			x	x	x
Belgium	Flemish Interuniversity Council	x							
Chile	*Comisión Nacional de Acreditación*				x	x			
	Consejo Superior de Educación				x				
Croatia	National Council for Higher Education		x			x			
Denmark	Danish Evaluation Centre	x	x	x	x	x			
Finland	Finnish Higher Education Evaluation Council	x	x		x	x		x	
France	*Comité national d'évaluation indépendant*	x	x				x	x	Influence on contracts with govt
Iceland	Division of Evaluation and Supervision (Ministry of Education, Science and Culture)	x	x				x	x	
Japan	National Institution for Academic Degrees and University Evaluation	x	x				x	x	
The Netherlands	VSNU (association of universities)	x							
Portugal	Evaluation Council (Foundation of Portuguese Universities)	x						x	
Spain	*Agencia Nacional de Evaluación de la Calidad y Acreditación*		x		x		x		
Switzerland	Accreditation and Quality Assurance Board			x		x		x	
United Kingdom	Higher Education Quality Council owned by universities			x			x		
	Funding councils	x					x		x

Note: The three main approaches to quality adopted by quality assurance systems are accreditation, assessment and audit. While accreditation and assessment monitor the quality of teaching and learning, audit focuses on internal procedures adopted by a higher education institute in order to achieve its objectives.

Source: Kis, V. (2005), *Quality Assurance in Tertiary Education: Current Practices in OECD Countries and a Literature Review of Potential Effects*, contribution to the OECD Thematic Review of Tertiary Education and OECD Development Centre's compilation.

Notes

1. Hill and Chalaux (2011) explain that teachers in private schools are held more accountable than their counterparts in state schools, which may explain significant differences in teacher attendance and student learning outcomes. Regular public school teachers are normally employed by state governments on permanent contracts and are unlikely to be dismissed, while teachers in private schools are employed on fixed-term contracts. The difference in incentives may be compounded by the fact that private school teachers are more likely to come from the local community and so have a greater stake in ensuring positive outcomes for students.

2. Sixty-four economies originally participated in PISA 2009. Ten additional partner participants, who were unable to participate within the PISA 2009 project timeframe, participated in the PISA 2009 study on a reduced and delayed timeline in 2010. This is known as the PISA 2009+ project. The PISA 2009+ economies are: Costa Rica, Georgia, India (Himachal Pradesh & Tamil Nadu), Malaysia, Malta, Mauritius, Venezuela (Miranda), Moldova, United Arab Emirates. PISA 2009+ involved testing just over 46 000 students across these ten economies, representing a total of about 1 377 000 15-year-olds (Australian Council for Educational Research, www.acer.edu.au/media/acer-releases-results-of-pisa-2009-participant-economies/).

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CHAPTER THREE

Policy priorities for growing beyond the middle-income trap in Emerging Asia

Abstract

The Emerging Asia region has made tremendous economic progress over the past four decades. Some developing countries – in particular China, India, Indonesia, the Philippines, Thailand and Viet Nam – are now within the middle income group of countries as defined by the World Bank. All these countries can aspire to join Japan, Korea, Chinese Taipei and Singapore in the ranks of high-income, advanced, economies within the next several decades, in some cases within the next one or two decades. However, they will need to overcome difficult challenges to grow beyond the "middle-income trap".

Success will require fundamental changes in these developing countries' economic structures, toward more extrinsic growth that is driven on the supply side by productivity increases underpinned by human capital development, innovation and infrastructure development. On the demand side, growth will need to become more dependent on domestic demand and less dependent on exports. Notably, there should be further development of service sectors, especially "modern" services such as information and communication technology (ICT), finance, and business services. In essence, there are two key policy messages for developing countries to grow beyond the "middle-income trap". First, further development of institutional capacities – in areas such as education and training, legal and regulatory framework for competition, corporate governance and macroeconomic and financial – which help to enhance human capital, foster competition and innovation, and facilitate infrastructure development, needs to be central to development strategies of the middle-income Emerging Asian countries as they enter their next stage of development. Second, the growing regional integration among the Emerging Asia countries and with the broader Asian region can be a major asset in their efforts to rise into the high-income ranks. The on-going efforts to achieve this integration thus have a potentially very high payoff.

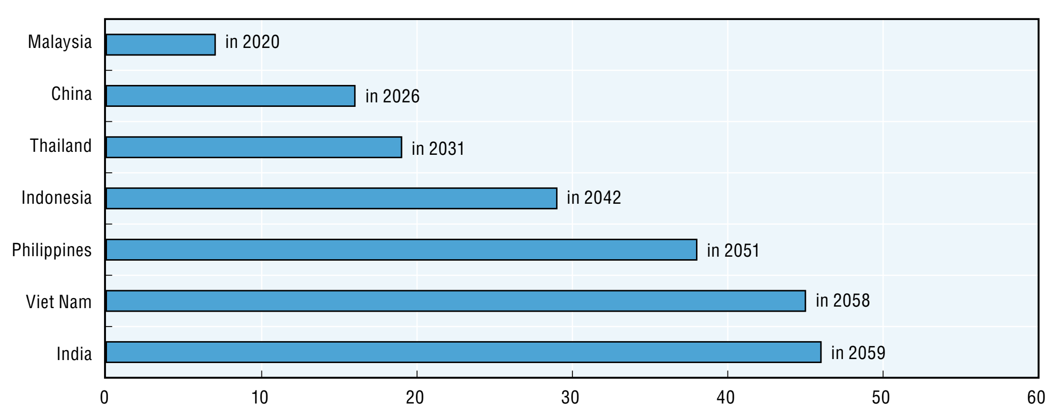
Introduction and overview

Emerging Asia (Southeast Asian countries as well as China and India) have made remarkable progress over the past four decades in raising their income levels, reducing poverty and developing their manufacturing and export sectors. Countries such as China, India, Indonesia, the Philippines, Thailand and Viet Nam are now within the middle income group of countries as defined by the World Bank, with Malaysia approaching the upper end of that range. All these countries can aspire to join Japan, Korea, Chinese Taipei and Singapore in the ranks of high income, advanced, economies within the next several decades provided they can continue to sustain rapid growth and development at a pace comparable to (if not quite as great as) what they have until now.

The speed at which these Emerging Asian countries will be able to rise into the ranks of the advanced economies depends on their current state of development and their other economic conditions. According to “best scenario” simulations of the OECD Development Centre based on historical growth trends, Malaysia could reach the high income group (defined by gross national income (GNI) per capita above USD 12 000) in eight years. The next countries, China and Thailand, could reach this group within 20 years. Indonesia and the Philippines, whose growth has been on average somewhat slower, are likely to take considerably longer, between 30 and 40 years, if these trends continue. Viet Nam, which only recently joined the lower middle-income group, may need around 45 years to reach the high-income group (Figure 3.1).

Figure 3.1. **"Best scenario” simulation of estimated time required to become high-income countries for middle-income countries in Emerging Asia**

Years



Note: Based on World Bank’s criterion for classifying economies, high income countries are defined as having GNI per capita above USD 12 000 in 2013. Growth, CPI and exchange rate prospects in this simulation are in line with MPF-2014. Population projections are based on UN data.

Source: OECD Development Centre estimate.

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Historical experiences have shown, however, that sustaining development beyond the middle-income range is not assured. Many countries have grown rapidly in their initial stages of development only to have growth falter at a later stage and fail to progress much further. The reasons behind this “middle-income trap” are varied and still under debate (Box 3.1) but it underscores the fact that the challenges of sustaining development become more difficult and complex as development progresses.

In most developing countries, growth initially has been driven by the reallocation of labour from low productivity agriculture into higher productivity manufacturing, rapid accumulation of capital from an initially low base, and adoption of existing technologies. In Asia, these processes were reinforced by the development of labour-intensive and low-technology manufacturing sectors for export, based on abundant low wage labour. Institutions such as the financial system and monetary and fiscal policy capacities are typically relatively unsophisticated in the early stage compared to more advanced economies but their limits pose little constraint on development given the relatively simple structure of the economy.

The processes that drive development in the initial stage are self-limiting. The availability of labour from low productivity agriculture diminishes and the supply of existing technologies that can be introduced into the developing economy begins to run out. The growth in the capital stock that can be supported by a given amount of savings declines as its level rises. As cheap labour becomes less abundant, labour costs begin to rise, eroding the international competitiveness of labour intensive manufacturing sectors. These changes occur gradually but historical experiences indicate that they are well along by the time countries rise into the middle- income range (see, e.g. Gill and Kharas, 2007).

Continued rapid growth and development requires in the first instance a fundamental shift away from "intrinsic" growth based mainly on factor accumulation toward "extrinsic" growth based on increases in productivity driven by improvements in the quality of human and physical capital and in the organisation of production and related business activities (total factor productivity, or TFP). The achievement of this transformation requires extensive changes at the micro-economic level industrial structure, in labour skills and business know-how. However, successful transformation and the broader objective of sustained rapid growth also depend critically on macroeconomic and financial stability, which are essential to providing a conducive environment for business development and investment and to avoid prolonged interruptions to growth and setbacks to development.[1] Many of the initially fast-growing countries that have failed to achieve high income status have undergone prolonged and/ or periodic bouts of macroeconomic or financial instability.

Productivity-led growth and macroeconomic and financial stability only define what needs to be achieved. Whether they are achieved, or how well, depends on the degree to which key requirements are met, which in turn depends on the quality of the *institutions* – the government and non-government entities and arrangements shaping economic decisions – that support them. Attainment of extrinsic growth requires shifting of industrial structures toward higher value-added and higher technology sectors ("moving up the value chain"), supported by human capital accumulation, innovation, and infrastructure. These in turn depend upon the effectiveness of education and training institutions in providing the mix of skills needed by the labour force, on the quality of university and other research facilities, and on the capabilities of financial institutions and markets to provide infrastructure financing. Macroeconomic and financial stability depend on effective tools to manage the changing risks encountered as development proceeds. Well developed financial systems are essential to ensuring that resources are allocated to those activities that contribute most to economic efficiency and growth. Thus institutions provide the conditions and tools that largely determine whether the requirements for sustained rapid development are achieved.

Box 3.1. **What is the middle-income trap?**

Since the end of the Second World War, a large number of low-income countries have succeeded in escaping the poverty trap and joined the ranks of a broad group of middle-income countries. But only a few, notably Japan, Korea, Chinese Taipei and Singapore in Asia, Israel in the Middle East, and Ireland in Europe, have sustained their development progress and transformed themselves into high-income countries.

In recent years, scholarly and policy attention has turned to explaining how and why most middle-income countries have failed to make the transition. This failure has been called the "middle-income-trap" (Gill and Kharas, 2007). It refers to a developmental stage characterised by a slowdown in growth due to an inability to move up the value chain, away from factor-driven, export-dependent growth and into new innovation-driven industries.

The Gill and Kharas paper has spawned a lively controversy on the concept, causes and consequences of the middle-income trap (MIT) puzzle. Several studies (Agénor, Canuto and Jelenic, 2012; Canuto, 2011; Eichengreen, Park and Shin, 2012) suggest the trap arises from a Lewis-type development process. A low-income country makes rapid economic gains in the initial stage of development as labour moves from low-productivity sectors like agriculture to higher-productivity labour-intensive industries. In addition, expanded access to technologies allows it to reduce huge inefficiencies that had held the economy back. However, productivity gains from sector shifts and technology catch-up are eventually exhausted. Wages rise, undercutting the country's competitiveness in labour-intensive sectors but innovation does not take root, preventing the economy's evolution into new higher-value activities. Some evidence suggests that developing countries become vulnerable to the growth slowdowns characteristic of the MIT at two stages: one at around income per capita of USD 10-11 thousand and again in the region of USD 15-16 thousand (at purchasing power parity exchange rates and 2005 prices).

Some observers have questioned whether the growth slowdowns associated with the MIT can be viewed as a "trap" in any meaningful sense. They argue that protracted growth slowdowns can and have occurred at various levels of per-capita income and reflect the difficulties of sustaining development (Jiang, 2011). However, whether termed a "trap" or something else, the fact that so many middle-income countries have found it difficult to sustain their development progress points to the overriding challenge now facing a large number of countries that have eliminated widespread poverty in continuing to raise living standards and transformed themselves into advanced economies with strong innovation engines.

Note: In this Outlook, we define the "middle-income trap" as a structural transformation phenomenon where economies require a range of structural reforms in the process of changing from a model of "intrinsic" growth based mainly on factor accumulation to a model of "extrinsic" or productivity-led growth driven by improvements in the quality of human and physical capital and in the organisation of production and related business activities. This transformation is usually needed in economies that are categorised in the middle-income group.

The experiences of the Asian countries that have been successful in achieving the conditions for rising into the high income ranks – Japan, Korea and Singapore – provide some useful insights for the Emerging Asia as they seek to join them. Notably they highlight the importance of capable and efficient government agencies with clear strategic vision in formulating and implementing economic policies and the critical importance of adapting to, and not suppressing, new competitive challenges. However the developing Emerging Asia countries are now facing somewhat different challenges – for example a more open and competitive international trade and investment environment and a growing importance of technology and innovation in determining competitiveness – that will need to be taken into account in their development strategies.

The remainder of this chapter examines several of the key policy challenges facing the aspiring Emerging Asian economies in achieving the transformations needed for sustained growth beyond the middle-income trap. The focus is on China and the five middle-income ASEAN countries (Indonesia, Malaysia, the Philippines, Thailand and Viet Nam). These countries face common challenges but their emphasis differs according to their state of development, their comparative advantages, and their historical legacies.

The next section examines the microeconomic changes in economic and industrial structure that will be needed to sustain more extrinsic, higher productivity growth that meets the changing needs of the population. This is followed by a discussion of key institutions that need to be strengthened for achievement of this transformation, notably institutions to better support human capital development and to provide a more efficient and competitive environment for business development. Section 4 then discusses the challenges of strengthening the financial system so that it can allocate resources efficiently in rapidly changing economies while maintaining financial stability. Section 5 concludes the discussion with a consideration of key macroeconomic challenges the countries will face and their implications for macroeconomic policy.

Overall, the discussion in this chapter emphasises two key messages.

- The first is that further development of **institutional capacities** needs to be central to development strategies of the middle-income Emerging Asia countries as they enter their next stage of development.

- The second is that the growing **regional integration** among the Emerging Asia countries and with the broader Asian region can be a major asset in their efforts to rise into the high income ranks. The on-going efforts to achieve this integration thus have a potentially very high payoff.

Changing economic structures to achieve productivity-led growth

It is widely acknowledged that Emerging Asia developing countries will need to alter their development paradigm toward growth driven less on the demand side by exports and more on the supply side by productivity increases. As discussed further below, there have been significant differences in productivity performances among the Emerging Asian countries. Improvement in the performances where they have lagged and the sustaining of extrinsic productivity-led growth in the future will require significant changes in industrial structure – including services as well as manufacturing – with more emphasis on meeting domestic demand and a shift toward higher productivity sectors that are more dependent on innovation and highly skilled workers ("moving up the value-chain").

Structural changes, such as rising labour costs, along with changes in the international environment, are likely to have significant effects on the regional production chains ("factory Asia") that have underpinned the region's development. These changes have three important implications for the future direction of the countries' industrial structures – including services as well as manufacturing – and the policies that will be needed to support it.

- Manufacturing and regional production chains will remain important but they will be increasingly oriented toward meeting demands within the Emerging Asia region and other Asian countries. Manufacturing structures will need to shift toward higher value-added and technology intensive sectors while labour intensive activities are shifted toward lower wage countries, both within and outside the region.

- The services sectors will be increasingly important, both as a source of employment and as support for the further development of more sophisticated manufacturing activities. As with manufacturing, the structure of the services sectors will need to shift toward more technology intensive "modern" services such as financial services and ICT.

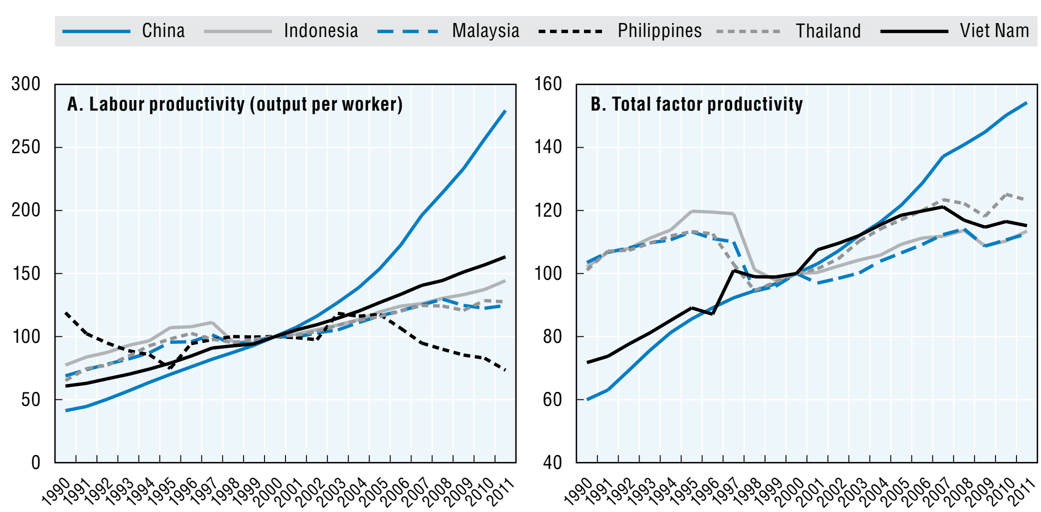
The specific implications of these changes will differ among the six countries, with those furthest along in their development, notably Malaysia, facing somewhat different challenges and policy imperatives than those less far along, such as Viet Nam.

Productivity growth has been uneven across countries in the region

Historical trends underscore a significant divergence among China and the middle-income developing countries in ASEAN in their productivity growth. According to figures compiled by the Asian Productivity Organization (APO), labour productivity in China (total output per worker) has risen nearly seven-fold since 1990 and by almost three-fold since 2000. The increase in (estimated) total factor productivity has been less rapid but no less impressive (Figure 3.2). In contrast, productivity increases have been noticeably more modest in the five middle-income developing ASEAN countries and at best lacklustre in some. Labour productivity in the Philippines has fallen since 2000 and is now below its level in the early 1990s. Labour productivity gains since 2000 have been modest in Indonesia, Malaysia and Thailand although somewhat greater for Viet Nam.

Figure 3.2. **Productivity trends in Emerging Asia, 1990-2011**

Index, 2000=100



Source: Asian Productivity Organization (APO) database.

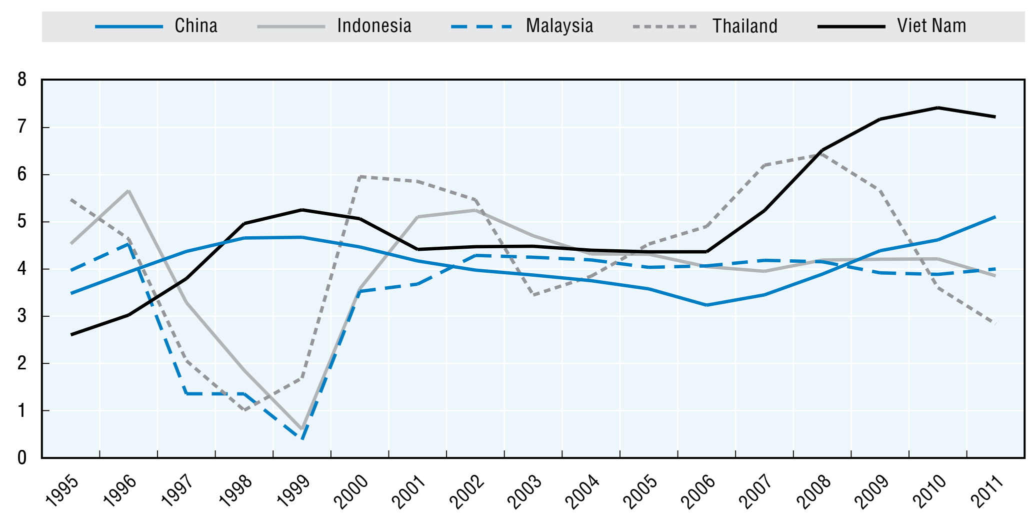
StatLink http://dx.doi.org/10.1787/888932938840

Incremental capital-output ratios (ICORs) provide another indication of comparative productivity among the countries and their trends over time. The ICOR is the ratio of capital investment to real gross domestic product (GDP) growth and equals the inverse of the marginal product of capital. The higher the ICOR, the more additional capital it takes to produce a unit of GDP, that is the lower the marginal productivity of capital. Generally, ICOR tend to be comparatively low in early stages of development, when the aggregate capital stock is low and higher at later stages, when the capital stock is higher and additional investment produces less of an increase in output.

Examination of trends in estimated ICORs suggests that there has been an increase in capital productivity in generating output in Thailand since 2000, as well as relative to the mid-1990s, before the 1997-98 Asian crisis (Figure 3.3). The ICORs of Malaysia and Indonesia show little net change since 1995, while those of Viet Nam and (more mildly) China, have risen, pointing to some decline in the productivity of capital accumulation in generating increased output.

Figure 3.3. **Incremental capital-output ratio (ICOR) in Emerging Asia, 1995-2011**

Percentage



Source: OECD Development Centre`s calculation based on World Bank, *World Development Indicators*.

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Overall, the data suggest that China has been having more success in sustaining rapid productivity-led growth than the middle-income ASEAN countries, as well as India (Box 3.2). China's comparative success is consistent with the high priority it has been giving to industrial restructuring and upgrading in its development plans. The 10th five-year plan (5YP, 2001-2005) strongly emphasised the importance of productivity. It also promoted industrial structure upgrading, efficient allocation and use of resources, and the spread of the use of information technologies and modern management methods in state-owned enterprises. In the 11th 5YP, the emphasis was on implementing the scientific development concept, which required a shift to economic growth based more on increases in efficiency and knowledge, rather than resource inputs. Accordingly, one policy orientation of the 11th 5YP was toward promoting development by optimising industrial structure.

The apparently less favourable productivity performances in Indonesia, particularly that of TFP, have been blamed on factors like relatively low foreign direct investment, lack of technological development and poor governance (UNIDO, 2005). Current major micro level challenges that affect productivity growth in Indonesia include high transportation and logistics costs because of poor infrastructure. This prevents existing manufacturers from expanding and enjoying economies of scale (World Bank, 2012a).

Box 3.2. Is India's growth changing in character?

A number of studies suggest that India's labour productivity growth in manufacturing over the past two decades was mainly due to capital deepening rather than TFP growth (OECD, 2009). This may be changing, however. Virmani (2006) found that, for the industrial sector as a whole, TFP may have increased from 2002. And the data shown here suggest that TFP did grow during the 2003-07 period. This TFP growth could imply that the opening of the economy and higher competition is finally bearing fruit. In fact, the competitive environment created by the reduction of external barriers to trade has been credited with TFP growth. However, TFP growth in India seems to have decelerated and plateaued in 2007-08. One likely explanation is that innovative activities in India face barriers that include the shortage of skilled labour and a lack of effective collaboration with the research and development (R&D) institutions.

(See Government of India, *Eleventh Five Year Development Plan*)

The productivity data alone do not themselves suggest that any of the middle-income ASEAN countries are at any imminent risk of falling into a middle-income trap, particularly given their comparatively strong growth performances since the 2007-08 Global Financial Crisis (GFC). However, they do suggest that a number of the countries, particularly Indonesia and the Philippines, have been having some difficulty sustaining the productivity growth they will need to sustain a rise into the ranks of the high income countries. The relatively high and rising ICOR for Viet Nam suggests that it may need to improve its TFP growth performance to sustain rapid growth in GDP. Furthermore, although China has experienced more rapid productivity growth in recent years, the rise in its ICOR suggests it will need to sustain, and may even need to improve on that performance to make up for the declining productivity of raw capital accumulation.

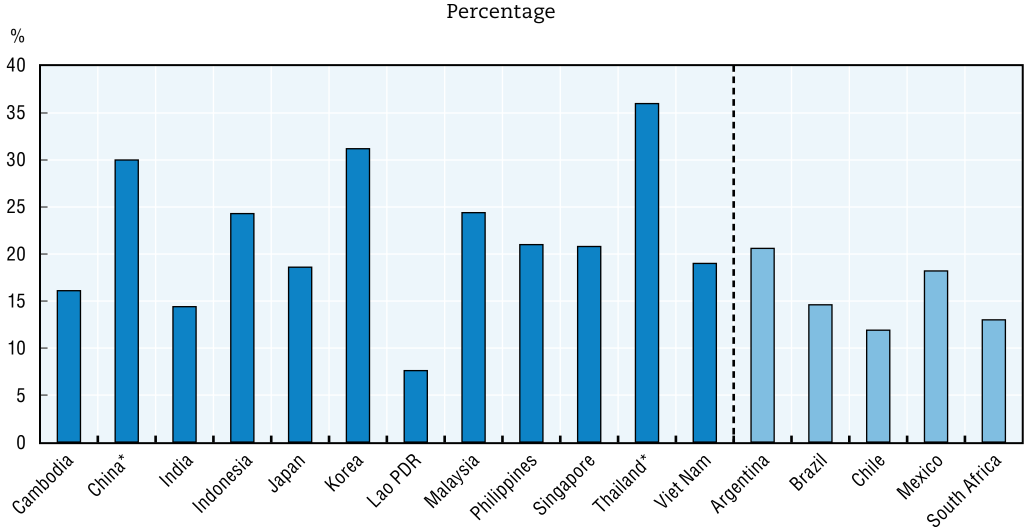
Factory Asia has been a major driver of development in Emerging Asia

Emerging Asia developing countries are often characterised as part of a "factory Asia" devoted to manufacturing for exporting, in large part to advanced economies in Asia, North America and Europe. This is accurate in the sense that compared to developing countries in other regions, Emerging Asia countries are relatively specialised in manufacturing (Figure 3.4). The manufacturing share of GDP in the middle-income countries (excluding less developing countries) ranges from about 20% of GDP in Viet Nam and the Philippines to about 30% in China and nearly 36% in Thailand. These shares have been fairly stable over the past decade, except for Thailand where the share has continued to rise. It is also true that global value chains in the region play a key role in manufacturing in these countries: participation in such chains by the Emerging Asia countries including Hong Kong, China and Chinese Taipei is highest among developing country regions and second only to the European Union among the major world regions.[2]

However, the overall factory Asia characterisation obscures two important aspects: much of the final manufacturing output of the Emerging Asia countries goes to domestic users and users within the region; and there are important differences in the specialisation of the countries within the group and in their participation in regional supply chains. These facts can be illustrated by examining five major categories of manufacturing differentiated by their dependence on technology and innovation, labour intensiveness, the importance of proximity to natural resources or final customers, and their tradeability (ADB, 2013a, McKinsey Global Institute, 2012) (Table 3.1).

Figure 3.4. **Share of manufacturing sector in total GDP in Asia and other selected countries, 2011**

Percentage



Note: *Figures for China and Thailand refer to 2010.

Source: World Bank, *World Development Indicators*.

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Table 3.1. **Classification of manufacturing sectors**

	Production requirements	Market competition factors	Tradeability	Products
Global innovation for local markets	High R&D	Innovation and quality driven; production location geared toward serving nearby customers	High trade intensity; divisible production	Chemicals and pharmaceuticals; transport equipment; machinery and electrical appliances
Regional processing	High local content and proximity to raw materials; automated production with low R&D;	Proximity to final demand	Low tradeability; complex and costly logistics	Rubber and plastics; fabricated metals; food and beverages; printing and publishing
Energy and resource intensive	Proximity to primary inputs	Mainly intermediate inputs to other sectors; competition largely based on price	Low tradeability	Wood products; paper and pulp; basic metals and minerals-based products; refined petroleum, coke, and nuclear products
Global technologies/ innovators	High R&D intensity	R&D is key; little/no need for production to be close to final buyers	Highly tradeable; divisible production	Computers and office machinery; semiconductors and electronics; medical, optical, and other precision equipment
Labour intensive tradeables	Highly labour intensive	Intense price competition; low need for production proximity to final customers	Highly tradeable; some production divisibility	Textiles, apparel, leather; furniture, jewellery, toys, and other light manufactured goods

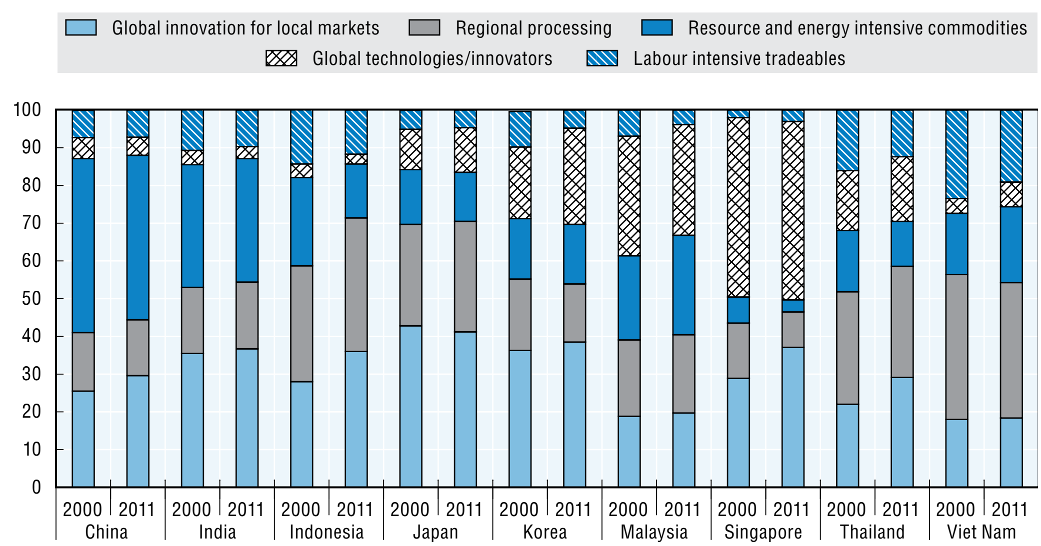
Note: Production divisibility refers to the scope for dividing production among global/regional value chains.

Sources: McKinsey Global Institute (2012), *Manufacturing the Future: The Next Era of Global Growth and Innovation*, November 2012; and ADB (2013), *Beyond Factory Asia: Fuelling Growth in a Changing World*, Asian Development Bank, Mandaluyong City.

Resource or raw materials intensive products along with products that are mostly processed domestically or regionally ("regional processing products" – see McKinsey Global Institute, 2012) together account for more than half of total manufacturing value-added in the region for China, Indonesia, Malaysia and Viet Nam, and nearly 40% for Thailand (Figure 3.5). The importance of these categories reflects the substantial (although differing) endowments of natural resources in these countries. Competitiveness in these sectors generally depends importantly on proximity to resource and raw materials and to final markets and they are comparatively less intensive in their need for research and development. Transport costs are relatively high, which limits the degree to which they can be traded internationally. A third major category of manufacturing goods – consisting of chemicals and pharmaceuticals, transport equipment, and machinery and electrical appliances – and accounting for between about 20% (Malaysia and Viet Nam) and 30% (China, Indonesia and Thailand) of total manufacturing value-added – are more tradeable and more intensive in the use of R&D but tend to be located near their final domestic or regional customers ("global innovation for local markets").

Figure 3.5. **Sector share of total manufacturing value-added in Asia, 2000 and 2011 (or closest year available)**

Percentage



Notes: Data for China refer to 2000 and 2010. Data for India refer to 2004 and 2010.
Data for Indonesia refer to 2001 and 2010. Data for Japan refer to 2002 and 2009.
Data for Korea refer to 2001 and 2011. Data for Malaysia refer to 2000 and 2010.
Data for Singapore refer to 2000 and 2010. Data for Thailand refer to 2000 and 2006.
Data for Viet Nam refer to 2000 and 2010.

Source: Staff calculations based on United Nations Industrial Development Organization (UNIDO), *Industrial Statistics Database*.

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The classic labour intensive products, such as textiles and clothing, furniture and toys, actually make up the smallest share of overall manufacturing output in the region, although they are in some cases more important in the countries' exports. These products are heavily traded globally because of their relatively low transport costs relative to the value of output and are comparatively low in their demand for R&D and innovation.

Finally, semi-conductors, computers, and office equipment, and medical, optical and other precision instruments (globally innovative products) are also highly tradeable and demanding of R&D but unintensive in their use of labour. These products presently account for less than 5% of total manufacturing output, well below that in the more advanced economies in Asia, particularly Korea where the share is nearly 25%.

The composition of exports of the Emerging Asia countries is noticeably different than that of their total manufacturing and has undergone significant changes over the past 20 years (Table 3.2). Except in Viet Nam, where they still account for one-third, the share of textiles and apparel (labour intensive group) in overall merchandise exports has fallen considerably since 1995, from 34% to 17% for China and to around 5% for Thailand and the Philippines. This decline has been accompanied by a rise in the importance of consumer electronic and ICT products for the region as a whole, especially in China and the Philippines, where they now make up more than half of total exports. These products now make up more than half of total exports in the Philippines and Malaysia and nearly one-third in China and Thailand. Electronic products are still only a small fraction of exports in Indonesia and Viet Nam, while exports of products from extractive activities are comparatively more important.

Participation by the Emerging Asian countries in regional value chains has increased as the share of electronics goods has increased. Production of these goods and of automobiles (which fall mainly into the global innovation for local markets and global innovators groups) is comparatively easily divided among different locations, due in part to relatively low costs of transporting components (UNCTAD, 2013).

Table 3.2. **Leading export sectors in Emerging Asia and other selected economies, 1995 and 2006**

Percentage of total exports

Economy	ISIC Rev.3	Sector	1995	2006
Australia	10-14	Mining and quarrying	28	43
	15-16	Food products, beverages and tobacco	15	12
	27	Basic metals	22	18
China	17-19	Textiles, textile products, leather and footwear	34	17
	30	Office, accounting and computing machinery	4	15
	32	Radio, television and communication equipment	9	19
	36-37	Manufacturing n.e.c; recycling	12	9
India	17-19	Textiles, textile products, leather and footwear	35	21
	23	Coke, refined petroleum products and nuclear fuel	2	9
	24	Chemicals and chemical products	7	12
	36-37	Manufacturing n.e.c; recycling	20	15
Indonesia	10-14	Mining and quarrying	26	27
	15-16	Food products, beverages and tobacco	7	7
	17-19	Textiles, textile products, leather and footwear	18	10
	20	Wood and products of wood and cork	13	3
Japan	24	Chemicals and chemical products	9	10
	29	Machinery and equipment, n.e.c	16	16
	32	Radio, television and communication equipment	19	15
	34	Motor vehicles, trailers and semi-trailers	17	19
Korea	17-19	Textiles, textile products, leather and footwear	16	3
	24	Chemicals and chemical products	9	10
	32	Radio, television and communication equipment	27	31
	34	Motor vehicles, trailers and semi-trailers	6	10
Malaysia	10-14	Mining and quarrying	5	8
	30	Office, accounting and computing machinery	12	19
	32	Radio, television and communication equipment	38	36
New Zealand	01-05	Agriculture, hunting, forestry and fishing	15	12
	10-14	Mining and quarrying	2	3
	15-16	Food products, beverages and tobacco	38	44
Philippines	15-16	Food products, beverages and tobacco	10	3
	17-19	Textiles, textile products, leather and footwear	15	5
	30	Office, accounting and computing machinery	10	15
	32	Radio, television and communication equipment	30	49
Singapore	23	Coke, refined petroleum products and nuclear fuel	11	19
	24	Chemicals and chemical products	6	17
	30	Office, accounting and computing machinery	32	15
	32	Radio, television and communication equipment	26	26
Chinese Taipei	17-19	Textiles, textile products, leather and footwear	13	4
	24	Chemicals and chemical products	9	11
	30	Office, accounting and computing machinery	16	8
	32	Radio, television and communication equipment	15	37
Thailand	15-16	Food products, beverages and tobacco	17	9
	17-19	Textiles, textile products, leather and footwear	12	6
	30	Office, accounting and computing machinery	16	14
	32	Radio, television and communication equipment	14	17
Viet Nam	01-05	Agriculture, hunting, forestry and fishing	19	7
	10-14	Mining and quarrying	21	23
	15-16	Food products, beverages and tobacco	17	10
	17-19	Textiles, textile products, leather and footwear	32	31
World	01-05	Agriculture, hunting, forestry and fishing	4	2
	10-14	Mining and quarrying	6	11
	15-16	Food products, beverages and tobacco	6	5
	17-19	Textiles, textile products, leather and footwear	8	6
	23-26	Chemical, rubber, plastics, fuel, and other non-mineral	16	18
	27-28	Basic metals and fabricated metal products	6	6
	29	Machinery and equipment, n.e.c	9	8
	30	Office, accounting and computing machinery	5	5
	31	Electrical machinery	4	4
	32	Radio, television and communication equipment	8	10
	33	Medical, precision and optical instruments	3	3
	34-35	Transport equipment	12	11
	20-22, 36-37	Other manufacturing	7	6

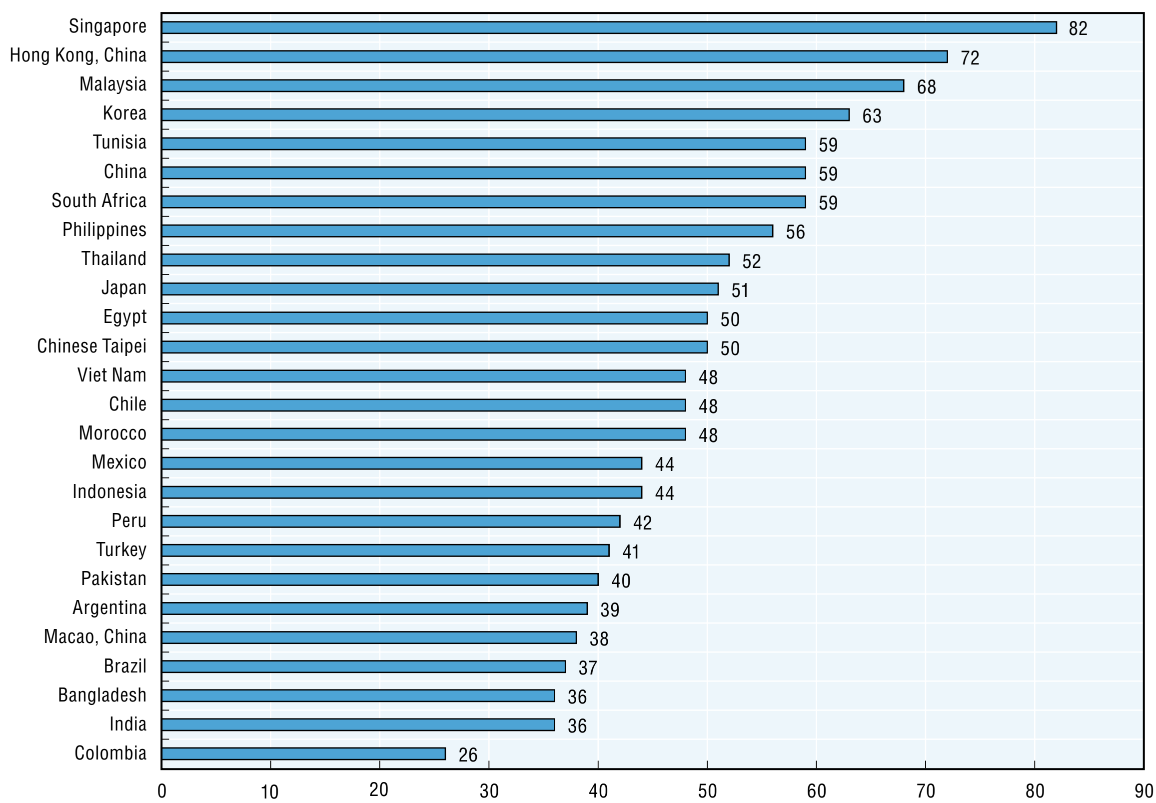
Note: Export shares were calculated from import-based bilateral trade statistics.

Source: OECD Bilateral Trade Database, March 2010.

The degree of participation in the regional value chains and its character vary among the countries of the Emerging Asia. Malaysia, together with Hong Kong, China and Singapore, are the most extensive participants in global value chains among all (non-oil developing) countries while China, Thailand and the Philippines are in the top ten (Figure 3.6). All those countries participate heavily both "downstream" in the production chains through their imports of parts and components and "upstream" in their exports of intermediate goods which are used at a later stage of processing and assembly. Compared to the other five, Malaysia's activities in the chains tend to be in higher value-added segments. Indonesia and Viet Nam also participate in the regional value chains, although the latter's participation is focused on providing petroleum and other extractive products, while Viet Nam's participation is concentrated in textiles and apparel and other labour intensive products.[3]

Figure 3.6. **Global value chain (GVC) participation rate of Emerging Asia and other selected economies, 2010**

Percentage



Source: United Nations Conference on Trade and Development (UNCTAD), *World Investment Report 2013*.

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China plays a critical role in these regional value chains, which have been transformed by its rise (OECD, 2010a; ADB, 2013a; WEF, 2012a). China is the focal point of the chains as the leading platform for assembly of finished goods, particularly of consumer electronics, other electrical equipment, ICT products and in automobiles for sale in the growing local market. China is the leading destination for intermediate goods exports of electronic goods from the ASEAN countries, which are typically produced by importing higher technology components from advanced economies, particularly Japan and Korea. This "China-centred" pattern is reflected in the increasing importance of inter-Asian trade in the exports of ASEAN countries, while the share of intra-ASEAN trade has changed little over the past two decades (OECD, 2010a).

Regional production chains are facing some major challenges

Participation in the regional production chains has been a key factor in the success of Emerging Asia countries in developing their export sectors but in recent years some limitations have become apparent. Activities are concentrated in lower value and lower technology portions of the production chain; although Malaysia and China have had more success in expanding into more technology intensive areas (ADB, 2013a). Development of product brands for export is in a very early stage, and mainly in China, but essential to establishing competitiveness in higher end consumer and other products. The import content of exports has risen since 1995 in most of the five countries, in both low and high technology activities (OECD, 2010a), a trend consistent with the growth of regional production chains (Table 3.3). However the trend also suggests that there has been only limited strengthening of links between export activities and the domestic economy.[4]

Table 3.3. **Imported input share of exports in Emerging Asia and other selected economies, by industry group, 1995 and 2005**

Percentage

	Total		Manufacturing				Services	
			Higher technology		Lower technology			
	1995	2005	1995	2005	1995	2005	1995	2005
Australia	14	14	28	25	16	20	10	11
China	16	25	22	34	15	20	10	14
India	10	13	16	21	12	18	8	6
Indonesia	15	18	40	36	20	21	9	13
Japan	8	15	9	16	12	22	4	7
Korea	30	39	32	41	34	42	19	23
Malaysia	39	52	49	65	40	45	13	31
New Zealand	18	18	27	26	20	19	15	14
Philippines	32	42	56	60	45	35	17	16
Singapore	56	59	69	71	68	78	24	30
Chinese Taipei	35	48	45	55	34	53	14	19
Thailand	33	50	57	67	29	47	13	22

Notes: Higher technology-intensive manufacturing group is defined as ISIC Rev.3 24, 29-35; lower technology-intensive manufacturing group is defined as ISIC Rev.3 15-23, 25-28, 36-37; services sector is ISIC Rev.3 50-95.

Sources: OECD, Input-Output Database, March 2010; IDE-JETRO, Asian International Input-Output Database, 2005; OECD, Bilateral Trade Database, March 2010; OECD, Trade in Services, January 2010.

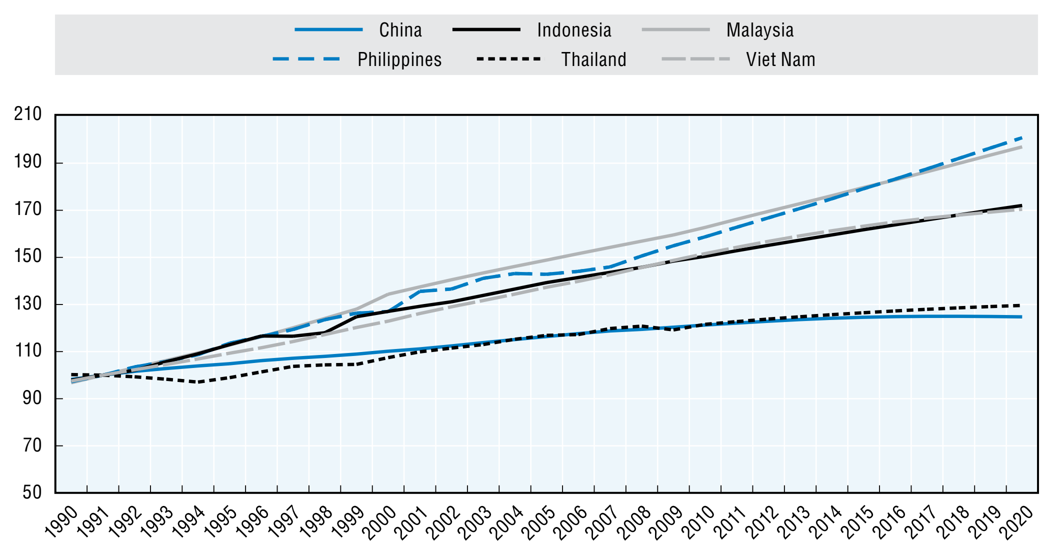
In coming years, manufacturing industries in Emerging Asia will need to adapt to several important changes in the international environment (See ADB, 2013a; WEF, 2012a). Growth in aggregate demand of OECD economies is likely to be slower, at least over the medium term, than its average before the 2007 crisis, leading to slower growth in the final demand for the exports of ASEAN and other Asian developing economies to these more advanced economies. There are also signs, although only in a limited number of sectors so far, that technology and other factors are leading to some return of earlier out-sourced manufacturing production back to some OECD countries (ADB, 2013a; McKinsey Global Institute, 2012).

Natural disasters in Asia, exchange rate fluctuations and some other factors have complicated the management and raised uncertainties of extended production chains, which could in some areas lead to greater concentration nearer to the source of final demand. Technological changes, in particular the increased importance of software and the use of robotics have been altering production processes, potentially increasing the need for innovation and skilled labour and reducing the demand for unskilled labour.

While these factors overall may tend to inhibit the growth of Emerging Asia manufacturing, trends within the region are pulling in both directions. On one side, wages in the region, particularly in China, are rising more rapidly than in advanced economies, and in most developing countries outside the region. This has led to rising labour costs that have been eroding competitiveness in labour intensive activities relative to lower wage developing countries, both within the region (notably Viet Nam) and elsewhere in Asia (notably Bangladesh) and in other regions. Pressures on labour supplies and wages are likely to be further increased by slowing labour force growth in some countries, particularly China and Malaysia where the labour force is approaching a peak and is projected to begin declining within the next decade (Figure 3.7). Demand for skilled workers will grow more rapidly than overall employment and could lead to shortages in countries unless the capacities to supply highly educated and skilled workers are strengthened, particularly in countries, such as Indonesia and Thailand which have already been encountering difficulties in keeping up with the demand for skilled workers (OECD, 2012 and 2013a).

Figure 3.7. **Labour force projection in Emerging Asia, 1990-2020**

Index, 1991=100



Notes: Labour force refers to population aged 15 years old and over. Figures between 1990 and 2010 are estimates. Figures from 2011 are projections.

Source: International Labour Organization (ILO), *LABORSTA database.*

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Against these headwinds, two important trends are occurring that should favour manufacturing and "factory Asia" in the Emerging Asia region. First, the more rapid growth in incomes in the region relative to the world as a whole and the accompanying growth of the middle class have been and are likely to continue to shift the locus of world final demand for manufactured products toward the region (see OECD, 2012). This shift in demand is likely to be particularly pronounced for consumer electronics and other products most in demand by middle class buyers. For example, China has become the largest, and one of the most rapidly growing, markets for automobiles. Demand for automobiles is growing rapidly in the other middle-income countries in the region and could, before much longer, also become significant in the lower income CLMV countries (Cambodia, Lao PDR Myanmar, Viet Nam). Emerging Asia countries have significant advantages in their proximity to markets and their existing regional value chains in meeting this increasing demand.

Second, the process of ASEAN regional integration, and toward greater integration with China, India, and other Asian countries, has considerable potential to increase the scope for a more efficient division of production among the countries and wider access to markets. As discussed further below, liberalisation of trade in services, to achieve greater integration of services activities within the region, would also help greatly to enhance the competitiveness of the region's manufacturing and regional value chains.

Manufacturing will remain very important but its characteristics will need to change

Overall, manufacturing in the Emerging Asia countries, and the factory Asia model, are likely to remain very important. Indeed, it is quite possible that the region will remain as competitive and prominent in world manufacturing as it is now. As has been the case in more advanced economies, manufacturing will be the crucial driver of innovation and productivity increases in the Emerging Asia countries.

However, the characteristics of manufacturing in the region are likely to change significantly in coming years. Manufacturing is likely to become increasingly oriented toward meeting final demand within the region and elsewhere in Asia. There is likely to be a significant reallocation of production activities within the region. Countries furthest along in their development, particularly China, Malaysia and Thailand will need to move increasingly away from lower technology and labour intensive component processing and assembly operations toward higher technology and higher-productivity segments of the value chain, and to improve their capacities to innovate and to develop their own brands in certain areas. These countries will need to continue to manage their gradual loss of competitiveness in labour intensive activities and to ensure that resources thereby released are re-employed in more competitive sectors. Indonesia will also need to move up the value chain as well as strengthen links with regional value chains, although it should be able to continue to benefit from its resource activities and is likely to remain competitive in labour intensive activities somewhat longer than the others. Viet Nam's textile based and other labour intensive industries may well be able to expand for some time as production activities from neighbouring countries that are becoming less competitive in these areas are shifted to that country (as has been happening with China). However, it will need to diversify its export markets and prepare the conditions for moving up the value-chain in coming years.

To successfully manage and take advantage of the forces shaping manufacturing in the Emerging Asia region, countries will need to strengthen and develop effective policies in a range of areas, both to facilitate the transfers of resources and development of the business sector that will be required and to ensure that the necessary human and other capital are available. As discussed further in this chapter and in more detail in the structural notes and in previous editions of this *Outlook*, the following policy areas will need to be given very high priority.

- Development of human capital, including especially the provision of higher quality skills that better meets the needs of the evolving labour market
- Further development of infrastructure, particularly transport and ICT infrastructure, to meet the demands and support the competitiveness of an increasingly technology intensive manufacturing sector.
- Strengthening and in some cases development of innovation capacities, both within businesses and in academia and research institutions, as an essential requirement for success in moving into higher value/productivity sectors.
- Improvement in conditions to accelerate development and diversification of the services sectors, particularly more sophisticated services such as finance and ICT services, that are important to higher technology/productivity manufacturing sectors.
- The overall environment for businesses will need to be strengthened, through regulatory and other reforms, to improve competitiveness and to facilitate exit of less productive firms and entry of and development of the more productive.

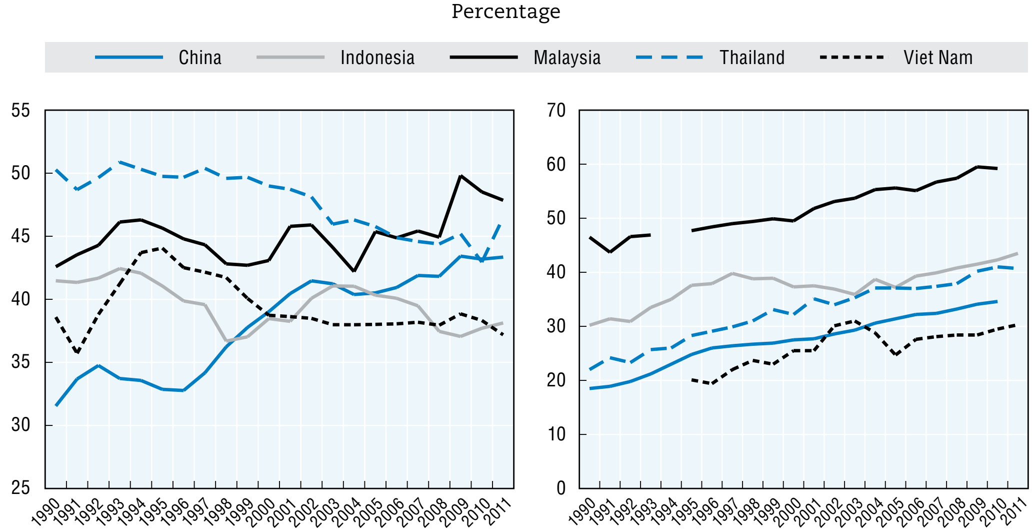
Apart from these efforts at the national level, the various effort at the ASEAN and Emerging Asia regional levels to liberalise trade and promote integration have the potential to greatly increase the prospects for success.

Service sector development needs to be reinvigorated

While manufacturing will continue to be important, further development in the Emerging Asian countries is likely to depend increasingly on the services sector. The services sector's contribution to the economies of the region is already substantial. The aggregate contribution of services activities to GDP ranges from 37% of GDP in Viet Nam to over 45% in Malaysia and Thailand and services account for between 30% of total employment in Viet Nam to nearly 60% in Malaysia (Figure 3.8).

Figure 3.8. **Services sector's share in GDP and employment in Emerging Asia, 1990-2011**

Percentage



Source: World Bank, *World Development Indicators*.

Sources: World Bank, *World Development Indicators* and ADB, *Key Indicators 2012*.

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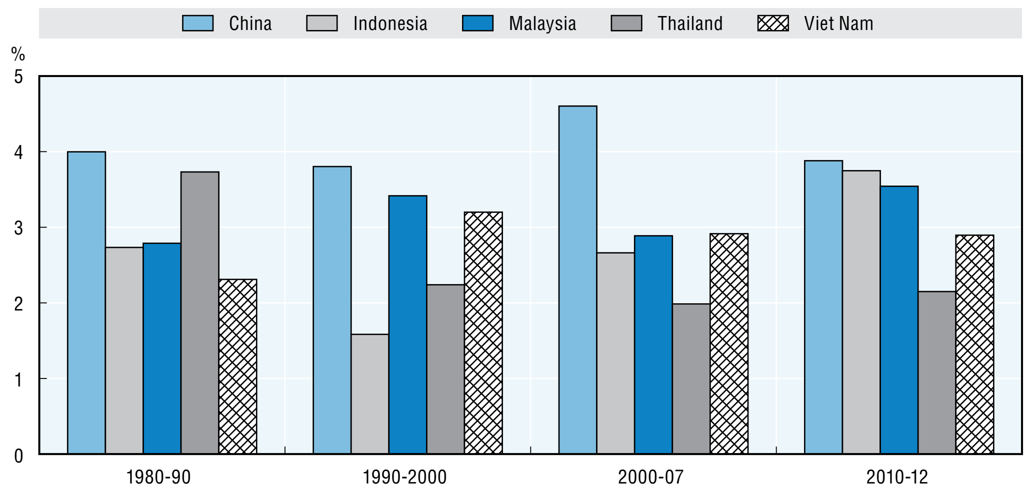
Services have also been making major contributions to GDP growth and to exports. In the seven years prior to the world financial crisis, services accounted for one-third or slightly more of total growth in the five countries, and except in China has sustained its contribution during the recovery from the crisis (Figure 3.9). Services accounted for between 9% and 24% of total exports of the five countries and trade in services amounts to over 25% of GDP in Malaysia and Thailand although much less in China and Indonesia (Figure 3.10).

Figure 3.9. **Services sector's average annual contribution to GDP growth in Emerging Asia, 1980-2012**

Percentage



Source: OECD Development Centre calculations based on CEIC.

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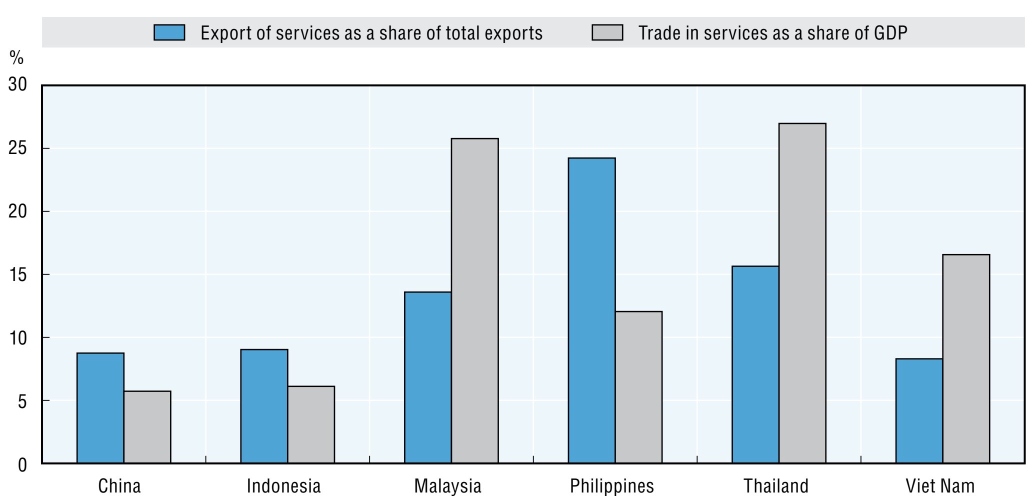
Figure 3.10. **Export of services as a share of total exports and trade in services as a share of GDP in Emerging Asia, 2011**

Percentage



Notes: Export of services as a share of total exports refers to the share of exports of services to total exports of merchandise and services. Trade in services as a share of GDP refers to the share of total trade (i.e. exports and imports) of services to GDP. Services refer to commercial services.

Source: World Trade Organization (WTO).

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Despite these contributions, development of the services sectors in the most of the Emerging Asia region is well behind that of advanced economies. For example, services account for over 70% of GDP in Japan and Singapore, as well as in the United States and Germany. Service sector productivity in developing Emerging Asia countries is on the order of one-fifth the OECD average, a considerably larger productivity gap than that for manufacturing.

Much of the lesser development of services in developing Emerging Asia reflects their lower overall level of development. Service sector size relative to GDP tends to rise with per capita GDP, starting at an early stage of development with the proliferation of lower productivity activities such as retail trade and restaurants, and later (beginning around per capita income of USD 4 000) with the expansion of more sophisticated services such as finance (Eichengreen and Gupta, 2009; see also Noland, Park and Estrada, 2012) However, there is evidence that service sector development in Southeast Asia as well as China has lagged that of developing countries in other regions. The share of the service sector in GDP has fallen since the early 1990s in Thailand, Indonesia and Viet Nam and has been largely unchanged until recently in Malaysia; only in China has the service sector share continued to rise over the past decade (see Figure 3.8).

The composition of the service sector further highlights limitations on its development so far. Wholesale and retail trade, hotels and restaurants, and other traditional services, which typically employ lower wage workers, account for nearly one-third of total service sector value-added in Indonesia, Malaysia, Thailand and the Philippines and nearly one-quarter in China (Table 3.4). Services with typically higher productivity and wages and greater demands for technology ("modern services"), notably ICT, finance, and business services account for about one-fifth of total services in China and Indonesia, and 18% in Thailand, well below the ratios of around 30% recorded in more advanced economies such as Singapore and the United States. Only in Malaysia is the share of modern services more comparable to that of the advanced economies. Furthermore the shares of these modern services have declined considerably since 1990 in China and to a lesser extent Indonesia, although the share has risen in Indonesia.

Table 3.4. **Composition of services sector in Asia, by type, 1990 and 2010**

Percentage share in value-added of total services

	Traditional services		Wholesale and retail trade		Modern services	
	1990	2010	1990	2010	1990	2010
China	70.2	78.3	26.7	24.4	29.8	21.7
India	80.9	79.5	27.8	30.2	19.1	20.5
Indonesia	84.7	79.3	39.4	36.3	15.3	20.7
Japan	77.3	76.3	21.4	16.9	22.7	23.7
Korea	78.3	72.5	27.6	18.6	21.7	27.5
Malaysia	67.9	68.3	29.2	30.9	32.1	31.7
Philippines	77.4	74.8	28.9	31.6	22.6	25.2
Thailand	77.8	82.1	45.6	41.4	22.2	17.9
Singapore	60.8	58.7	24.5	26.1	39.2	41.3

Notes: Modern services comprise finance, business, and ICT services; traditional services comprise all other services.

Source: Noland, M., D. Park and G.B. Estrada (2012), *Developing the Service Sector as Engine of Growth for Asia: An Overview*, ADB Economics Working Paper Series, No. 320, November 2012.

Overall, service sector development in the five countries is well behind that of more advanced economies, and seems to have lagged particularly in Thailand and Indonesia. Malaysia's service sector appears to be further along but will need further development of higher productivity segments.

Further development of services, particularly higher-productivity and higher-technology services, will be critical to the success of Emerging Asian developing countries in becoming advanced economies. Services are a critical support for countries' participation in GVC (WEF, 2012a). Movement up the value-chain in manufacturing will require further development of services, particularly modern services as well as improvements in transport and other infrastructure services. In particular, higher productivity and technology-based manufacturing industries need more sophisticated service sector inputs, such as ICT, than lower-technology industries. This demand is being reinforced by technological changes that have made software increasingly important in production processes. Service sectors themselves are a major and increasing source of product and process innovations and increasing user of research and development.

Services sector development will also be very important to broader development goals of the Emerging Asia countries (Ghani, 2011). The growth of the middle class will continue to increase demands for nearly all types of services, but particularly more sophisticated services in health, education and communications. Development of these services is also critical to reducing poverty and regional disparities in development and promoting connectivity – which are key goals especially in China, Indonesia, the Philippines and Thailand.

Further development of services sectors will also help to achieve greater economic diversity and foster more efficient allocation of resources and reduced vulnerability to economic shocks. In particular, technological changes are increasing the scope for international trade in services. For example, improvements in communications and other capabilities have fostered the off-shoring of customer service centres and back-office activities such as accounting. India and the Philippines rank number one and three respectively in these business processing activities. Other Emerging Asia countries, such as Singapore, have given development of tradeable services such as IT and back-office business functions as high priority. Hotel and other services associated with tourism in the Philippines and Thailand have significant scope for further development, provided the necessary improvements in transport and other supporting infrastructure can be put in place. These examples suggest that there is significant potential for increased trade in services among Emerging Asia countries and with other regions, and for the development of service "production chains" in which countries specialise in different service inputs according to their competitive advantages.

Services sectors are still relatively heavily regulated and trade-restricted

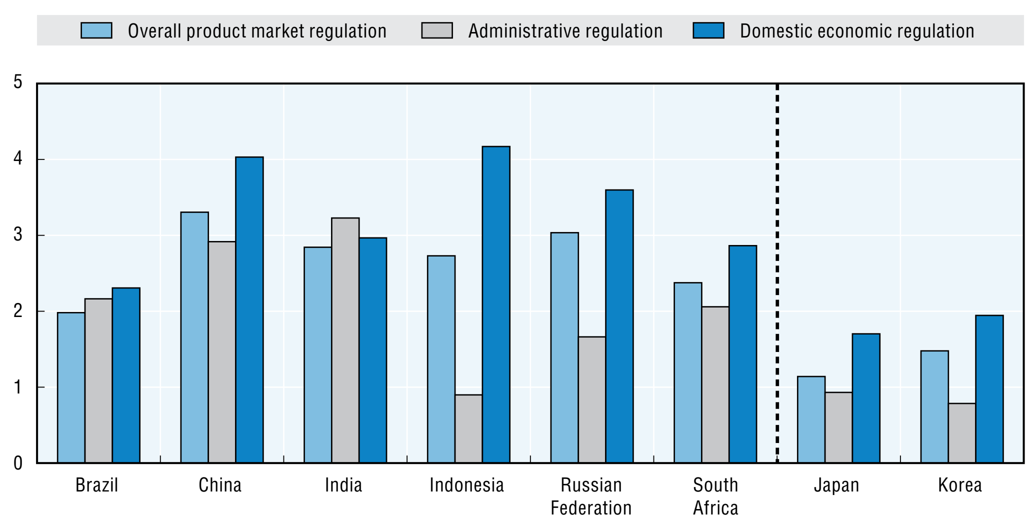
The key to fostering the growth of services activities to meet the needs of an increasingly sophisticated economy and growing middle class is to remove barriers that now limit entry, stifle competition and inhibit growth and trade in services. Partly because services have, until recently, been given relatively lower priority than industry in national development strategies and plans, regulatory, trade, and foreign direct investment (FDI) reforms generally have gone less far in services than in manufacturing.

Transport, health, education, finance and many business services are highly regulated in developing Emerging Asian countries. These regulations include restrictions on entry, particularly for private sector investors, product standards requirements, prudential requirements in finance and some business services such as accounting and other provisions. Although motivated by a range of strategic, prudential, public health and safety, and equity considerations, and they are often necessary, these regulations have the effect of raising costs of entry and on-going business operations and restricting competition. The impediments imposed by formal regulations are very often increased by lack of transparency and inefficiencies in their application, such as fragmentation in administration and excessive time required for compliance.

According to the OECD Product Market Regulation (PMR) indicators – widely used as an indicator of the stringency of regulation – China's and Indonesia's services markets are considerably more restricted than those of more advanced Asian economies, notably Japan and Korea, and the most restrictive among the largest developing countries (BRIICS – Brazil, China, India, Indonesia, Russian Federation and South Africa) (Figure 3.11). Their restrictive rating is substantially attributable to the considerable government direct involvement in the services sectors (including state ownership) and barriers to competition, although China also rates relatively poorly in terms of administrative opacity and costs and barriers to entrepreneurship.

Figure 3.11. **OECD Product Market Regulation (PMR) indicators in BRIICS, Japan and Korea, 2008**

Index scale of 0-6 from least to most restrictive



Notes: The OECD Indicators of Product Market Regulation (PMR) are a comprehensive and internationally comparable set of indicators that measure the degree to which policies promote or inhibit competition in areas of the product market where competition is viable. The OECD PMR indicator covers general regulatory issues in fields such as public control and price controls, legal and administrative barriers to entry, and barriers to trade and investment. The indicators are based on qualitative information that is coded by assigning a numerical value to each of the possible responses to a given question. The coded information is normalised over a scale of 0 (=least restrictive) to 6 (=most restrictive), reflecting increasing restrictiveness of regulatory provisions for competition.

The indicator of administrative regulation is a simple average of the two indicators "Regulatory and administrative opacity" and "Administrative burdens on startups" in the domain "Barriers to entrepreneurship". Domestic economic regulation is the simple average of "Public ownership", "Involvement in business operation" and "Barriers to competition". The 2008 data refer to beginning of 2008.

Source: OECD, *Product Market Regulation Database.*

StatLink http://dx.doi.org/10.1787/888932939011

Although PMR indicators are not available for other Emerging Asian countries, other evidence points to considerable restrictions in key service sectors, especially in Thailand and Viet Nam. Restrictions on wholesale and retail trade are comparatively stringent in Indonesia, Malaysia, and Thailand, and in maritime transport in Indonesia, the Philippines and Thailand. Postal services are a state monopoly or near-monopoly in all of these countries (Table 3.5) (see ADB 2012).

Table 3.5. **Restrictions on trade in services in Emerging Asia and OECD countries**

Index scale of 0-100 from "completely open" to "completely closed"

	China	Indonesia	Malaysia	Thailand	Viet Nam	Germany	Japan	Korea	United States
Overall	36.6	50.0	46.1	48.0	41.5	17.5	23.4	23.1	17.7
Financial	34.8	23.4	44.6	49.4	40.8	1.3	1.9	2.3	21.4
Telecommunications	50.0	25.0	25.0	50.0	50.0	0.0	25.0	50.0	0.0
Transportation	19.3	66.4	55.4	47.1	38.6	24.4	15.6	20.8	7.9
Professional	66.0	76.0	73.0	74.0	31.5	59.0	56.0	66.0	54.0

Notes: Completely open (0); Virtually open but with minor restrictions (25); Major restrictions (50); Virtually closed with limited opportunities to enter and operate (75); Completely closed (100).

Source: World Bank, *Services Trade Restrictions Database.*

The legacy of state ownership has been a major factor sustaining regulation of services sectors in many Emerging Asian countries. The perceived need for government involvement to meet strategic objectives and to protect incumbent state enterprises has sustained often stringent restrictions on private sector participation. The restrictions are widest and most stringent in those countries and sectors where state-owned enterprises are most important, notably China and to a lesser extent Indonesia. In China, virtually all of the banking sector and most of the rest of the finance sector is state-owned and entry of private institutions, although now permitted in principle, is still very limited.

Regulatory barriers in domestic services markets are reinforced by restrictions on cross-border trade and FDI in services, which remain generally more stringent than for goods. Indeed, unlike manufacturing, tax and other incentives to attract foreign investment into domestic service sectors are only very rarely applied. Restrictions on FDI in services typically take the form of maximum limits, and in some cases outright bans, on foreign ownership stakes in domestic services enterprises, restrictions on joint-ventures, limits on permitted activities of foreign-owned or invested service firms, and requirements to employ local workers or to use local products.

These barriers tend to be most stringent in transport and infrastructure services and finance, although there has been significant liberalisation of restrictions on foreign participation in the latter sector in recent years, particularly in China. Restrictions on foreign participation often apply across a wider range of services than domestic regulations, extending to wholesale and retail trade, health and education and business services. Foreign investment in wholesale and retail trade is largely prohibited in Indonesia, except for hypermarkets and other of the largest operations, and also prohibited for smaller wholesale and retail establishments in Thailand and Malaysia. Where permitted, foreign investment in trade establishments is generally limited to a minority interest (less than 50%) in Thailand and until recently in Viet Nam. Limits on foreign equity are also applied to hospitals and other health provision institutions in Indonesia, Malaysia, and Thailand. Certain types of business services firms, notably in accounting and credit rating, face significant restrictions on foreign participation in China.

Overall, barriers to services trade in the five Emerging Asian countries are relatively restrictive compared not only to advanced countries such as Japan, Korea and the United States but also many other major developing countries. The barriers in China and Viet Nam are somewhat less restrictive than in the other five (due in part in China's case to the considerable pressure applied for service sector liberalisation by China's partners and recent liberalisations in the Viet Nam) and most stringent in Indonesia and Thailand. Foreigners face especially stringent (major) restrictions (score of 50 or more) on their participation in telecommunications in China, Thailand and Viet Nam, on transport services in Indonesia and Malaysia, and in professional services in all but Viet Nam.[5]

Infrastructure, skills development and regulatory reforms are key to productivity in services

Services sectors in Emerging Asia countries need not only to expand but, more importantly, to increase in productivity achieved through expansion of modern relative to traditional services. To achieve this improvement, policies need to focus on four priorities.

First, as discussed further in the next section, institutional capacities to improve the educational attainment and overall skill level of the labour force, and, equally importantly, to ensure that the mix of skills supplied keeps up with the changing needs of the economy, will be critical to development of higher productivity service sector that can better support the overall economy. Skills shortages are already emerging in many Emerging Asian countries. As discussed in prior *Outlooks* (OECD 2012), technical vocation and education programmes need to be strengthened in most countries and their links to the business sector improved to ensure that they are keeping up with changing skill demands. In some countries, especially Indonesia, the Philippines and China, the quality of and access to basic education, particularly in rural areas and poorer provinces, needs to be strengthened as a precondition for development of higher level skills and to reduce disparities in service sector development. The fostering of closer ties among academic and research institutions and service and manufacturing industries is an important medium-term priority in those countries, notably Malaysia and China, where development of ICT and some other modern services is well underway but will also be important for Indonesia and Thailand.

Second, infrastructure development, particularly of transport and communications infrastructure, will be essential to success in developing a more productive service sector. Infrastructure to improve geographic connectivity is particularly important in Indonesia and the Philippines to realise the country's potential for tourism as well as to achieve more balanced service sector development across regions. Strengthening of ICT and alleviation of gaps in its development is particularly important, given its spill-over effects in promoting innovation and increasing productivity and improving the inclusiveness of economic development by allowing previously excluded population segments better access to economic services. ICT development in terms of access to cellular phone services and to the Internet has increased markedly since 2000 in all the Emerging Asia countries but it still lags that of more advanced Asian economies in the Philippines and Thailand, as well as the access now available in Viet Nam (ADB, 2012).

Third, and probably most important, country regulations that now restrict competition or raise costs in service activities need to be removed as far as possible. While there has been significant progress, notably in China, in removing barriers to the entry of private firms in telecommunications, wholesale and retail trade, and some business services, more will need to be done.

Progress on achieving freer trade in services will greatly enhance the benefits from domestic liberalisation of services sectors. ASEAN countries have adopted an ambitious agenda for near-full services integration as part of the ASEAN Economic Community frameworks agreed upon in 2003, which seeks to realise the vision for services sector integration outlined in the 1995 Framework Agreement on Services (Box 3.3).

Box 3.3. **Initiatives to foster greater trade and integration of services in Emerging Asia**

The need for freer trade and greater regional integration of services in order to expand their markets and realise the benefits of a more efficient division of labour has long been recognised in the developing Asian region. In 1995, the ASEAN countries adopted the Framework on Services to promote these goals. The Framework mandates co-operation among ASEAN countries to improve efficiency and competitiveness in services and to diversity service sector capacity, supply and distribution, both within and outside the region; and sets a goal to substantially liberalise trade in services among ASEAN members, beyond their obligations under the General Agreement on Trade and Services (GATS), with the ultimate aim of creating a free trade area in services. Under the Framework, responsibility for co-operation in service sector issues was vested in a Coordinating Committee on Services (CCS). The Framework laid out some key principles that would guide later efforts but contained no concrete goals or benchmarks for completion of agreements or their implementation. Moreover, key sectors, notably air transport, financial services, and certain other areas were removed from removed from CCS consideration and responsibility transferred to other organs (Tan, 2009).

These limitations limited the concrete progress that was made on service sector liberalisation until 2003, when the adoption of the agreement on the ASEAN Economic Community (AEC) added new impetus to the effort. The ultimate goal of the AEC is to create a single market, similar to that of the European Community, with a free flow of goods, services, investment, capital and labour.

Under the AEC, the mandates for service sector liberalisation under the AEC contain specific targets specifying dates for completion of agreements in specific service sectors and modes of trading in those services. All restrictions on services are supposed to be "substantially" removed (that is except for agreed-upon exclusions) by 2010 in four of the AEC priority service sectors (air transport, health care, tourism, and E-ASEAN), in logistics by 2013 and in all other sectors by 2015. Flows of services or service customers across borders (modes 1 and 2) are supposed to be completely eliminated except for those based on "bona fide" regulatory grounds and agreed upon by the members on a case-by-case basis. Equity participation restrictions on foreign investment in service sectors are to be relaxed in stages, culminating in a minimum of 70% by 2015.

Services integration with ASEAN has been paralleled by negotiation on services trade liberalisation with other Asian countries. Agreements with China and Korea were concluded in 2007 and with Australia and New Zealand in 2009. Agreements with Japan and India are in the process of being negotiated.

Source: ASEAN (2009), *ASEAN Integration in Services*, Association of Southeast Asian Nations, Jakarta.

Policies to foster the transformation of economic structures

Government policies will be very important in determining the success of the Emerging Asia countries in shifting their economic and industrial structures toward sustained productivity-led growth. The past approaches taken by the three Asian countries that have succeeded in becoming advanced economies, Japan, Korea and Singapore, offer some insights for Emerging Asia countries now but they need to be carefully interpreted.

Japan and Korea made extensive use of industrial policies in the earlier stages of their development. Industrial policies refer to measures to promote the development of certain sectors of the economy, including direct government intervention in markets and businesses and preferential tax, credit and other policies given to some sectors.

The institutional set-up in Japan also ensured that targeted industries received support from government financial institutions (such as the Japan Development Bank and the Japan Export and Import Bank). It also allocated foreign exchange to firms to enable them to buy foreign technologies. The result was that Japan rapidly gained competitive advantages in a growing range of targeted manufacturing activities including steel, shipbuilding and automobiles. Consumer electronics was a notable but successful exception to the strategic approach of targeting industries adopted by the Ministry of International Trade and Industry (MITI). But it too benefited from certain distinctive features of the Japanese economic landscape. One such feature is the system of lifetime employment that large companies had evolved to ensure employee loyalty (Takada, 1999). The stable relationships between employers and workers together with government support allowed Japanese firms to take a strategic and longer-term view of competition. Japanese firms were able to learn from international competition and adopt productivity-boosting measures such as quality control circles and just-in-time manufacturing techniques. Japanese institutions and employment practices therefore helped Japanese firms to penetrate foreign markets.

The transformation of Korea, like Japan, was export-led with a developmentally oriented state playing a key role in keeping out foreign firms from entering the domestic market. As in Japan, the government in Korea showered favoured firms with cheap credit and other assistance to enable them to develop a competitive edge in export markets. It focused on manufacturing industries starting with labour-intensive ones like footwear and clothing and moving up the ladder to heavy industries, shipbuilding, automobiles and electronics. Favoured local conglomerates or multi-industry *chaebols* had to meet performance criteria in exports and other areas in return for state financial and regulatory support (Rodrik, 1995; Stiglitz, 1996).

Korea shares with Japan another policy choice – the decision, especially, in the early stages of development, not to rely on foreign direct investment but to license technology from abroad. In Korea, foreign investments amounted to less than 2% of GDP for most of the 1970s and 1980s (Yoshida et al. 1994). In both countries, ethnically homogeneous and historically wary of foreign influences and interventions, self-reliant nationalism was a constant and powerful driver of economic change (Adelman and Morris, 1967).

In Singapore, the government actively set up institutions to strengthen economic growth and maintain social harmony. It pursued economic progress with a mix of pragmatic policies that ensured financial prudence, industrial peace, efficient and honest public institutions, and social and ethnic harmony. It openly welcomed foreign investors for not only the capital they brought but also for their market connections and technology (Huff, 1999). The massive influx of foreign capital did not crowd out local investments. It generated opportunities for local firms to become partners and suppliers to multinational enterprises. Local investments rose from SGD 2.9 billion (Singapore dollar) in 1970 to SGD 28.9 billion in 1981 (Lim and Pang, 1982).

State interventions took many forms, all aimed at strengthening economic growth and maintaining social harmony. Beginning in the early 1970s as the economy reached full employment, the government intervened in the labour market to promote "orderly" wage increases. It promoted tripartism – co-operation between state-approved unions, employers and state agencies – as a principle that was absolutely critical to attracting foreign firms.

The Singapore government also changed the Central Provident Fund (CPF) – a contributory savings scheme set up in the colonial era, using it to raise the national savings rate by increasing the rate of contributions by workers and employers. The CPF provided the government a large source of funds to finance, at a low interest rate, development projects as well as public housing, education and training (Huff, 1999). Institutional efficiency and human capital capabilities combined with the liberal import of foreign skilled and unskilled workers have made it possible for Singapore to build and maintain an extraordinary hard and soft infrastructure that reliably supports economic activities.

Policies now need to focus on developing institutions

The key lesson from these experiences for the Emerging Asia countries now is the critical importance that effective institutions played at all points in their development A very large and growing literature has demonstrated the critical role of institutions to economic development (Box 3.4).

Box 3.4. **The Importance of institutions to development**

Economic growth and development is not possible in an institutional vacuum. Growth and development requires a legal and administrative framework within which individuals, firms, and governments interact to generate wealth. A good institutional framework allows orderly transactions to take place; agents are able to operate confidently knowing that the decisions they take and the contracts they make will be protected by law, and enforced. To make rational optimising economic decisions, all agents need a framework of rules to operate within.

Institutions are also one of the important pillars of competitiveness and play a key role in the ways in which societies distribute the benefits and bear the costs of development strategies and policies. They affect economic performance by their impact on the costs of exchange and production. Costs include transaction costs such as search and information costs, bargaining and decision costs, policing and enforcement costs (Coase, 1961; 1968; Dahlman, 1979). By providing common legal frameworks, institutions lower transaction costs. And by providing policing and justice systems for the adherence to common laws and regulations, they encourage trust.

Box 3.4. (contd.)

While there is no one set of institutions that will suit all countries, there is a consensus among development economists that at least five main types of market-supporting institutions are necessary, if not sufficient, conditions for rapid economic progress (see e.g. Rodrik, 2000):

- property rights and legally binding contracts: market-creating institutions;
- regulatory institutions: market-regulating institutions;
- institutions for macroeconomic stability: market-stabilising institutions;
- social insurance institutions: market-legitimising institutions;
- institutions of conflict management: market-legitimising institutions.

In poorer countries, institutions defining and protecting property rights, rules against fraud and anti-competitive behaviour, arrangements that mitigate risk and social conflict, and the rule of law are often particularly weak (Rodrik, 2000).

How much does improving the quality of institutions contribute to economic development? According to the results of the IMF's research on this question, if the average institutional quality in Africa could be raised to the level currently prevailing in developing Asia, it would result in almost a doubling of per capita GDP in Africa over the long term. And, likewise, incomes in developing Asia could roughly double if they were to strengthen their institutions to around the average of all countries.

While the transformation experiences of Japan, Korea and Singapore differ in many ways, especially in their initial conditions and dependence on foreign investment, they share a few common traits with respect to the role of institutions. First, they enjoyed effective public institutions by the time they had completed their labour-intensive phase of development. In the case of Japan and Korea, these institutions guided and supported the export drive and technological learning of their national champions. In the case of Singapore, efficient state institutions were instrumental in creating an environment that attracted foreign capital and encouraged industrial upgrading.

Second, all three countries paid persistent attention to their educational and training institutions and provided incentives for firms to invest in job training. All of them had cultures which encouraged parents to invest in their children's education. But this cultural inclination would have mattered little in the absence of state-guided industrial upgrading which created desirable high-skilled jobs. The relationship between human capabilities and industrial transformation is mutually reinforcing.

Third, the institutional strengths that underpinned industrial upgrading also enabled the three countries to develop the hard infrastructure – power plants, ports, transport and communication systems, etc. – that was so vital to their export competitiveness. Serious infrastructure bottlenecks – so evident in many middle-income countries today – were not common in these countries, thanks to their evolved planning capabilities.

These experiences strongly suggest that policies in the Emerging Asia countries need to concentrate on strengthening institutions to support market-based transformations to achieve productivity-led growth. In any case, the need and scope for industrial policies involving direct government interventions or other preferential policies is now fairly narrow and limited (Box 3.5).

Box 3.5. **The narrowing scope for industrial policies**

The scope for industrial policies has been considerably narrowed by the considerable progress on trade and investment liberalisation over the past three decades, both within the GATT/WTO and from numerous regional and multilateral agreements. These agreements have sharply circumscribed the measures countries can use to discriminate in favour of domestic businesses relative to foreign competitors, both in foreign trade and the domestic economy and which have been the core of industrial policies in the past.

Apart from international commitments, the scope for industrial policies is likely to be constrained by budget limits and imperatives in other areas. Industrial policies can be quite expensive in terms of subsidy costs and forgone tax revenues, both directly through tax preferences and indirectly if sectors and enterprises targeted do not perform up to expectations. The potential benefits of expenditure through industrial policies has to be weighed against the benefits of spending on other policy priorities, such as education, the need for which will grow as countries rely more on technology and innovation driven industries and services. This cost benefit analysis also needs to take into account the capacity of governments to design and implement effective industrial policies, which can be quite difficult, especially for more interventionist policies that depend on identifying specific sectors to be targeted.

The increasing mobility of international investment and businesses also limits the potential benefits from many traditional industrial policies. Preferences given by one country to multinational companies can be matched by competitor countries, potentially setting off a "race" in which no country gains a permanent advantage but which erodes tax bases and reduces government revenues. As discussed in the last *Outlook* (OECD, 2013a), there is evidence of such competition in tax and other preferences associated with FDI.

In terms of the role of institutions, Thailand, Indonesia and the Philippines lag behind Malaysia (WEF, 2012b). And while Malaysia has paid persistent attention to its educational and training institutions, it, together with Thailand, Indonesia and the Philippines, still lags very far behind Japan, Korea and Singapore. For example, Malaysia's performance in the OECD's PISA 2009 is evidence of this. And in terms of infrastructure, Thailand, Indonesia and the Philippines all rank behind Malaysia, though all four countries lag far behind Japan, Korea and Singapore (WEF, 2012b).

In these four middle-income ASEAN economies, more therefore needs to be done to improve their institutions which are important, indeed crucial, for sustainable growth. For example, rent-seeking behaviour is allegedly endemic in some Southeast Asian countries. This reflects badly on the quality of their legal institutions, and obviously more needs to be done to improve them. La Porta et al. (1997; 2000) have influentially argued that the extent of rent seeking by corporate insiders is affected by the quality of a country's legal institutions. In Malaysia, for example, the country's New Economic Model has in fact put forth suggestions to eliminate rent-seeking behaviour in the economy.

Institutions supporting human capital development will be critical …

It has been suggested that the middle-income trap is "less likely in countries where the population has a relatively high level of secondary and tertiary education and where high-technology products account for a relatively large share of exports" (Eichengreen, Park and Shin, 2013). Countries prone to the middle-income trap can scale the "technology ladder" with high-quality human capital, particularly secondary and tertiary-educated manpower. In the case of Chinese Taipei and Korea, "advanced infrastructure" – high-speed communication networks and broadband technology – plays a big role in attracting highly-skilled workers (Agénor, Canuto and Jelenic, 2012). These workers are critical to the development of innovation-driven industries. Countries need not only to develop human capital but to also improve physical infrastructure to escape the middle-income trap.

A distinction can be made between development trajectories dependent on "basic" and "advanced" infrastructure (Agénor, Canuto and Jelenic (2012). Advanced infrastructure promotes design activities with knowledge externalities that expand the possibilities for product diversification. It is not low GDP growth that traps middle-income countries but inappropriate use and allocation of talent. Human capital is vital to enable a middle-income country to progress from an imitation stage of development to an innovation-driven stage. An economy lacking in human capital will not encourage the evolution of the knowledge networks so critical to enabling it to climb the value-added product chain.

In Japan, the country's early and consistent investments in quality secondary education has paid off in a large pool of trainable, adaptable workers. Employment practices favouring long worker tenure together with the emphasis on job training produced a highly-motivated workforce able to assimilate new technologies quickly (Ohno, 2006). Export experience also played a key part in improving worker capabilities. Thanks to the country's attention to the quality of basic and secondary education, Japanese firms had access to a pool of well-educated, disciplined workers who could learn quickly on the job. And as they remained with their companies all their working life, their employers were motivated to invest in job-specific training which raised productivity (Ito, 1996).

In Korea, a society imbued with Confucianist values of order and harmony, education has had a central role in society throughout its history. Such cultural underpinnings for learning have greatly facilitated Korea's ability to build up its human resource capabilities. Korea's education system produced industrious and disciplined workers – the kind of workers that Korean industry needed. As Korea's economy expanded, so did the social and economic demand for education, especially tertiary education. As a result, the number of Koreans with degrees from Korean universities and overseas institutions has surged, enabling Korean firms to upgrade and move into higher-technology activities.

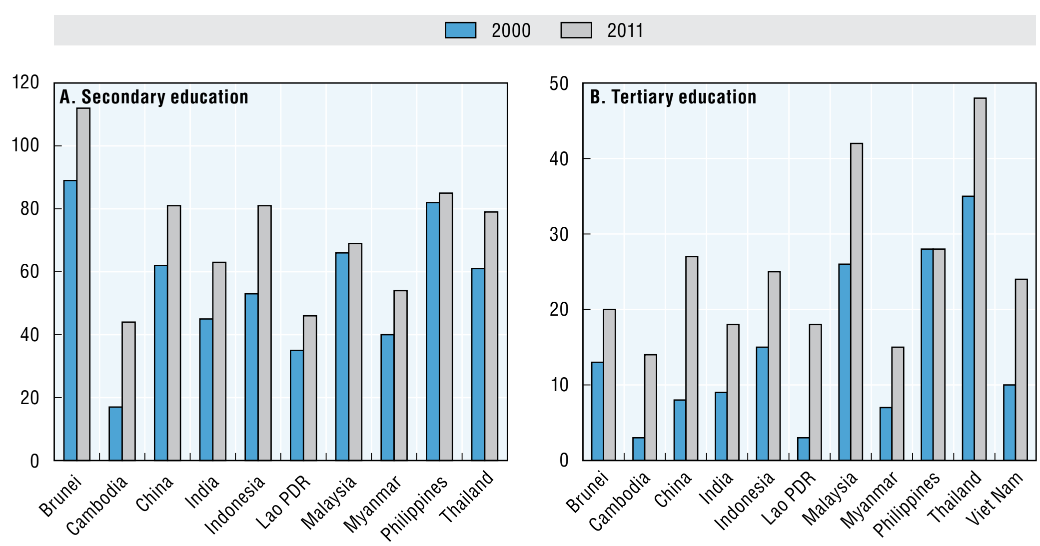
There is similar emphasis on human capital in Singapore. When Singapore began on the road to export-led industrialisation, its labour force was disciplined but not highly educated. In 1980, after it had achieved full employment and was beginning to import unskilled workers to meet labour shortages, half its workforce had only a primary level of education and less than 10% had university degrees. Since 1980, the education and training system has expanded greatly, providing qualified manpower for higher value-added industries. More training institutes, polytechnic schools and universities have been set up, offering a wide range of courses to prepare workers for new industries. Since 2000, new approaches to learning aimed at training a new generation of workers for innovation-driven industries have been introduced.

As mentioned earlier, Japan, Korea and Singapore paid persistent attention to their educational and training institutions and provided incentives for firms to invest in job training. There is evidence of high education performance in all three countries. These three countries all did extremely well in the Programme for International Student Assessment (PISA) 2009 conducted under the auspices of the OECD. For example, Singapore ranked fifth in reading, second in mathematics and fourth in science out of the 65 countries and economies that took part. Singapore also had the second highest proportion (12.3%) of students who were top performers in all three domains.

In Emerging Asian countries, enrolment rates have been increasing for the past ten years but the quality of education remains a big concern (Figure 3.12 and Figure 3.13). Among these countries, Malaysia, Thailand and Indonesia face huge challenges on the human resource front. In the PISA 2009, for example, Malaysia performed in the bottom third for reading, mathematics and science, well below the international and OECD average in all three areas. Its performance was at least 100 points below that of regional peers such as Singapore, Japan, Korea on all three subjects. Almost 60% of Malaysian students did not meet the minimum benchmarks in mathematics, while 44% and 43% of students did not meet minimum proficiency levels in reading and science respectively (Ministry of Education Malaysia).

Figure 3.12. **Gross enrolment rates in Emerging Asia, by level of education, 2000 and 2011 (or closest year available)**

Percentage



Source: World Bank, *World Development Indicators*.

Source: World Bank, *World Development Indicators*.

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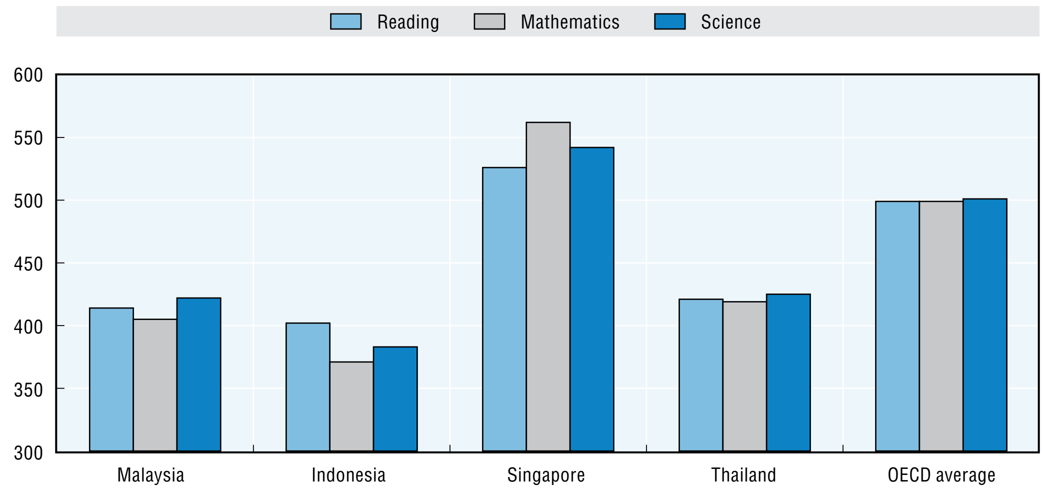
Figure 3.13. **OECD PISA score in Southeast Asia and OECD countries, by area, 2009**

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: OECD, *PISA database*.

StatLink http://dx.doi.org/10.1787/888932939049

The weaknesses in education system in these countries need to be addressed because education has an important bearing on their ability to continue to sustain rapid growth. Education has a direct and positive effect on economic development, economic growth and productivity. Denison (1967) found that between 10% and 15% of the growth in the real national income of the United States can be attributed to education. And to avoid growth slowdowns or the middle-income trap, growth in productivity is key. Education is not only essential to improving human capital and labour productivity, it is critical to innovation to raise TFP, which is based on research by scientists, engineers and other very highly educated and skilled people. In fact, innovation and productivity can be regarded as "engines of growth", the deficiency of which can have dire consequences for economies seeking to avoid the middle-income trap.

… as is the development of innovation capabilities

Human capital development is also a key underpinning of another key requirement for industrial transformation into higher productivity activities: *innovation*. Other institutional capabilities are equally critical. Innovation is not a new product, process, design, or form, or organising or delivering or using a product or service that is new to the world, though it is new to the country, the sector or the unit (individuals, firms, social organisations, government) using it (Dahlman, 2012). Innovation has a critical role in the economic and social development of countries. The main source of economic growth, it improves productivity, and is the foundation of a nation's economic competitiveness. It is therefore vital to the success of Emerging Asia and other developing countries in becoming advanced economies.

There is a clear connection between innovation and improvements in the standard of living. For example, Korea is where it is today because of innovation; two-thirds of the differences in the growth performance of Korea and Ghana over four decades, according to the World Bank, are attributable to technology-related improvements (World Bank, 2007).

Fostering innovation is a vital component of national policies in most countries. The role of governments, besides monitoring progress and intervening to avoid market failure, now includes ensuring that the country's overall innovation system operates more effectively.

The boundaries of a nation's innovation system include the "framework conditions" that encompass elements such as the educational system or macroeconomic environment, elements far removed from the innovation process itself. In its reviews of innovation systems, the OECD, for example, includes such framework conditions as part of the current generation of innovation policies that now involve a "whole-of-government" approach where all departments are potentially concerned (World Bank, 2007).

The best practices of OECD countries' policies supporting innovation include the following main components (OECD, 2013b):

- *Conducive framework conditions*. Government provides a favourable climate in which entrepreneurs can easily create firms, have incentives to innovate and grow, and can access the necessary resources at a reasonable and predictable cost.
- *Measures to build innovation capacities*. For example, measures that foster an entrepreneurial culture.
- *Measures to facilitate financing of innovation*. For example, provision of seed financing and support for the development of venture capital.
- *Measures to promote networking and partnerships*. For example, interfacing scientific and innovation networks through public-private partnerships (PPPs).

In January 2006, the Chinese government released its Medium- and Long-Term Plan for Science and Technology Development (2006–2020) (MLP) to drive innovation. The Plan includes preferential tax treatment and policies aimed at high-tech industrial zones, foreign technology assimilation, and strengthening intellectual property rights protection for Chinese innovators. There are also policies to strengthen and diversify the funding for science and technology and to make government expenditures more efficient. Policies are specified to develop human resources in science and technology, including cultivating world-class experts and expanding the role for scientists and engineers in industry, recruiting talent from abroad, and reforming education to support the goals of greater creativity and innovative behaviour in the research environment (Liu, 2011).

In recent years, Malaysia has introduced a range of fiscal and non-fiscal measures to promote research and innovative activities by foreign and domestic firms. These include attracting foreign knowledge-intensive companies and promoting technology acquisition and diffusion. Fiscal incentives extended to spur R&D include a double deduction on non-capital expenses incurred for undertaking R&D activities. Fiscal relief also covers activities for export promotion and branding. Large firms have been the main beneficiaries of the R&D tax incentives; small firms find the procedures too cumbersome (OECD, 2013b).

In Thailand, the government has invested in science and technology parks to encourage linkages between firms and other actors in the national innovation system. The Thailand Science Park has 60 companies in operation, of which 75% are Thai, together with the public research institutes BIOTEC, MTEC, NECTEC and NANOTEC. Plans are to increase the Thailand Science Park to 200 companies and 4 000 knowledge workers. Software Park Thailand is home to more than 30 firms, mostly Thai, along with IBM, Hewlett Packard, Sun Microsystems, and Oracle. Training and certification are offered jointly by the NSTDA and Carnegie-Mellon University of the United States (OECD, 2013b).

There is much scope for improving the enabling institutions for business and markets

Among policies to improve institutions to sustain development, reforms to strengthen market functioning, the capabilities of businesses and the environment for business development and investment will be especially critical to the success of Emerging Asian countries industrial development. To make the transition to higher productivity growth, markets need to provide accurate signals and incentives to guide resource allocation, businesses need to have the capabilities and incentives to respond to the signals, and the business environment needs to facilitate entry of new firms that have potential to be competitive and the exit of those that do not. Vigorous competition, strong corporate governance and investor protections, effective insolvency regimes, and effective business regulation and taxation are essential to these capabilities. Labour markets need to be efficient and flexible enough to facilitate transfers of workers from declining to newer industries. Improvement in these institutional capabilities is partly a matter of further development but will also require reforms to remove barriers and distortions created by past policies that are no longer appropriate.

The *Doing Business* rankings published by the World Bank provide one revealing indication of the state of the enabling conditions for business in the Emerging Asian countries[6] (World Bank, 2012b). Among the developing Emerging Asia countries, Malaysia ranks particularly high at 12th in the overall ranking ("Ease of Doing Business") and Thailand also ranks relatively favourably with a ranking of 18. (Table 3.6). Both countries' rankings are above those of many other developing countries with per-capital incomes at or above their own. The rankings for Indonesia and the Philippines are much lower but not out of line with those of other countries at their income level.

Table 3.6. **World Bank Doing Business indicators in Asia**

Ranking out of 185 countries

	Overall rank: Ease of Doing Business Rank	Starting a business	Dealing with construction permits	Getting electricity	Registering property	Getting credit	Protecting investors	Paying taxes	Trading across borders	Enforcing contracts	Resolving insolvency
China	91	151	181	114	44	70	100	122	68	19	82
Hong Kong, China	2	6	1	4	60	4	3	4	2	10	17
India	132	173	182	105	94	23	49	152	127	184	116
Indonesia	128	166	75	147	98	129	49	131	37	144	148
Japan	24	114	72	27	64	23	19	127	19	35	1
Korea	8	24	26	3	75	12	49	30	3	2	1
Malaysia	12	54	96	28	33	1	4	15	11	33	49
Philippines	138	161	100	57	122	129	128	143	53	111	165
Singapore	1	4	2	5	36	12	2	5	1	12	2
Thailand	18	85	16	10	26	70	13	96	20	23	58
Chinese Taipei	16	16	9	6	32	70	32	54	23	90	15
Viet Nam	99	108	28	155	48	40	169	138	74	44	149

Source: World Bank (2012b), *Doing Business 2013 - Smarter Regulations for Small and Medium Sized Enterprises*, World Bank, Washington D.C.

The underlying components of the *Doing Business* rankings indicate that high costs of starting and operating a business are important obstacles in the business environment of most of the Emerging Asia countries. For example, all the five countries rank lower in terms of business start-up costs than their overall rating; and the rankings of China, Thailand and Viet Nam on the costs of paying taxes are also noticeably lower than their overall rank. All of these countries have been making efforts to streamline regulatory procedures applying to businesses, but the indicators suggest that more remains to be done. Continued relative weakness of bankruptcy regimes in Indonesia, the Philippines, and Viet Nam are reflected in their low rankings in the "resolving insolvency" dimension. However the rankings also reflect improvements in some areas that have come about as a result of some important legal and regulatory changes over the past decade. For example, Viet Nam now ranks relatively favourably in terms of registering property, enforcing contracts and investor protection. China's ranking on "resolving insolvency" has improved considerably since the institution of its reformed bankruptcy law in 2007.

The indicators of competitiveness published by the World Economic Forum (WEF, 2012b) provide further insights about business sector enabling conditions. (Table 3.7) The indicators have a broader focus on a full range of factors influencing countries' international competitiveness, including infrastructure, the state of health and education capabilities, and innovation, in addition to the quality of institutions that directly shape the business environment. China, Indonesia, the Philippines and Viet Nam rank more highly overall on this index than on the World Bank indicator, due mainly to their comparatively large internal markets.

Table 3.7. **WEF Global Competitiveness indicators in Emerging Asia and other selected countries**

Ranking out of 144 countries

	Selected main components					Selected sub-components						
	Overall rank	Institutions	Product market efficiency	Labour market efficiency	Innovation potential	Property rights	Corruption	Strength of corporate boards	Auditing / reporting standards	Burden of government regulation	No. of procedures to start a business	Intensity of local competition
China	29	50	59	41	33	47	67	91	72	23	134	37
Indonesia	50	72	63	120	39	82	111	62	87	48	87	96
Japan	10	22	20	20	5	15	11	24	39	87	87	2
Malaysia	25	29	11	24	25	28	46	14	30	8	20	36
Philippines	65	94	86	103	94	74	108	51	41	108	137	50
Singapore	2	1	2	1	8	3	3	3	5	1	8	21
Thailand	38	77	37	76	68	103	80	68	53	75	29	54
United States	7	41	23	6	6	42	42	23	37	76	47	18
Viet Nam	75	89	91	51	81	113	118	99	132	112	97	44

Source: WEF (2012b), *Global Competitiveness Report 2012-2013*, World Economic Forum, Geneva.

Nevertheless, the specific indicators underlying the WEF index are broadly consistent with the impressions conveyed by the World Bank rankings. The indicators also provide insights into the state of other enabling conditions that bear on the competitiveness of businesses and the overall economy, such as intellectual property rights protection, corporate governance, protection of minority shareholder interests and labour market efficiency. China, Indonesia and Viet Nam, and to a lesser extent Thailand, also score comparatively low in some or all of these areas, while Malaysia is generally more favourably ranked. Indonesia, Thailand and Viet Nam also rank relatively low in terms of labour market efficiency.

The WEF indicators also indicate that businesses view corruption and an inefficient government bureaucracy as two most "problematic" factors for doing business in Indonesia, Malaysia, the Philippines and Thailand (WEF, 2012b). In China and Viet Nam, access to financing and inflation are cited as the most important obstacles.

The Emerging Asian countries have been taking extensive measures to improve the conditions measured by the indicators. As discussed further later in this chapter and in earlier issues of the *Outlook*, there have been important improvements in recent years in streamlining tax systems to reduce their burden on businesses and other tax payers (see OECD, 2013a) and in improving investor protections and corporate governance. Some of these reforms are reflected in improvements in the indicators over time while the effects of others may not yet be fully manifest.

The enabling conditions for business in the Emerging Asian countries will need to improve in coming years if they are to achieve the quality of institutions characteristic of more advanced economies. The indicators from the World Bank and WEF suggest some priority areas.

- Further regulatory reforms to reduce costs and obstacles to starting new businesses, particularly in China, Indonesia, the Philippines and Viet Nam. The five countries have made considerable progress in reducing these obstacles for foreign invested firms in special economic zones (notably in China) but less progress has been made for domestic businesses.

- Reduction in incentives for and better enforcement of laws against corruption, especially in Indonesia, Thailand, the Philippines and Viet Nam. Regulatory reforms to simplify government procedures and improve transparency can help considerably in combating corruption since overly complicated and opaque regulations multiply opportunities for officials to extract bribes or other favours.

- Further corporate governance reforms and improvement in investor protections in all countries, but especially in China and Viet Nam.

- Further efforts, especially in China and Viet Nam, to increase the role of non-state enterprises in sectors now dominated by state-owned enterprises (SOEs), in parallel with further reforms to strengthen corporate governance and market discipline of SOEs that are deemed essential.

Strengthening the financial system to support development beyond the middle-income trap

The success of Emerging Asian countries in avoiding the middle-income trap will depend critically upon the capabilities of their financial systems. In coming years, these systems will have to meet at least five challenges.

- Credit will need to be channelled efficiently and on financially sound terms to sectors and businesses leading the transformation of the economy, which will often be different, or have different characteristics, from those to whom credit has traditionally gone.

- Financial institutions will need to have the capabilities and incentives to operate as commercial entities and to sustain sound lending and risk management practices as their client base changes and as they enter new markets and activities.

- Financial instruments and services will need to be developed to meet the needs of the growing middle class, the ageing of populations, as well as the needs of rural households and other segments that are now underserved in order to ensure that growth is inclusive.

- Financial regulatory and supervisory systems will need to be capable of containing risks to financial system stability that can arise from rapidly changing domestic and international economic conditions.

- Domestic financial systems will need to adapt to and accommodate growing linkages to regional and international financial markets.

Emerging Asian countries have made considerable progress since the 1997-98 Asian financial crisis in making changes in their financial to meet these challenges. Probably the most important accomplishment has been the reform and impressive strengthening of prudential norms and of financial regulatory and supervisory capabilities. The fruits of these reforms are manifest in the generally strong financial positions that banks in most of the countries took into the 2007 financial crisis and have sustained since then. Significant progress has also been made in many countries in strengthening the efficiency and competitiveness of banking and other financial institutions segments and in developing capital markets, particularly stock markets.

Despite this progress, however, important limitations remain in Emerging Asia's financial systems that will need to be addressed if they are to adequately support economic development beyond the middle-income trap.

- Efficiency and competition in *banking systems* are still limited in some countries, owing in part to restrictions on private sector or foreign participation.

- *Capital markets*, especially bond markets, are comparatively underdeveloped, perpetuating the high dependence of and concentration of financial risks on the banking system, and limiting the ability of borrowers and savers to diversify their financial options.

- *Diversity and sophistication* of financial instruments and services, such as consumer credit, derivatives for managing risks, and vehicles for longer-term investment, including infrastructure development and retirement saving is still limited

- Key segments of the population as well as businesses – notably small and medium-sized enterprises (*SMEs)* – are presently underserved in terms of their overall access to credit and to financial services and instruments that they need.

- The *international integration* of the domestic financial system is incomplete, due in part to remaining capital controls.

Further strengthening of financial supervision and regulatory systems and of financial system infrastructure along with other reforms will be needed to address these limitations.

These limitations are widely acknowledged within the region and a number of countries have formulated detailed medium and longer-term plans to address them (Box 3.6). The remainder of this section examines key challenges facing the five countries in these areas and the policies that are being taken to meet them.

Banking sector capabilities will need further improvement

Banks have overwhelmingly dominated the allocation of credit in the Emerging Asia countries, accounting for between one-half to more than three-quarters of total financial system assets. While capital markets and other credit sources will become more important in coming years, banks are likely to remain key to supporting the changes essential to sustaining rapid growth and development.

Box 3.6. **Medium-term plans and priorities to strengthen financial systems in the five countries**

Financial system development is a key element of the overall medium and longer-term development plans of all countries of the regions. The plans contain a number of common features, such as development of capital markets but also differ in some respects owing to the state of development and structural conditions of the countries' financial systems.

Malaysia's *Financial Sector Blueprint, 2011-2020* contains an ambitious agenda to prepare the financial system to support the high income and value-added economy based on innovation, knowledge and strong international competitiveness that is the overall development goal. The current plan seeks to extend and build on the progress of the previous blueprint (2001-2010), which focused on improving the capacities of domestic financial intermediaries and financial infrastructure and preparing for greater integration with international financial markets. The current blueprint envisages that the financial sector will continue to grow more rapidly than the overall economy, with financial system assets reaching six times GDP by 2020. The plan outlines five main priorities: *i)* development of a more diverse array of financial instruments and services, notably for risk capital and for very long-term investments, including infrastructure; *ii)* foster and manage increased regional and international presence of domestic financial institutions and participation of foreign financial institutions in the domestic financial system; *iii)* further strengthen Malaysia's position as an international centre for Islamic finance; *iv)* further strengthening of financial regulatory and supervisory capabilities; and *v)* further strengthening of electronic payments and other key financial infrastructure.

Thailand is currently implementing the second phase of its *Financial Sector Master Plan* (FSMP, 2010-2014) for financial institutions under the responsibility of the Bank of Thailand (BOT) and the *Capital Market Development Master Plan* under the responsibility of the Thailand Securities and Exchange Commission (TSEC). As with the first phase (2004-2009), the second phase of the FSMP focuses on the banking sector, with priority on: reducing banking system operating costs through further rationalisation and reduction of unnecessary regulations; improving competition and access to bank services by broadening the permitted range of services and activities as well as by relaxing limitations on foreign banks; and strengthening financial infrastructure.

Thailand's capital market development plan seeks to reinvigorate development of the stock and bond markets by improving competition, efficiency, and a greater diversity of instruments through regulatory and tax reforms. The Plan also seeks to improve the international competitiveness of Thailand's financial markets and to strengthen linkages between the domestic and international financial systems.

Box 3.6. (contd.)

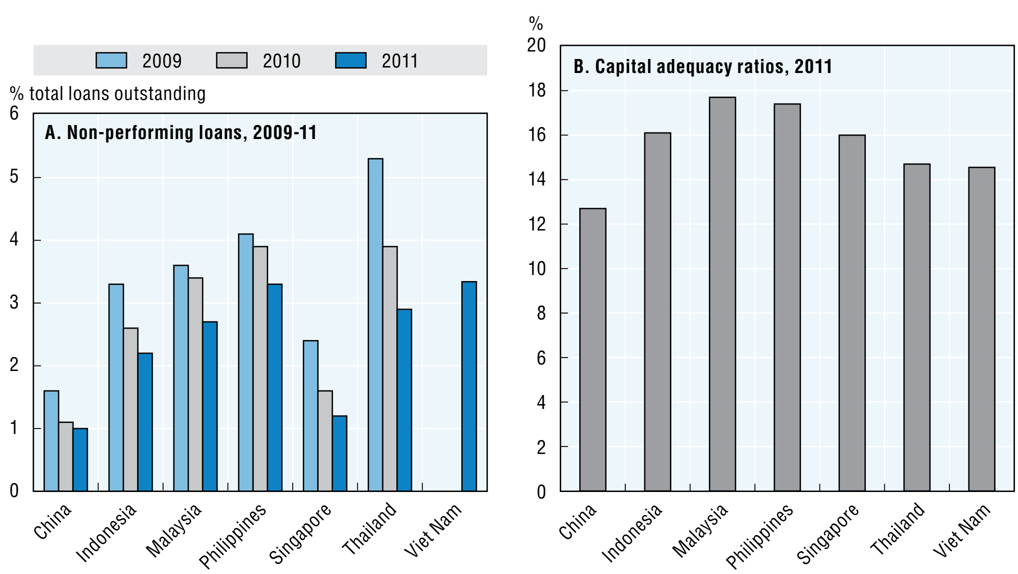
Indonesia is continuing to pursue banking system consolidation and rationalisation through programmes under the Indonesia banking architecture instituted in 2004. The focus is on consolidation to improve banking sector efficiency and competitiveness, long-term development of sharia banking, improvement in financing for SMEs, and capacity strengthening of the rural banks.

The twelfth five-year plan in **China** specifies continued reforms to liberalise interest rates, to improve governance and prudential capabilities of financial institutions, and to continue gradual opening of the capital account and "improvement" of the exchange rate regime. The plan calls for greater participation of private capital in banking, insurance, and securities firms, as well as for participation of private capital in the restructuring of rural banks and credit co-operatives.

As described further in the next box, the key priority for the financial system in Viet Nam is the restoration of the solvency of the state banking system and strengthening of their prudential and competitive capabilities.

Much progress over the past decade has been made in improving banks' financial soundness in the Emerging Asian region. Banks in most of the countries are now financially stronger than they have been in many years. Capital adequacy ratios in China and most of the middle-income ASEAN countries are moderately to considerably above the minima specified by Basel II and non-performing loan ratios rose only modestly during the global financial crisis and have fallen back to low levels (Figure 3.14). Pressures from regulators and the market have spurred considerable improvements in banks systems for credit assessment and risk management. Bank regulation and supervision capabilities have also been considerably strengthened and extended, notably to include assessment of macro-prudential risks in most countries.

Figure 3.14. **Banking indicators in Emerging Asia**



Source: World Bank, *World Development Indicators*.

Source: World Bank, *World Development Indicators*.

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Box 3.7. **Remaining bank recapitalisation needs in Viet Nam and China**

In Viet Nam, restoration of the financial viability of the state-owned banking sector has become an urgent medium-term priority. After falling significantly from 2006-09, the non-performing loan ratio surged back in the wake of the 2007-10 credit boom, to nearly 5% according to estimates by the central bank, and over 10% according to estimates by Fitch rating agency.

Similar to the approach taken in China's bank recapitalisation earlier in the past decade, Viet Nam authorities have been moving to restore the financial solvency of the state banks in the near-term while instituting reforms to strengthen the banks' incentives and capabilities to operate prudently and profitability in the future. The latest bank reform plan unveiled in March 2013 calls for recapitalisation of the banks to conform to Basel II standards by 2015; creation of an asset management company to help dispose of problem loans; and progressive redirection of bank lending away from "high risk" ("speculative") activities toward lending to infrastructure, export and other sectors important to the country's development. The process of converting state-owned banks into joint-stock companies in order to improve their governance will continue. The plan also envisages improvement in the efficiency and profitability of the banking sector through mergers and acquisitions to reduce create a smaller number of more competitive banks, to expand bank branches, to diversify bank funding sources and encourages state banks to expand into overseas markets.

The restructuring and reform of the rural credit system in China, which was essentially insolvent in the middle of the last decade, has made great strides but still has some distance to go. The reforms started with pilot programmes in several provinces beginning in 2003 and were later extended to the nation as a whole. Reform of the rural credit system is central to China's efforts to reduce disparities between rural and urban areas and among provinces.

The focus of the restructuring has been to consolidate, restructure and recapitalise the approximately 8 500 rural credit co-operatives that existed in 2007 into a system of rural commercial co-operatives and rural commercial banks operating under China's national banking law. The restructuring has been accompanied by governance and other reforms to strengthen the (traditionally very weak) capabilities and incentives of the institutions to function as sound commercial entities and to reduce the interference from local governments and other outside interests in lending decisions. Parallel reforms have been taken to strengthen the capabilities and China Development bank (CDB) in lending to rural infrastructure projects and of the Agriculture Bank of China (ABC) to support rural development; as well as to strengthen the governance of the Postal Savings System, which has been a key conduit for gathering savings from rural households. The authorities are also fostering the development of rural micro-finance facilities, drawing on the expertise and support of foreign NGOs and foreign micro-finance enterprises (OECD, 2010b).

Impressive progress has been made under the reforms. The number of rural credit co-operatives was reduced dramatically by 2010. Some 85 and 223 new rural commercial banks have come into being and account for nearly 40% of the total assets of all the rural credit institutions (except the ABC and CDB). Nearly 400 "new type" financial institutions (village or township banks and rural mutual credit co-operatives) have been created to further improve access to formal credit by businesses and households.

However to build on and to sustain these accomplishments will require further improvements. Both China and Viet Nam have unfinished business in restoring financial solvency to key segments of the banking sector (Box 3.7). In China and the ASEAN-5 countries, strengthening banking system efficiency, improving their ability to meet the needs of now under-served segments as well as growing demands from businesses and sectors with characteristics different from those of their traditional customers, and strengthening competition and incentives to operate profitably and prudently are key priorities over the medium and longer run.

Despite the emergence in China and several other countries of leading regional and international banks, the overall efficiency of banking sectors in much of the Emerging Asia region is lower than that of other regional peers, such as Hong Kong, China; Japan; Korea and Singapore. Indicators of operating efficiency, such as the ratio of operating costs to income and to assets and the spread between loan and deposit rates (although only very rough measures) suggest that banks in Indonesia, the Philippines and Thailand are disadvantaged relative to their international and regional peers in terms of operating efficiency (Table 3.8). While there are quite strong and profitable banks in all three countries, there are also some chronically weakly performing banks that lower overall system efficiency. The authorities in Indonesia have been making efforts to improve banking system efficiency through various forms of consolidations.[7] In Malaysia, banking system rationalisation and consolidation efforts have been underway since 1997, with the number of domestic banking institutions reduced from 22 in 1997 to 8 in 2011, and with a noticeable if modest improvement in their profitability (Bank Negara Malaysia, 2011).

Table 3.8. **Banking system performance indicators in Asia**

Country	Net interest margin	Lending-deposit rate spread	Non-interest income to total income (%)	Operating costs ratio to total assets	Return on assets (%)	Return on equity (%)	Cost/ Income ratio (%)	3 bank concentration
China	2.74	3.06	16.54	1.23	0.77	12.77	38.48	49.92
Hong Kong, China	2.15	4.99	68.39	3.85	1.16	17.03	66.89	301.63
India	3.02	0.00	26.27	1.65	0.95	13.79	44.53	61.99
Indonesia	6.32	5.47	23.23	3.39	2.26	20.04	49.20	31.95
Japan	1.01	1.04	25.77	0.79	0.28	5.85	61.65	219.65
Korea	2.65	1.61	16.99	1.22	0.88	11.31	42.11	72.14
Malaysia	2.60	2.00	31.04	1.29	1.31	15.10	41.52	120.93
Philippines	3.65	3.28	33.91	2.76	1.38	12.66	59.43	51.27
Singapore	1.52	5.21	35.39	0.80	1.00	9.21	38.13	123.02
Thailand	2.94	4.64	29.33	1.84	1.16	11.90	47.40	99.67
Viet Nam	3.98	2.96	13.91	1.73	1.35	15.38	42.28	12.24

Source: World Bank, *Global Financial Development database.*

The need to improve banking system efficiency is becoming pressing in the ASEAN countries as they prepare to meet the mandate to achieve banking sector integration among the ASEAN-5 by 2020. Under the plan (discussed further later in this section), leading banks in each country will be allowed to establish operations and to participate in the banking markets of their partners. Banks that are unable to improve their efficiency risk losing market share and weakening financial positions, which could pose prudential problems and burdens on public finances if they become severe.

The dominance of state-owned banks presents special challenges in several countries

State-owned or controlled institutions dominate the banking systems in China and Viet Nam (where they also dominate the other segments of the financial institutions sector) and are also very important in Indonesia[8] (Table 3.9). The state-owned commercial banks alone account for more than one-half of commercial banking assets in China, about 43% in Viet Nam and about 45% in Indonesia (including the 26 provincial government-owned banks). Moreover, state entities (including local governments) have the controlling interest in nearly all the remaining banks in China and Viet Nam, although many of these banks have minority private ownership shares.[9] Foreign banks are the only genuinely private banks in these countries but their market shares are relatively small. The contrast between the near complete dominance of state control of banks and other major financial institutions in China and the growing private sector has become increasingly stark.

Table 3.9. **Structure of commercial banking sector in Emerging Asia**

	China	Indonesia	Malaysia	Philippines	Thailand	Viet Nam
	2010	2009	2011	2012	2011	2012
Number of Institutions						
All commercial banks	379	120	39	36	32	159
Private banks - domestic	12	116		17	16	34
State-owned banks	5	4		3		5
Foreign Banks	130	38	23	16	15	59
Subsidiaries	40			2	1	9
Branches	90			14	14	50
Other banks	232	1653		651		
Assets/GDP						
All commercial banks	186.3	44.0	194.5	67.2	103.9	172.4
Private banks - domestic	37.4	10.0		47.1	82.8	73.2
State-owned banks	117.8	20.0		9.9	21.1	74.6
Foreign Banks	4.4	13.0	45.0	8.2	16.4	18.2
Subsidiaries		9.0				
Branches		4.0			16.4	
Other commercial banks	26.7	1.0		8.2		

Notes: For China domestic private banks refer to joint stock banks. For Indonesia foreign banks refer to 10 foreign majority owned and 28 joint-venture banks; other banks refer to rural banks; state-owned banks include regional banks. For Malaysia commercial banks also include Islamic banks. For the Philippines other banks refer to thrift banks as well as rural and co-operative banks. For Viet Nam foreign banks subsidiaries refer to four joint-venture banks and five completely foreign owned subsidiaries.

Source: National sources.

Large state ownership in the banking system is hardly unique to these three countries. State-owned banks are important in many developing countries and many advanced economies, notably a number in Europe (e.g. France) have had large and dominant state-owned banks in the not-so-distant past, although in most advanced countries these are now largely privatised (Nasr, 2008). These experiences, however, have indicated that maintaining good governance, commercially effective operations and financial soundness can be particularly difficult for state-owned banking (and other financial institutions). These difficulties stem from the use of state-owned banks for lending to priority sectors and businesses (usually SOEs) on non-commercial terms, limited (at best) market discipline and incentives to operate efficiently or profitably, and limited capabilities for sound lending practices and for serving less preferred segments of the economy. In many countries, these have led to chronic inefficiency in the banks' operations, inefficient allocation of bank credit, and periodic bank solvency crises.

China's state-owned banking system became virtually insolvent by the late 1990s and required many years of government efforts and very large amounts of government financing to resolve (OECD, 2007). Viet Nam is now in the midst of a similar massive effort to restore the solvency of its banks. (The government-owned banks in Indonesia have also suffered from periodic financial solvency problems and their efficiency is still comparatively low[10] [see Srinivas and Sitorus, 2004]).

The governments of these countries have made a number of major efforts to strengthen the capabilities of the state-owned banks so that they can better meet the financial needs of the economy and avoid becoming a burden on public finances. The reform efforts have been most extensive in China, which began to reform its state banking system in the 1990s based on three principles: conversion of state-owned banks into commercial entities ("corporatisation"); diversification of their ownership to include private interests, with special priority on involving foreign banks as "strategic partners"; and strengthening of the banks' governance, management and internal systems for credit assessment, risk management, accounting and other functions (OECD, 2007). These reforms were significantly boosted and reinforced by important improvements in China's bank regulatory and supervisory system, notably the progressive prudential standards in line with international standards; as well as (in the case of listed banks) by China's securities regulator. More recently, the government in Viet Nam has charted a similar reform course, notably the corporatisation and ownership diversification of its banks, although it is less far along.

Indonesia began a process of privatisation of some of its state-owned banks in 2002 by selling large but still minority shares in several of the largest banks, beginning with Bank Mandiri, followed by Bank Rakyat Indonesia (2003) and most recently Bank Tabungan Negara (2009).

China's reforms, along with its bank recapitalisations, have resulted in an impressive improvement in the financial health and international prominence of China's banking system. All five of the state-owned commercial banks (SOCB) along with most of the joint stock banks are now listed on China's (Shanghai) stock exchange. These largest banks have extensive and expanding international operations. Banking system products, such as credit and debit cards, e-commerce and other services, are growing rapidly. Although lending, particularly by the largest banks, is still concentrated on SOEs, the portion of overall loans going to private companies, including SMEs, has grown considerably. The banks are largely autonomous in terms of their individual lending decisions, as "policy lending" directed by the government to particular sectors and firms has ended, although the banks continue to be subjected to overall ceilings on their aggregate lending on certain occasions (usually during periods when the People's Bank of China (PBOC) is seeking to slow credit growth).

However, there has been virtually no change in the overwhelming dominance of state-controlled banks in China or Viet Nam. Private, including foreign, investments in banks have risen considerably over the past decade in China, with encouragement from the authorities, but so far have been confined to minority interests. The share of government-controlled banks in Indonesia has fluctuated but is now roughly equal to its level just before the 1997 Asian financial crisis, although it has declined somewhat since 2000 (Srinivas and Sitoras, 2004).

Despite the progress of the banking system in China, there are reasons to believe that reducing government control by gradually increasing the scope for privately controlled banks would be beneficial. The durability of the improvement in banks' financial performances in China is not yet clear, particularly given that it is at least partly attributable to the rapid growth in the economy. Some evidence suggests that the bias toward lending to SOEs, particularly by the SOCBs, continues (OECD, 2010b). More generally, as with industrial policies, the traditional rationale for state ownership of banks and other financial institutions, namely to overcome market failures in credit allocation to "jump start" industrial development, has become less and less important as the countries have developed. The fact that state ownership of banks and other financial institutions has largely been phased in most advanced economies further reflects a judgement that, ultimately, the drawbacks outweigh the benefits.

In China, while the SOCBs are likely to remain state-controlled for the foreseeable future, giving greater encouragement to the gradual development of privately controlled banks with a regional or local focus could help to improve access to credit by smaller businesses and borrowers in rural areas, who are not underserved by the banking system. Evidence from international experiences indicates that foreign banks can contribute importantly to the development of host countries' financial system by increasing technology, transferring technology, and helping to improve labour skills (Ferri, 2003; Matheson and Roldes, 2001). Thus encouraging greater participation by foreign banks in China and well as Viet Nam, by relaxing remaining restrictions on their activities, would also be beneficial. In Indonesia, resumption of the privatisation of state-owned banks, including those owned by regional governments, should be given consideration.

SMEs will need improved access to financing to fulfil their potential to support development

Small and medium-sized enterprises are essential contributors to the economies of both advanced and developing economies. SMEs in the formal sector in the Emerging Asia countries account for between one-third and nearly 60% of GDP and more than half to as much as 80% of total employment (Figure 3.15). Although predominately oriented toward domestic markets, SMEs are also important contributors to exports. Furthermore, since many SMEs in these countries operate in the informal sector, these figures probably understate their contributions to the economy (Stein, Goland and Schiff, 2010).

Figure 3.15. **SMEs' contribution to GDP, employment and exports in Asia, 2011 (or latest year available)**

Percentage

Note: The definition of employment ratios is not exactly the same for each country. The differences are due to activities included or excluded when enumerating the labour force, the coverage of the age range and residential status. The figure for SMEs' contribution to employment for China refers to urban employment.

Source: Ministry of Commerce People's Republic of China, Government of India (2012), Report of the Working Group on Micro, Small and Medium Sized Enterprises (MSMEs) Growth for the 12th Five Year Plan (2012-2017), Ministry of Cooperatives and Small and Medium Businesses of Indonesia, SME Corporation Malaysia, Ministry of Trade and Industry Singapore, Office of Small and Medium Enterprises Promotion.

StatLink http://dx.doi.org/10.1787/888932939087

The importance of SMEs goes beyond their aggregate economic contributions. SMEs serving as sub-contractors to larger exporting firms play an important role in intra-regional ASEAN trade (Shinozaki, 2012). Individual and family-run businesses are an important source of income for many poorer and lower middle-income households and thus help to reduce poverty and support more inclusive growth. SMEs are also very important to success in sustaining innovative growth and development – in part because highly innovative enterprises tend to start as SMEs – as their role in advanced economies illustrates. Nearly 20% of R&D in the United States and European Union is carried out by SMEs, and SMEs account for more than half of R&D in some smaller OECD countries, such as Iceland, Norway, Portugal and Poland (OECD, 2004).

For a variety of reasons discussed further below, SMEs face important hurdles to their development and effectiveness in all countries. SMEs management and other internal capabilities are often less effective compared to large businesses and weaken their comparative ability to compete. SMEs also face greater external obstacles to their start-up and operations. Apart from financing, these tend to be high regulatory costs for starting and operating a business, limited access to infrastructure, burdensome taxation, and difficulties in finding sufficient skilled labour (Stein, Goland and Schiff, 2010; Harvie et al., 2010). These burdens are generally greatest in developing countries. These hurdles have probably prevented SMEs from contributing as much as they could to the economies of developing countries, including those in the Emerging Asia (Stein, Goland and Schiff, 2010) and could if not addressed prove to be an even greater drag on development in the future.

One of the most important of these barriers is the limited access to external finance faced by SMEs. Financing barriers in Emerging Asian countries are especially detrimental to SMEs' ability to compete in regional and international markets and to participate in regional production chains (Harvie et al., 2010). Accordingly, improvement of this access is one of the key challenges Emerging Asia countries will need in transforming their financial systems to sustain growth and avoid the middle-income trap.

Surveys of SMEs in developing countries have found that on average about one-quarter of the firms in middle-income developing countries and about one-third in lower income developing countries report that lack of access to external finance is an important (although not necessarily the most important) obstacle to their growth and development. Less than 20% of small SMEs in middle-income developing countries and less than one-third have had loans or access to lines of credit (G20, 2010).

Among the Emerging Asian countries, the portion of SMEs viewing lack of adequate financing as an important obstacle ranges from a low of 3% in China to 13%-15% in Indonesia, Malaysia and Viet Nam to more than one-quarter in Thailand (World Bank, 2013). Other indicators, notably rankings in "access to credit" in the World Bank's surveys on *Doing Business*, suggest that SMEs face the greatest difficulty in accessing external finance in Indonesia, still comparatively significant difficulties in China and Thailand, and the least difficulty in Malaysia, which ranks best in the world on this indicator.[11]

These figures, however, understate the constraints on access to external financing because many SMEs rely on personal funds (their own and from relatives and friends) and internal funds and do not need or want external credits. For larger and more rapidly growing SMEs – which tend to include the greatest potential contributors to overall growth and productivity – access to external funds is more important, sometimes essential, to their sustained development. The surveys indicate that in developing countries as a whole, of SMEs that need external funds, 45-55% are unable to obtain them at all, while another 20% are able to obtain some but not all the funds they need (Stein, Goland and Schiff, 2010).

Empirical analyses that have attempted to estimate the size of the "financing gap" between SMEs demand for external funds and those supplied to them also point to significant difficulties in their access. One such study estimates that in 2010 the gap for SMEs in the formal sector in East Asia was USD 350-410 billion, or 11-14% of total credit received (Stein, Goland and Schiff, 2010). The gap is even larger – USD 900-1100 billion – if informal SMEs are included.[12]

SMEs in developing countries that are able to access external funds tend to have a very limited array of choices. Bank loans are overwhelmingly the dominant source of external funds in most cases. Other sources of funds, notably leasing and factoring, are also used but are much less important than bank loans and typically less important than in more advanced economies (OECD, 2004, 2006). This limited use reflects the relatively less developed state of the supporting institutional, legal and regulatory conditions necessary for these instruments.

SMEs generally have much more difficult and limited access to bank loans and other external funds sources for four main reasons. First, SMEs themselves tend to have a higher risk of failure or default, in part because the business skills of their owners and managers are often inadequate and because their smaller size makes them comparatively vulnerable to setbacks.

Second, market failures, notably incomplete and asymmetric information and adverse selection make it difficult for lenders to accurately assess SMEs credit risks. The information problems are compounded by the often limited financial and business records maintained by SMEs.

Third, banks and other lending institutions in developing countries have more limited capacities to assess credit-worthiness and to manage the risks associated with lending to SMEs. The incentives to lend to SMEs are also limited by the lower scale of SME loans, and hence lower revenue to the lender, relative to the costs of evaluating them. Maximum ceilings and other regulations limiting interest rate flexibility in some cases (notably China and Viet Nam) have further reduced incentives to lend to SMEs by preventing banks from charging for the higher risks involved.

Moreover, banks, particularly the largest banks, in developing countries not infrequently have been mainly oriented toward lending to larger businesses instrumental to carrying out development plans. For example, in China and Viet Nam, the large state banks and joint-stock banks (in China) traditionally focused on lending to the larger state-owned enterprises in accordance with the government's economic plans. The large state banks in Indonesia and to some extent the largest banks in Thailand have similar traditional orientations. While this emphasis has been shifting for some time, changing the business culture of these institutions to diversify their lending takes some time. Smaller banks in these countries, such as the city banks and rural credit co-operatives in China and the rural banks in Indonesia, have been more oriented toward lending to SMEs, but their financial problems (notably those of rural credit co-operatives in China) have significantly limited their abilities at times.

Fourth, SMEs in Emerging Asia and other developing countries have faced significant institutional and regulatory barriers to their access to credit. Bank lending in Emerging Asia countries traditionally is secured by collateral. Although the situation has been changing, traditionally permissible collateral has been limited to real estate while "moveable" collateral, such as equipment, inventories, and receivables, have not been acceptable as collateral. SMEs typically own very little real estate than can be pledged as collateral and this constraint has been a major barrier to their ability to obtain bank loans. Indeed, surveys of SMEs in developing countries have typically found that lack of collateral is the single most important reason for their inability to access bank lending (see Shinozaki, 2012). The narrow range of permissible capital is partly a reflection of the limited development of supporting institutions, in particular arrangements to register collateral and to define the conditions under which lenders can take possession of it. Furthermore, the value of collateral to lenders has been lowered in some cases by inadequacies in bankruptcy regimes, which can make it very difficult and costly for lenders to take possession of collateral in the event of default.

Highly innovative SMEs, those with the greatest potential for rapid growth and for contributing to raising an economy's overall productivity, face especially difficult challenges in obtaining the external financing they need to develop; and, again, these challenges tend to be greatest in developing countries. A set of instruments have evolved internationally to meet the distinctive financing needs of these highly innovative enterprises, but these require supporting institutional and market capabilities that are in an earlier stage in most developing countries (Box 3.8.).

Box 3.8. Financing requirements for the development of innovative SMEs

SMEs specialising in innovation (innovative SMEs) have distinctive characteristics that imply different financing requirements compared to those of SMEs in other areas. Innovative enterprises have a comparatively high risk but high growth potential, depend for their success on the technical skills of their founders, specialise in intangible "products" such as technical and production processes, and operate in markets subject to rapid and difficult to predict changes. These characteristics make bank loans and other forms of fixed income financing less suitable and feasible and require instruments with equity characteristics allowing for sharing of risks and returns between the enterprise and investors.

Advanced economies have come to rely on *venture capital* to finance innovative enterprises in their early stages of growth. Venture capital (VC) is usually provided through private equity funds that invest in a number of promising new innovative companies with a view to making a high rate of return within the medium-term. Venture capital investments are by their nature of limited duration, and are intended to sustain an innovative company to the point where it can obtain funding from other sources, such as bank loans or equity. Venture capital firms not only invest in the companies but provide managerial, marketing and other business expertise to the firms and typically have considerable control over the companies' decisions.

Several institutional requirements are critical to the development of venture capital in country. Stock markets need to be sufficiently well developed with rules that facilitate equity offerings by innovative SMEs to allow venture capital firms to "exit" from involvement when a target country at the appropriate time. Venture capital firms are typically most easily structured as partnerships but need to be afforded limited liability under commercial law given the risks involved.

Venture capital first developed in the United States, and received a major impetus in 1958 when the Small Business Administration to license small business investment companies to finance and assist in the management of small entrepreneurial enterprises (Wikipedia), and is most developed in that country. Venture capital was a major force in the US technological boom in Silicon Valley, California in the 1960s and 1970s. Venture capital has also become well developed in Europe. Venture capital is less developed in developing Asian countries, in part because of the more limited development of equity markets and supporting legal/regulatory structure, but is growing rapidly, especially in India and China.

Sources: OECD, 2004; Wikipedia article, *Venture Capital*.

Emerging Asia countries have been making strong efforts to improve access by SMEs to financing

Since at least the early 1990s, Emerging Asia countries have been implementing a range of policies to improve SMEs' access to funding, and these efforts were further boosted in the wake of the 1997-98 Asian financial crisis, which underscored both the importance of SMEs and their problems. These policies have taken four basic forms: direct government mandated or "encouragement" of lending to SMEs by state lending institutions; strengthening and in some cases development of financial institutions and markets' capacities to provide financing to SMEs; provision of loan subsidies or credit guarantees for loans to SMEs; and legal and regulatory changes to remove impediments to SMEs' access to credit.

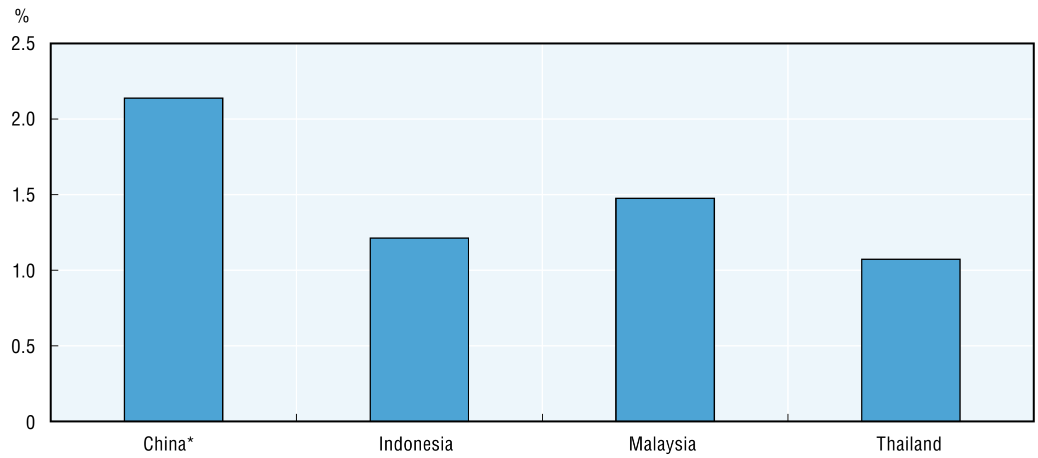
Many of the earliest efforts to improve SME financing focused on direct government interventions in lending or subsidies for bank loans. For example, Indonesia in 1990 instituted a mandate for banks to allocate 20% of their credits for working loans and investments of SMEs and co-operative enterprises (Machmud and Huda, 2010). Beginning in the late 1990s, Chinese authorities began to require the four largest state-owned and the joint-stock banks to establish special departments for SME lending and "encouraged" the banks to gradually increase the portion of their credit going to SMEs (OECD, 2010b). However experiences in these and other countries indicate that such direct mandates are of limited effectiveness unless accompanied by other reforms that improve the banks' governance and their incentives and capabilities to lend to SMEs (Stein, Goland and Schiff, 2010). Notably, compliance with the mandates in Indonesia was limited, at least in the earlier years. The mandates in China were accompanied by broader reforms to strengthen their governance and commercial incentives and capabilities and seem to have been more effective. However even in this case, loans to SMEs by the larger banks have tended to go to larger businesses rather than smaller SMEs with the greatest difficulty in accessing credit.

Some countries have established one or more dedicated financial institutions to lend to SMEs. Government-owned banks dedicated to providing financing and other services to SMEs were established in Thailand in 2002 and in Malaysia in 2005 (Bank Perusahaan Kecil & Sederhana Malaysia Berhad). The BNM in Malaysia also manages a number of programmes established in 2009 to improve finance to SMEs, including various microfinance schemes (Rasieh, 2010). Other countries in the Emerging Asia have established programmes for SME lending within their development banks.

Credit guarantees, which have long been widely used in developing and many advanced economies, have become a key instrument for overcoming barriers to SME finance in the Emerging Asia countries. Credit guarantees help to overcome information and other market failures by reducing the risks faced by lenders to SMEs. Credit guarantees in most ASEAN countries are provided through government-financed and controlled entities.[13] In China, the guarantees are provided through numerous non-state entities operating at the regional and local level rather than controlled or directed by the central government, although they are usually financed in large part by provincial and local governments (Shim, 2006). Within the Emerging Asia, credit guarantees are most extensive in China and Malaysia, where the total outstanding amounts to about 2% and 1.5% of GDP, respectively. (Figure 3.16) These figures compare to somewhat higher ratios in more advanced countries in Asia, notably Chinese Taipei (about 3.5%), Japan and Korea (5-5.5%) (Shim, 2006).

Figure 3.16. **Credit guarantees in Emerging Asia, 2011 (or latest year available)**

Outstanding guarantees as a percentage of GDP



Note: *Figure for China refers to 2009.

Source: OECD Development Centre`s calculation based on World Bank, *World Development Indicators*, Presentations by the Chengdu Small Enterprise Credit Guarantee Institute and the Credit Guarantee Corporation of Indonesia at the European Association of Mutual Guarantee Societies (AECM) (www.aecm.eu), Pacific Economic Cooperation (APEC) (http://apec.org/), and the Thai Credit Guarantee Cooperation (www.tcg.or.th/eng/).

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While credit guarantees have helped to improve SMEs' access to external credit, OECD countries' experiences have highlighted that the programmes need to be carefully designed if they are to be efficient and financially viable (Box 3.9.). These experiences also highlight the need for good governance and internal controls in the guarantee companies if they are to effectively manage the risks to which they are exposed. Credit guarantee institutions have tended to operate at a loss in many Emerging Asia countries and China's credit guarantee system experienced extensive financial distress in the middle of the last decade. While the low profitability of the institutions may reflect the need to subsidise the cost of the guarantees to make them affordable, it also highlights the challenges of achieving effective design of the programmes. The effectiveness of credit guarantee programmes can also be limited when the capacities of lending institutions are low. In China, banks receiving guarantees often also required collateral from the borrower, to the extent that any conceivable losses from default were more than covered ("over-insured") (OECD, 2010b). Banks receiving guarantees in Indonesia still often demand collateral of as much as 30% of the loan principle (Machmud and Huda, 2010).

Box 3.9. **The design of credit guarantee programmes**

Credit guarantees provide insurance against default for a specified portion of a loan made to an SME or other covered business. Typically, the bank or lending institution providing the loan is responsible for assessing the creditworthiness of the prospective borrower and for collecting and monitoring repayment, while the guarantee institution determines whether the loan is eligible for a guarantee.

The terms under which guarantees are extended vary among countries (and sometimes across the type of borrower) and reflect a balance between: the need to preserve the incentives of the lender to rigorously assess creditworthiness and to monitor compliance with the loan terms; the need to keep the costs of the guarantee sufficiently affordable while covering the costs of the guarantee institution, including the costs arising from loan defaults; and the need to maximise the total amount of guarantees provided given the amount of capital while maintaining its financial soundness. Three parameters largely determine how effectively this balance is struck: the coverage ratio of the guarantee, the guarantee fee, and the leverage ratio.

The *coverage ratio* is the portion of the loan covered by the guarantee. The higher the coverage ratio, the greater the risk assumed by the guarantee institution and the lower the risk of the primary lender. Coverage ratios typically range from 50% or more to as much as 100% internationally. In Indonesia, they are limited to 75% for Perum Sarana and 50-70% for Askrindo, to 50% in Thailand, and 30-100% in Malaysia. Very high coverage ratios tend to blunt incentives for banks to properly assess and monitor guarantee loans to SMEs and impose greater costs to the guarantee institutions from loan defaults. Overly low ratios insufficiently cover the risks of lenders and limit the extent to which the guarantees are used. International experiences suggest that coverage ratios between 60% and 80% tend to achieve the best results (OECD, 2009).

Guarantee fees typically range between 0.5% and 2% per annum of the amount guaranteed. The fee needs to be high enough to cover the losses from loan defaults if the institution is to be profitable; but fees that are too high will limit the extent to which the guarantees are used. For a given amount of risk in the guarantee portfolio, the higher the coverage ratio, generally the higher the guarantee fee will need to be to be to cover the losses incurred.

The *leverage ratio* is the ratio of outstanding guarantees to the capital of the guarantee institution. These maximum ratios vary widely internationally; in ASEAN, the ratio varies between 5 in Thailand, to 20 in Indonesia (a common figure for guarantee programmes internationally), with no maximum in Malaysia. The higher the leverage ratio, the greater amount of the guarantees that can be provided but also the greater the exposure to losses from loan defaults. Thus for a guarantee enterprise to make a given return on its capital, a higher leverage ratio typically will require a lower coverage ratio or higher guarantee fee.

Sources: Shim (2006), "Corporate credit guarantees in Asia", *BIS Quarterly Review*, December, www.bis.org/publ/qtrpdf/r_qt0612i.pdf. OECD (2010c), "Facilitating Access to Finance: Discussion Paper on Credit Guarantee Schemes", OECD, Paris.

Barriers to SME finance in most Emerging Asia countries have been significantly reduced by several important changes in the regulatory environment and supporting institutions. In China, the 2007 reformed Property Law provides for the use of mortgages on tangible moveable property, such as equipment, as collateral as well as in principle for the use of "future" property such as receivables and inventories (Arner et al., 2007; see Table 3.10). The use of at least some moveable property as collateral is also possible in

Indonesia and Thailand, including receivables in the former. Revisions to the civil code in Viet Nam that took effect in 2006 also provide for the use of some moveable property as security. The recent improvements in these laws have been reinforced in China and Viet Nam by the establishment of property registries. Reforms of bankruptcy codes, notably in China, have afforded creditors greater scope to take possession of collateral in the event of default. However the utility of collateral to lenders is still reduced in China as well as Indonesia and Thailand by cumbersome and costly procedures for taking possession. In Indonesia, secured creditors seeking to foreclose are required to resort to essentially the same court procedures as unsecured creditors (Arner et al., 2007).

Table 3.10. **Collateral use provisions in Emerging Asia**

Country	Real property		Moveable property	
	Allowed?	Conditions/Restrictions	Allowed?	Conditions/Restrictions
China	Yes	Only land-use rights in state-owned property can be mortgaged and used as collateral; foreign holders must register claims with State Administration on Foreign Exchange (SAFE)	Yes	Tangible moveable property such as machinery and vehicles can be mortgaged and used as collateral; The 2007 reformed Property Law sanctions the use of receivable, inventories and other property with fluctuation value as collateral
Indonesia	Yes		Yes	The Fiduciary Security Law permits borrowers to transfer title to property while retaining rights to its use outside of default. Permitted property includes intangibles and receivables
Malaysia	Yes		Yes	
Philippines	Yes		Yes	Chattel mortgages and pledges can be taken for tangible moveable property but not for future obligations; legal rulings (but not formal law) provide for use of some, but not all, types of inventories as collateral;
Thailand	Yes	Mortgaged land can be foreclosed only after loan interest or charges are past due for five years or more	Yes	Mortgages are limited to certain types of property, such as ships and some classes of machinery, boats; other types of moveable property can be pledged,
Viet Nam	Yes	Only land-use rights in state-owned property can be mortgaged and used as collateral	Yes	Provision for moveables in the civil code

Source: Arner et al. (2007), "Property Rights, Collateral, Creditor Rights, and Insolvency in East Asia", *Texas International Law Journal*, 42:515.

Another important area of improvement has been the strengthening, and in some cases the introduction, of credit registries containing records of repayment history, outstanding credit and unpaid debts on enterprises and individuals. China, Indonesia and Viet Nam established public credit registries in the middle of the last decade. Their coverage has since grown to include more than one-quarter of all adults and businesses in China and more than one-third in Indonesia and Viet Nam. There have also been significant increases in the coverage of the public credit registry in Malaysia and in the private credit registry system in Thailand. These improvements are reflected in noticeable improvement since 2004 in the World Bank's indicator of "depth of credit information" for these countries. Malaysia continues to get a top rating in this area while Thailand's rating has improved to second to the top.

A number of countries in the region have established or strengthened access to equity financing for SMEs, as part of a broader effort to improve financing for innovative SMEs with high growth/risk profiles. China established an SME board (SET) for SMEs on the Shenzhen stock exchange in 2003, followed in 2009 by the establishment of the Chinext board for high growth SMEs in 2009. As of the end of 2012, the SET and Chinext boards had 701 and 355 companies listed, respectively, with a market capitalisation of 5.5% and 1.7% of China's GDP, respectively (Shinozaki, 2012). Exchanges with regulations adapted to better suit SMEs (Alternative Investment Markets), particularly high growth companies, have also been established in Malaysia and Thailand.

Venture capital facilities are also growing rapidly in the region and are most advanced in China and Malaysia. China's private venture capital sector has grown very rapidly in recent years, when private participation was authorised. China and Malaysia ranked 22nd and 25th respectively in the attractiveness of its venture capital/private equity markets in the 2012 rankings developed by Groh, Liechenstein and Lieser, well below the rankings of Singapore and Hong Kong, China (5th and 6th respectively) but near that of the other two highest ranked Asian countries, Korea and Chinese Taipei (18th and 19th respectively) (Groh, A., H. Liechtenstein and K. Lieser, 2012). Venture capital markets in Indonesia, Thailand, the Philippines and Viet Nam are at an earlier stage of development but significantly improved in recent years.

Overall, Emerging Asia countries have made progress in improving conditions for SME financing. However, SMEs access in the Emerging Asia countries, particularly that of high growth potential and innovative enterprises, still needs considerable improvement if they are to be able to adequately support the countries development. Further reforms are particularly needed to:

- Further broaden the range of permissible collateral to include receivables and some intangible property and to lower costs and ease barriers to claiming collateral in the event of default.
- Increase the coverage of public and private credit registries, particularly in China, Indonesia and Viet Nam.
- Ease, as prudential considerations permit, listing requirements for SMEs on stock exchanges to improve their access.
- Continue to strengthen capacities of smaller financial institutions and micro-credit facilities to finance SMEs.

It will be particularly important to co-ordinate and integrate reforms to improve SMEs finance access with other policies to improve their business capabilities, such as marketing and innovation, and to reduce barriers to their access to certain sectors.

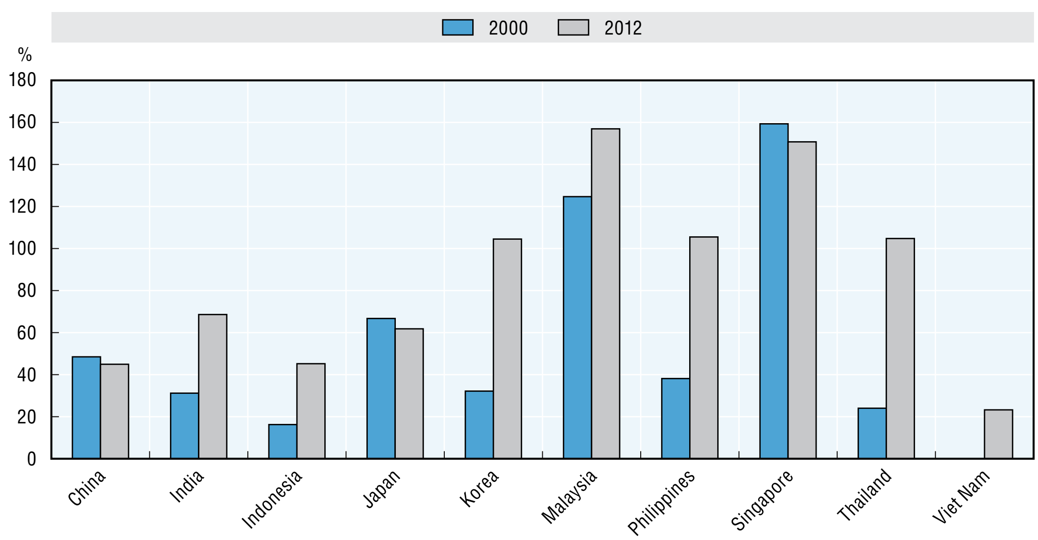
Improvement in financial capabilities depends on further capital market development

Capital markets provide important financial capabilities that will become increasingly important to Emerging Asia countries as they develop further. Corporations in the region will need to have access to a wider range of instruments to finance investment and manage risks in order to compete effectively with economies with more advanced capital markets. Capital market development is needed to provide the increasingly diverse array of financial instruments and services that will be needed by the growing middle class and to provide the ageing population with efficient savings vehicles for retirement. Well-developed capital markets are essential to the provision of derivatives and other vehicles to manage the increasingly diverse and complex risks that will be faced by businesses and households. Better developed capital markets are also essential to reducing the over-concentration of risks in the banking, and the hazards it poses to financial stability, as well as to managing the impacts of and containing the risks from surges in capital inflows.

There has been considerable growth in the capital markets of Emerging Asian countries since the 1997-98 Asian financial crisis underscored their importance, but the progress has been uneven both across market segments and countries. Stock markets have grown noticeably in aggregate size (market capitalisation relative to GDP) in China and most of the middle-income ASEAN countries. However, except for Malaysia, where the market is most developed, their size is still well short of that in more advanced economies in the region, such as Singapore; Hong Kong, China; Japan and Korea (Figure 3.17).

Figure 3.17. **Stock market capitalisation in Asia, 2000 and 2012**

Percentage of GDP



Source: World Bank, *World Development Indicators.*

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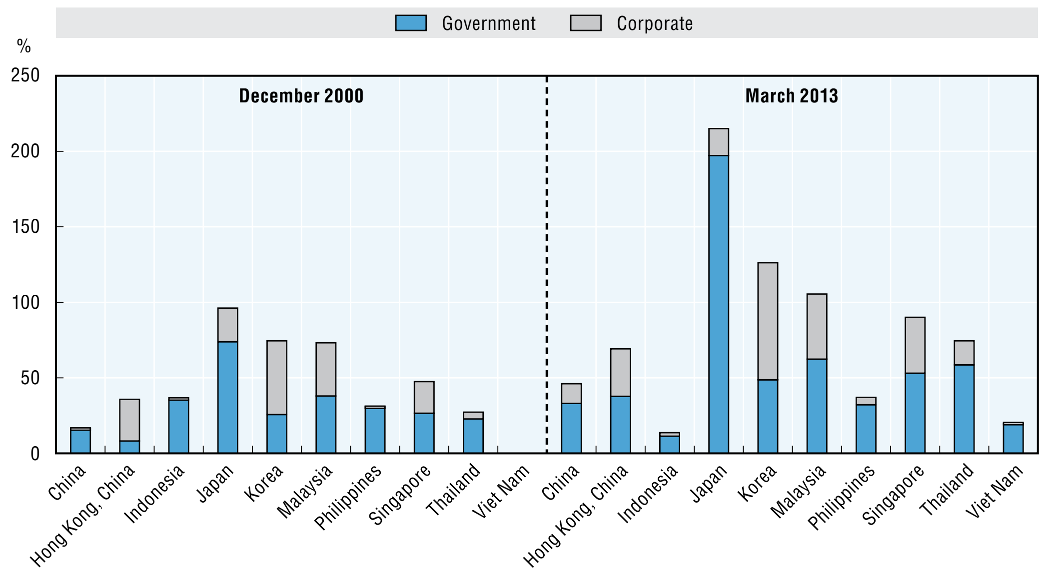
Bond markets have also grown considerably in aggregate size, particularly in Viet Nam where the market barely existed a decade ago, and in China (Figure 3.18). Indonesia is a notable exception to this growth, as its bond market is now smaller relative to GDP than it was in 2000. Overall, the bond markets in the region are noticeably smaller than those of Japan and Korea, much smaller than those in the United States and the United Kingdom, and smaller than those in a number of emerging markets outside the region. The ASEAN-6 countries together account for only 1.3% of total world bonds outstanding, China for 3.3%, and India for 1% – shares that are all less than these countries' shares of world GDP. Brazil accounts for a larger share of world bonds outstanding than the ASEAN 6 countries combined (OECD, 2012).

Figure 3.18. **Bonds outstanding in Asia**

Percentage of GDP



Source: Asia Bonds Online.

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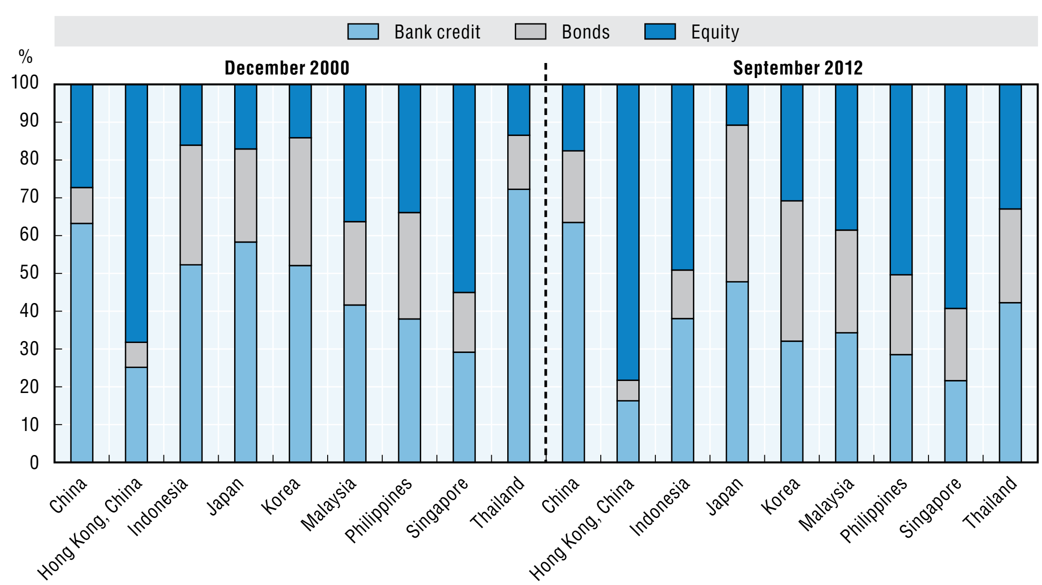
The growth of the capital markets has helped to reduce the dominance of banks in the financial systems in the region but it has not ended it. Banks still account for more than half of the assets of all financial institutions in Malaysia and Thailand and nearly three-quarters in Indonesia. Outstanding bank credit as a share of total financial system assets has also fallen but is still well over half in China and more than one-third in Indonesia, Malaysia and Thailand (Figure 3.19).

Figure 3.19. **Domestic financing profile in Asia**

Percentage share of financial system assets



Notes: Bank credit, share of total credit outstanding of banks to total of the three; bonds, share of total bonds outstanding as total of the three, Equity, share of stock market cap to total of three.

Source: Asia Bonds Online.

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Growth in the equity and bond markets has also been uneven across major segments. Most of the growth in regional bond markets is attributable to government bonds, whose increase has been driven by the greater resort to deficit financing since the 1997-98 Asian crisis, and particularly in the wake of the 2007-08 global financial crisis. The growth in the markets for corporate bonds has been much slower. Except for Malaysia, corporate bond markets are the least developed segment of the capital markets in the region and are the most behind their counterparts in more advanced economies in the Asian region and in the United States and much of Europe. The lagging development of corporate bond markets is all the more significant given that corporate bonds are particularly important to improving financial options for corporations and thereby reducing the concentration of commercial risks on the banking system.

There is also comparatively limited diversity in the participants in equity and bond markets in much of the region. In China, stock market listings and corporate bond issuance are overwhelmingly dominated by state owned enterprises, in part because they have been given preferential access compared to private and other non-state companies, although this situation has begun to change.

Securitised assets, such as mortgage backed securities, have played an important role in advanced economies by increasing access of borrowers and improving risk diversification in the financial system. Securitisation is less developed in Emerging Asian economies, with the markets in Malaysia, the Philippines and Thailand being the most active (Gytelburg and Remelona, 2006). Securitisation is in its infancy in China and Indonesia, but is growing rapidly in the former, boosted by the advent of the "loan designation" system under which banks offer investors a portfolio of loans based on their specifications of desired return and industry exposure (OECD, 2013a). Derivatives markets (which are important to the development of asset securitisation and other more sophisticated capital market instruments) are also at a very early stage of development in China and most ASEAN countries.[14]

Other indicators further highlight the comparatively lesser development of the capital markets in the Emerging Asia region. Liquidity, as measured by market turnover relative to outstanding issues and bid-ask spreads (in bond markets), is lower in most cases than in the more developed markets in advanced economies (Table 3.11 and Figure 3.20). The typical size of issues and market transactions in the bond markets in the region is also comparatively low. Together, these indicators suggest that bond markets are most advanced in China and Malaysia and Singapore but much less advanced in Indonesia, Thailand and Viet Nam.

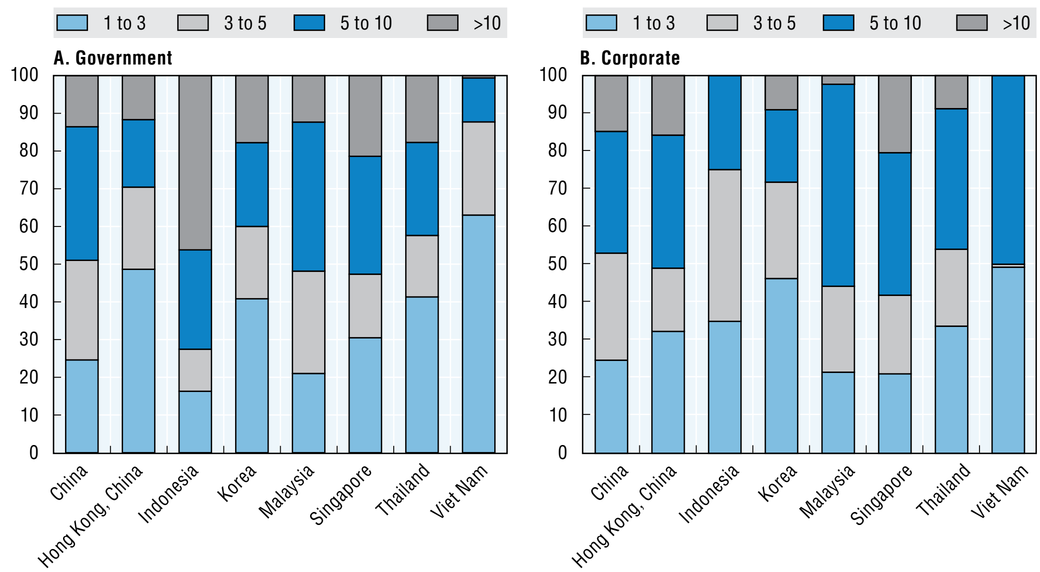
Table 3.11. **Bond market indicators in Asia**

	Indonesia	Malaysia	Philippines	Singapore	Thailand	Viet Nam	Hong Kong, China	Korea
Government								
Typical issue size (USD million)	1.8	10.0	3.0	7.9	4.7	2.4	7.3	6.5
Trading volume (USD million)	20.0	115.7	80.5	68.2	200.5		150.6	606.3
Turnover ratio	0.2	0.6	1.0	0.6	0.9		1.6	1.1
Corporate								
Typical issue size (USD million)	103.6	285.9	146.0	158.5	98.2	73.0	46.8	94.3
Trading volume (USD million)	2.2	13.1	-	-	5.1		10.9	125.8
Turnover ratio	0.1	0.1	-	-	0.1		0.1	0.1
Bid-ask spread (basis points)	38.8	2.7	2.1	3.1	3.2	30.5	6.4	0.6

Source: Asia Bonds Online.

Figure 3.20. **Bond maturity profiles in Asia, as of June 2013**

Percentage share of maturities



Source: Asia Bonds Online.

Source: Asia Bonds Online.

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Capital market development in the Emerging Asia countries, particularly development of corporate bond markets, has been limited by a number of economic, institutional and regulatory factors, many of which are common in developing economies in all regions. In particular, key supporting infrastructure, such as clearing, settlement, and payment systems and benchmark yield curves, on which capital markets depend tend to be more limited in developing countries, largely because they and the legal and regulatory arrangements that support them require time to develop. Credit rating agencies, which play a key role in providing information allowing investors to assess risks in corporate bond markets, have only recently begun to develop in much of the region.

Legal and regulatory restrictions, such as restrictions on who can issue in the markets and on the type and amount of various types of capital market instruments that domestic financial institutions are permitted to hold, are often based on prudential concerns, mainly to avoid excessive risk-taking by institutions with limited capabilities and experience, but also in some cases reflect industrial policy or other priorities. For example, the authorities in China have limited ("rationed") new listings in the stock markets and until recently largely restricted corporate bond market issuance to the largest and most financially sound SOEs.

Capital market development has been further inhibited in the Emerging Asia region by several other, more distinctive, factors.

- The limited size of a number of the region's economies restricts the scale that the markets can achieve, at least based on their domestic investor base. Evidence suggests that this limit is especially binding on corporate bond markets, whose optimal scale tends to be greater than for equity or government bond markets (Goswami and Sharma, 2011). Other evidence suggests that among developing

Asian economies, only the corporate bond markets in China and Malaysia have yet achieved the size necessary for full efficiency (McCauley and Remelona, 2000; Siackhachanh, 2012).

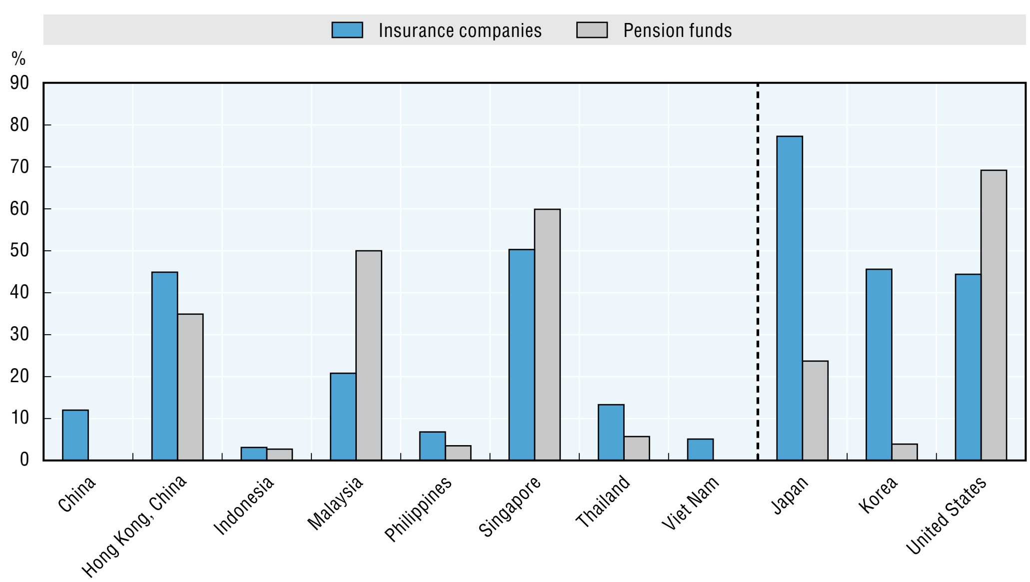
- The comparative importance of foreign invested firms in the region's corporate sectors has tended to depress the potential supply of new issues on the domestic corporate bond (and to some extent stock) markets because these firms tend to fund themselves from offshore or internal funds (OECD, 2012).[15]

- Development of bond as well as equity markets has also been constrained by limitations in financial infrastructure, such as clearing and payment systems that are common in developed countries.

The limited state of pension funds, mutual funds, insurance companies, and other institutional investors in most ASEAN countries has been an important factor slowing the development of domestic capital markets. Pension fund assets amount to only about 1% of GDP in China and less than 5% of GDP in Indonesia, the Philippines and Thailand (Figure 3.21). These are much lower than the ratios of around 25% in Japan, nearly 60% and 65% respectively in Malaysia and Singapore, and nearly 70% in the United States.[16] Insurance company assets are similarly comparatively low relative to GDP in the ASEAN countries and China, with the notable exception of Malaysia. The comparatively limited role of institutional investors in the region is partly a reflection of the early stage of development of pension and social security arrangements and of financial instruments for insurance and old age savings.

Figure 3.21. **Ratio of assets of insurance companies and pension funds to GDP in Asia and OECD countries**

Percentage of GDP



Note: Insurance figures for 2009, except for Indonesia (2007); Pension fund figures for 2010, except for Indonesia (2007) and Malaysia (2008).

Source: World Bank, *Global Financial Development Indicators*.

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Regulatory restrictions on the institutions' investment choices and permitted business activities – due in part to the understandably high priority placed by financial regulators on maintaining the financial soundness of the institutions and protecting savers – have also inhibited the development of institutional investors. For example, until recently in China, corporate bond issuance was limited to the highest rated state owned enterprises; although the recent authorisation given to the two exchanges to list bonds issued by smaller or less highly rated companies should help to widen the market considerably (OECD, 2013a). Insurance companies and pension funds in a number of countries (notably China and Indonesia) are limited in the share of their assets they are permitted to invest in corporate bonds.

Many of the constraints on capital market development in China and the ASEAN countries have eased over the past decade (see OECD 2012). Most countries have taken steps to broaden the investor and issuer bases, including by easing access by foreigners to domestic capital markets. There has been considerable improvement in market infrastructure, which in some areas is well in line with international standards and best practices. Growth and broadening of the Islamic bond markets in Malaysia (which is now the dominant international player in this area) and Indonesia have provided an important impetus to the capital markets in those countries.

A number of other developments are also favourable for an acceleration in the development of regional capital markets. The rapid growth of mutual funds, especially in China, India and Malaysia, will further help to boost demand for capital market instruments. Demand from international investment funds could also boost growth of regional capital markets, particularly given that emerging market debt is still underweighted in the portfolio of OECD investment funds and given the comparatively high credit ratings of ASEAN countries as well as China among emerging markets.

A number of policies at the national level would be beneficial to further capital market development in the region, including the following (OECD, 2012).

- Further relaxation of restrictions on listing, bond issuance and institutional investors' portfolio choices;
- Further reforms to improve disclosure, enforcement of rules against insider trading and other harmful market practices, and to strengthen corporate governance;
- Strengthening of market infrastructure in certain areas, notably clearing, depository, and settlement systems for bonds;
- Authorisation for and development of derivatives markets, in line with the development of prudential standards and capabilities to ensure that their risks can be managed.

Regional initiatives have great potential to boost the development of ASEAN financial systems

The on-going initiatives in ASEAN to promote development of financial services and markets within the member countries and their intra-regional integration have considerable potential to boost the development of their financial systems. Better integration will help to make up for the limited scale of financial markets in most of the countries, improve competition, and help to strengthen the overall efficiency, competitiveness, and capabilities of ASEAN financial institutions and markets.

To date, financial integration within ASEAN has been rather limited. This limited integration is both a symptom of the limited development of key segments of the financial system within ASEAN countries but also an impediment to that development. Portfolio capital tends to flow between individual ASEAN countries and markets and institutions outside the region, particularly those in more advanced countries. ASEAN debt and equity assets make up about 8.2% of total portfolio assets held within this region in 2011, a modest share although up considerably from the 2.3% share recorded in 2000 (ADB regional integration database). This reflects the tendency of savers in ASEAN countries to place their foreign investments in the more developed markets rather than in the less developed markets within the region. The intra-regional share of portfolio assets for the Emerging Asia3 region is quite a bit higher, at 28.8%.

Foreign banks' involvement in ASEAN financial systems is extensive, both as cross-border lenders and (to a lesser extent) as business presences in the region's domestic markets. But again, most of this activity involves banks outside the region. Foreign banks with operations in ASEAN countries come mainly from North America, Europe and Japan, although a few banks from China have begun to establish presences. Only a few ASEAN banks – Bangkok Bank (Thailand), Maybank (Malaysia) and United Overseas Bank of Singapore – have region-wide operations and then only in seven of the countries. ASEAN-based foreign banks account for about 8.5% of total banking assets in Malaysia, or about 20% of all foreign bank assets, and 3.5% of total banking assets in Thailand, or about one-quarter of total foreign bank assets (see ADB, 2013b). The limited extent of cross-border banking service provision reflects the relatively small size of most of the banks by international standards and their lesser development.

The Asian Bond Market Initiative (ABMI) has been underway since 2003 and is focused on developing national bond markets through investments by regional funds and initiatives to develop national and regional financial infrastructure. The Asian bond market funds created under the auspices of the ABMI invest in local currency bonds of the member countries. The funds have helped to spur national reforms to reduce tax, accounting and regulatory impediments to cross-border investments in bonds (Bhattacharyay, 2011). The ABMI has also set up working groups to consider measures for: developing new securitised bond instruments, establishment of a regional bond guarantee agency and a regional credit rating agency, and the creation of regional settlements and clearance systems[17] (OECD, 2012).

In the wake of the 2007 global financial crisis, the ABMI's efforts have been intensified. In 2011, Asian finance ministers approved the establishment of a regional Credit Guarantee and Investment Facility (CGIF) to finance infrastructure investment across ASEAN. The CGIF has a mandate to promote issuance of bonds in local markets of companies with good but less than AAA rations and to facilitate cross-border bond issues by investment grade rated companies in countries with below investment grade sovereign ratings (Siackhachanh, 2012).

A broader roadmap for ASEAN financial integration has been proposed as part of the ASEAN Economic Community (AEC) agreed upon in 2007 with the goal of creating a free flow of goods, services and investments and a freer flow of capital among the members by 2020. The roadmap for financial integration is based on three "pillars":

- liberalisation and integration of financial services (FSL);
- capital account liberalisation (CAL);
- regional co-operation in regulatory policies, including crisis prevention and management and regional payments arrangements.

Implementation of the objectives under these pillars is to be based on principles similar to those governing regional trade liberalisations, namely a "two-track" process allowing members who are ready to proceed with reforms while others can join them later ("ASEAN minus X"); respect for national objectives and conditions; flexible timelines and preconditions for proceeding with specific reforms; adherence to international standards; and safeguards against risks to macroeconomic or financial stability arising from the reforms (ADB, 2013b).

The ASEAN Banking Framework (under Pillar 1) aims to integrate the region's banking markets by ultimately allowing banks from one member country to enter and operate in the markets of other members, eliminating discrimination against foreign banks *vis-à-vis* national banks, and to create a more "consistent" regional banking environment. The framework allows for certain limitations to allow member states to prevent risks to their banking systems from foreign entry if they should arise. In particular, only the highest quality banks that meet stringent qualifications will be allowed to enter the markets of all the member countries and the granting of equal treatment for foreign entrants will be based on their risk profile. Domestic regulators will be afforded the option to maintain certain restrictions that may limit cross-border expansion if prudential concerns warrant them and the harmonisation banking regulations across country will proceed more slowly, except in certain areas including "prompt corrective action".

The specific plans for the second pillar, CAL, are still being considered and developed but certain principles have been enunciated. The AEC Blueprint defines three principles to shape the liberalisation: orderly liberalisation in line with member countries' policy priorities and conditions; safeguards against macroeconomic or financial instability that may arise from liberalisation; and ensuring that the benefits of liberalisation are shared among all member states. Some goals for capital account liberalisation through 2015 are outlined in the AEC Strategic Schedule on Freer Flows of Capital, the ASEAN Capital Market Forum Implementation Plan, and the Working Committee on CAL plan; but these goals as well as the timetables are rather general (Park and Takagi, 2012).[18]

The potential benefits of the ASEAN initiatives go beyond their direct impacts on regional financial integration. The initiatives are likely to also help to strengthen linkages between ASEAN and international financial markets generally, including those in the rest of Asia and in more advanced economies. Moreover, the efforts are already creating important incentives for member countries to strengthen their financial systems in preparation for integration. This is particularly the case for the banking integration initiative, which is imparting some urgency to efforts by banks and regulatory authorities in the region to improve the capabilities of their banking systems to meet the increased completion that integration is likely to bring.[19]

Strengthening macroeconomic policy capabilities

Achieving the transformations needed to sustain-productivity led growth is not simply a matter of microeconomic economic forces and policies alone. Macroeconomic and financial stability are also essential. Macroeconomic and financial instability are inimical to the ability of businesses to make sound investment and other decisions as well as to the capabilities of financial and other institutions that are critical to resource allocation. Numerous historical experiences, including that of Japan during the 1990s, have underscored the severe and protracted impediments to growth that macroeconomic and financial stability can pose.

Most Emerging Asian countries have been quite successful in maintaining macroeconomic and financial stability since the 1997-98 Asian financial crisis (AFC), particularly in the wake of the 2007-08 global financial crisis (GFC). Their success is a reflection of significant improvements in the key institutional frameworks that underpin macroeconomic and financial stability: monetary policy; financial supervision and regulation (prudential policy); exchange rate policy; and fiscal policies. However, the difficulties Emerging Asian countries had to overcome in maintaining stability in the wake of the GFC, their continuing struggle to manage large surges and withdrawals in capital flows, and the broader lessons that have come out of the GFC have highlighted the need for further improvements in these frameworks, particularly in the following areas:

- Strengthening of monetary policy instruments and, in some countries, clarification of priorities.
- Further development of macroprudential frameworks and capabilities.
- Increased flexibility for exchange rates.

Monetary policy frameworks are much improved but could be strengthened further

Monetary policy frameworks in the Emerging Asia countries have changed markedly since the 1997-98 Asian financial crisis. Following the abandonment of the fixed exchange rate peg to the USD and the resulting increased autonomy for domestic monetary policy, central banks in Indonesia, Malaysia, the Philippines and Thailand reoriented their monetary policy frameworks, with price stability as the central objective and with interest rates as the chief operational instrument. In China, the monetary policy framework has largely abandoned its earlier "command and control" approach to macroeconomic management in favour of an increasingly market oriented approach dependent on indirect instruments.

There are important similarities as well as differences among the characteristics of the monetary policy frameworks in the Emerging Asian countries. Three of the middle-income ASEAN countries, Indonesia, the Philippines and Thailand have adopted inflation-targeting monetary policy frameworks, while China and Viet Nam adhere to some form of monetary aggregates targeting (Table 3.12). Malaysia's monetary policy framework could be described as "eclectic" in the sense that the central bank does not set formal targets either for inflation or monetary aggregates (see Filardo and Genburg, 2012).

The primary formal monetary policy objective in nearly all these cases is price stability in some form (Filardo and Genburg, 2012). The commitment is most explicit in the inflation-targeting countries, whose central banks are obligated to maintain some measure of inflation – core consumer price index (CPI) inflation in the case of Indonesia and Thailand and headline CPI inflation in the Philippines – within a pre-determined range over the medium term. The formal frameworks of China, Malaysia and Viet Nam specify maintenance of the (real) value of the currency as the primary objective. This implies a commitment to price stability, but it could also imply some obligation to exchange rate stability. This also true of the formally stated objective of monetary policy in Indonesia, which specifies maintenance of the value of the rupiah.

In some countries, the central bank is also formally charged with other objectives. This is most clearly the case for Viet Nam, whose central bank is also formally charged with contributing to economic development and which in practice has tended to pursue multiple goals of inflation, economic growth, exchange rate stabilisation, and financial stability with somewhat opaque priorities among them (Bhattacharya, 2013; Camen, 2006). Malaysia's central bank is charged with ensuring an adequate supply of credit to the economy. Such additional "side" obligations are far from unique – for example, the United States Federal Reserve has a legally mandated obligation to foster full employment – and need not necessarily prevent the central bank from pursuing price stability as the main longer-term objective. However they can create confusion about central bank priorities, particularly where central bank autonomy is circumscribed.

Monetary policy frameworks in the six countries also differ somewhat in the degree of autonomy of the central bank in carrying out monetary policy and in the instruments used. In two countries, the Philippines and Indonesia, the central bank has been given legal autonomy to carry out monetary policy. In the other countries, in general, the central bank is directly accountable in some form to the government, and its policies in some cases are either made by the government or must be approved by it. Decisions on interest rates by the People's Bank of China in China and by the State Bank of Vietnam in Viet Nam must be approved by the government. Moreover, the specific final targets of monetary policy are typically determined by the government, or subject to its approval; the government sets the inflation target in the Philippines and Indonesia, for example. Central banks are all formally required to report on their activities to the government and the public. These requirements are necessary to sustain the public support for and understanding of monetary policies that is critical to their effectiveness.

The *de facto* autonomy of central banks to use their operating instruments to carry out monetary policies and to manage their functions ("operational" or "behavioural" autonomy) and their freedom from requirements to finance government deficits or other restrictions on their balance sheet choices ("balance sheet autonomy") are much more important to their effectiveness. According to the index constructed by Ahsan, Skully, and Wickramanayake (2008), the central banks of the Philippines and Indonesia enjoy the greatest *de facto* autonomy among the Emerging Asian countries (due in part to their *de jure* autonomy), while the central banks of China, Thailand and Malaysia are less autonomous.

Table 3.12. **Monetary policy frameworks in Emerging Asia**

	Type of framework/ goal	Official objectives	Current target	Operating instrument	Intermediate target	Main instruments	Central bank autonomy	Communications
China	Monetary aggregate target	Stability of value of the currency and economic growth		Policy interest rate [rediscount rate];	Growth in monetary aggregates (now M2) and bank credit	Policy interest rate; reserve requirements; open market operations; exchange rate operations;		
Indonesia	Inflation targeting with goal of "Rupiah stability" (i.e. both price and exchange rate stability)	Rupiah stability (both price and exchange rate stability)	Core inflation of 4.5% +/- 1%	Interbank overnight rate (BI rate)			Amended BI act of 2004 gives BI "full autonomy" in implementation of monetary and banking policies; inflation target set by govt since 2004	Central bank required to send quarterly reports to Parliament to report on its progress
Malaysia	Eclectic	Price and exchange rate stability; ensuring an adequate supply of credit to the economy		Overnight policy rate (effectively overnight interbank rate)		Purchases of interest bearing deposits from commercial banks; central bank bills (limited amts); [repos against treasury securities]		Monetary policy statements following each meeting; monetary policy annual report and other publications
Philippines	Inflation targeting with goal of price stability	Price stability	Headline CPI Inflation: 3-5% for 2013-14; 2-4% for 2015-16	Overnight repurchase and reverse repurchase rates	None	Reserve requirements; open market operations; rediscounting	Inflation goal set by national govt; operating and instrument independence; administrataive autonomy guaranteed by the constitution; legal restrictions on Cbank financial assistance to govt	Periodic letters to public; in case of breach of target, Central bank governor required to send "open letter" of explanation to President
Thailand	Flexible inflation targeting	Price stability	Core inflation: 0.5-3.0%/ year	1 day bilateral repo rate	None	Bilateral repo transactions; purchase/ sale of BOT bonds and bills; FX swaps; outright purchase/sale of securities; BOT lending windows	Governor appointed by cabinet	
Viet Nam	Monetary aggregate target	Value of the currency together with inflation. Secondary goal of contributing to development			Dong depreciation; growth in monetary aggregates, liquidity, and credit	Reserve requirements; discount and relending facilities; open market operations; FX operations. Also uses "base interest rate" and other more direct instruments to control interest rates	Limited; policy goals set by govt which also oversees implementation	

Sources: OECD Development Centre based on national and other sources. Goodfriend, M. and E. Prasad (2006), "Monetary policy implementation in China", in "Monetary policy implementation in Asia: Approaches and implmementation", *BIS Paper* No. 31; Mariano and Villanueva, (2006); Bank of Thailand. Filardo, A. and H. Genberg (2010), Targeting inflation in Asia and the Pacific: Lessons from the recent past, *BIS Papers*, 52. Filardo, A. and H. Genberg (2012), "Monetary policy strategies in the Asia and Pacific region: which way forward?", in Kawai et al, *Monetary and Currency Policy Management in Asia*. Camen, U. (2006) "Monetary Policy in Vietnam: the case of a transition economy", *BIS Papers*, No 31.

The central banks in the middle-income Emerging Asian countries now rely mainly on "indirect" operating instruments that work by influencing financial market conditions. Typically, a short-term interbank interest rate, normally overnight or one-day, is used as the operational target (the rate the central bank can control most directly). This rate is controlled through central bank purchases and sales in the interbank market, foreign exchange transactions and other operations that affect the supply of bank reserves in the interbank market. In China and Viet Nam, the current reliance on such indirect instruments reflects the considerable development of their interbank markets since the late 1990s, which has allowed a shift away from primary reliance on direct controls on bank lending and interest rates. However, both countries, especially Viet Nam, have continued to use direct to supplement the indirect instruments at certain times, particularly during periods of very rapid credit growth.

Transparency of monetary policy actions – the effectiveness with which monetary policy objectives and the rationale for actions meet those objectives – has become increasingly important for central banks worldwide over the past two decades and not least in the Emerging Asian economies. All of the central banks of the middle-income Emerging Asian countries publish extensive periodic reports on their assessments of economic conditions and explanations of monetary policy as well as issue explanations when major policy changes occur.

Transparency has been found to help reduce inflation volatility and the persistence of temporary inflationary shocks (see Filardo and Genburg, 2012). Some recent evidence suggests that central banks in Asia have had some success in making their future policy intentions more credible and understandable, thereby improving the effectiveness and predictability of monetary policy operations (Garcia-Herrero and Remelona, 2008). Indicators of central bank transparency indicate that it tends to be highest for inflation-targeting frameworks, in large part because of the specificity of the target and the requirement inherent in the framework to account to the government and public for success or failure in meeting it. Among the middle-income Emerging Asian countries, the Philippines and Indonesia score highest in degree of transparency while China scores noticeably lower (see Filardo and Genburg, 2012).

While still developing, the monetary policy frameworks in the middle-income Emerging Asia countries have proved to be fairly effective in most cases in sustaining low inflation and containing pressures from commodity price fluctuations and other shocks. However the performances since the GFC have revealed some weaknesses, especially in Viet Nam.

In Viet Nam, monetary policy control has been significantly complicated by the high degree of dollarisation of the economy and constraints arising from its effectively multiple objectives of management of the exchange rate and mandates to support government development plans (OECD, 2012). The effectiveness of monetary policy has been further limited by weaknesses in the monetary transmission mechanism owing in part to controls on interest rates but also to mandates imposed on state owned banks to lend to state enterprises to support development objectives. These factors have contributed to a "stop-go" pattern of periodic surges in inflation followed by marked slowdowns in economic activity as credit was tightened. There have been two such episodes during and since the GFC, during 2004-08 in the wake of rising international commodity prices and foreign direct investment inflows in anticipation of Viet Nam's accession to the WTO; and again in 2010 as real GDP growth accelerated following the fiscal stimulus package introduced after the GFC (Bhattacharya, 2013; IMF, 2010). As a result, Viet Nam has experienced both higher average inflation and greater variability in output growth than the other middle-income ASEAN countries since the GFC, and this variability appears at times to have undermined international investor confidence in the country (IMF, 2010).

These experiences indicate a strong need for reforms to the monetary policy framework as well as broader reforms to improve the effectiveness of monetary policy instruments and the transmission mechanism. At the least, monetary policy objectives need to be narrowed to place inflation control as the overriding priority and to place responsibility for supporting industrial development plans elsewhere.[20] The new central bank (SBV) law adopted in 2010 marks an important step in this direction, as it removes growth promotion from the list of the Bank's objectives (IMF, 2010). Interest rate liberalisation would also help to improve the transmission of monetary policy actions to the economy. As discussed further below, greater exchange rate flexibility is likely to be needed to allow monetary policy to more effectively concentrate on inflation control.

Macroprudential frameworks will be very important to maintaining stability

One of the key lessons to emerge from the GFC is the importance of macroprudential frameworks in detecting and containing systemic threats to macroeconomic and financial stability. The traditional approach to prudential policy, which is focused on the soundness of individual financial institutions and the health of particular segments of the financial system, proved to be woefully inadequate to detect the build-up in systemic risks to the overall financial system and broader economy in the run-up to the GFC. This failure is basically attributable to the inability of the traditional approach to assess systemic risks arising from the interdependencies (connectedness) among financial institutions – including not only commercial banks but also investment banks, insurance companies, and other institutions – markets, and instruments, and the resulting risks from the potential interruption in liquidity and cessation of financial market functioning in the face of major shocks. The traditional approach also does not take account of the tendency of aggregate risks to rise relative to the capital and other resources available to cover losses during economic expansions ("pro-cyclicality"). This tendency was all too evident in the years leading up to the GFC, as asset quality as evaluated by regulatory standards tended to rise during expansions, reducing the amount of capital required to be held and allowing a sharp rise in bank leverage ratios.

Since the GFC, financial regulators and international financial institutions in advanced and developing countries have been developing more formal and stronger institutional arrangements for macroprudential surveillance and management of systemic financial risks. The instruments used in these frameworks include traditional prudential instruments such as loan-to-value ratios, limits on maturity mismatches and open currency positions, as well as in some cases newer instruments such as counter-cyclical capital requirements (Lim et al., 2011). The settings of these traditional instruments when used in macroprudential policy are more dynamic than in micro-prudential policy and vary with assessments of systemic risk. The effectiveness of these frameworks depends critically upon mechanisms for sharing information and for co-ordination among financial regulatory bodies, both within individual countries and internationally.

The derivatives and other complex instruments that were central to the financial shocks that led to the GFC are admittedly not yet very important in the developing Emerging Asia countries. These countries are if anything more vulnerable than most advanced economies to other disturbances that can pose systemic risks, notably asset price bubbles, particularly in real estate, large fluctuations in capital flows, and currency mismatches (although these have become less of a risk since the abandonment of fixed exchange rates) (Park, 2011). The need for effective macroprudential frameworks is likely to grow in coming years as financial markets develop, more complex financial instruments emerge, and as capital account liberalisation proceeds.

ASEAN countries began to develop arrangements to monitor macroprudential risks after the 1997-98 Asian crisis and these arrangements were partly responsible for the fact that regional banking systems were relatively unscathed by that 2007-08 crisis. Macroprudential frameworks have since been developed and strengthened considerably further. Amendments to the central bank laws in China, Malaysia and Thailand adopted since 2007 have given (or strengthened in the case of Thailand) the mandate for their central banks for preservation of financial stability. In the other countries, explicit responsibilities for financial stability are spelled out in other laws (Lim et al., 2013).

Responsibility for macroprudential oversight is lodged with the central bank in China, Malaysia and Viet Nam, while responsibility is shared between the central bank and other government bodies through a financial stability committee or other co-ordinating body in the Philippines and Thailand. The responsibility in Indonesia is shared between the "integrated regulatory" body (Otoritas Jasa Keuangan, OJK) created in 2011 to take on responsibility for supervision of the country's banks and insurance companies and the securities markets.

Emerging Asian macroprudential frameworks now include the basic elements that have emerged (and are still being developed) as international "best practices". Most of the countries publish financial stability reports detailing the conditions and vulnerabilities of banks and other major financial segments to internal and external shocks. The countries all participate in the IMF's financial stability assessment programme, which provides another, outside review of the vulnerabilities and resilience of their financial systems. Macroprudential assessments include detailed simulations ("stress tests") of the effects of potential shocks to the financial system and economy.

Emerging countries have tended to use instruments for suitable for macro-prudential policy more heavily than have advanced economies (Lim et al., 2011). This partly reflects the use of such instruments in monetary policy operations, the lesser development of financial markets and often more limited flexibility of interest rates (which favour the use of direct over indirect instruments) and the greater use of capital controls. The middle-income Emerging Asian countries rely particularly on loan-to-value and to a lesser extent debt-income caps on lending and on limits open currency positions (Table 3.13). China, Malaysia and Thailand seem to have made most extensive use of macroprudential instruments, while the Philippines and Indonesia have made less use of them. None of the countries has as yet used more dynamic macroprudential instruments, such as counter-cyclical capital or provision requirements.

Table 3.13. **Institutional arrangements for macroprudential oversight in Emerging Asia**

	Primary responsibility	Financial regulatory agencies	Inter-agency co-ordinating body
China	Central bank	Separated	State council
Indonesia	Integrated regulator (IF)	Unified	Forum for financial stability co-ordination
Malaysia	Central bank	Central bank responsible for all but securities regulation	None
Philippines	Central bank	Separated	Financial stability co-ordination council (Financial sector forum)
Thailand	Central bank	Separated	Several consultive committees
Viet Nam	Central bank	Separated	None

Sources: OECD Development Centre based on national and other sources. Lim, C. et al (2011), "Macroprudential policies: What instruments and how to use them? Lessons from country experiences", *IMF Working Paper* 11/238; and IMF Financial System Stability Assessments for the Philippines (2011) and Thailand (2009).

The formal institutional arrangements and analyses for macro-prudential oversight have been very useful in focusing financial regulators attention beyond individual institutions to the risks to the stability of the financial system as a whole. They also provide a framework for the use of existing macroprudential instruments and their further development over time. However macroprudential policies are still in an early stage of development even in the most advanced economies and their effectiveness in the Emerging Asian region will depend on success in meeting several key challenges.

A major challenge is *co-ordination* across government bodies responsible for policies bearing on financial stability. Effective co-ordination requires sharing of information and responsibilities across agencies with often very different cultures and mandates. In a few countries, notably Indonesia and Malaysia, the central bank (in the case of Indonesia the Integrated Regulator [IR]) is responsible for supervising both banks and other key segments of the financial system. However in the other countries, financial regulatory responsibilities are more divided. The central bank is responsible for bank supervision in the Philippines, Thailand, and Viet Nam but separate agencies oversee insurance companies and the securities markets and companies. In China, financial regulatory responsibilities are even more divided with banking regulation and insurance regulation the responsibilities of the China Banking Regulatory Commission and the China Insurance Regulatory Commission, respectively, with responsibility for securities markets and securities companies is divided among the China Securities Regulatory Commission, the two stock exchanges, and the NDRC.

Consolidation of institutional responsibility for macroprudential policies has both advantages and disadvantages *vis-à-vis* more divided responsibility. In principle, information sharing and co-ordination should be somewhat easier in the first case since decisions are subject to a single authority and can make use of the analytical capabilities of the dominant institution. Implementation of macroprudential policy actions is also facilitated in this model since the single responsible agency makes the decisions about the settings of macroprudential instruments. However, the central bank model may reduce but does not completely do away with the need for co-ordination with other government bodies. In Malaysia, responsibility for regulation of the securities markets lies outside the central bank.[21] Another potential drawback of a single macroprudential agency, particularly when it is the central bank, is that macroprudential and other (notably monetary policy) mandates may become confused, degrading the effectiveness of both. This risk may be less when responsibility is shared among agencies, but the co-ordination difficulties are greater. Moreover, the government executive branch often assumes responsibility for macroprudential decisions when responsibility is shared, which increases risks that political or other considerations will constrain necessary macroprudential policy actions.

Another key challenge is to ensure that macroprudential policies and objectives are well defined and targeted and effectively co-ordinated with monetary policy objectives. Monetary and macro-prudential policies are clearly closely related: monetary policy influences how macroprudential risks vary through the business cycle; and at least some macroprudential policies can affect aggregate demand. Monetary and macro-prudential policies can be potentially reinforcing in achieving some objectives, for example in managing the risks from capital inflows.

However there are also risks to "mixing" macroprudential and monetary policy objectives. For example, some analysts have argued that monetary policy should be used to explicitly target asset prices or at least that monetary policy settings should be modified when asset price "bubbles" appear to have emerged (See, for example, Cechetti et al., 2000). There are considerable practical problems, though, in such targeting, especially in emerging economies (See OECD, 2013a). It is very difficult in practice to distinguish unsustainable asset price bubbles from those driven by changing fundamentals. The comparatively high volatility in asset prices in emerging economies, including those in the Emerging Asian region, would also lead to large and often unwarranted swings in monetary policy. The resulting increased complexity of monetary policy "reactions" to economic developments could also central bank transparency and credibility. Overall, macroprudential instruments are probably better suited to addressing such situations.

The success of macroprudential policies in the Emerging Asia region will depend on effective *regional consultation and co-operation*. The need for such co-operation will grow as ASEAN financial integration proceeds, increasing the need for regulators in individual countries to have information on the conditions of foreign banks and other financial institutions participating in their domestic markets and on the activities of their own institutions abroad. European countries have a well developed array of institutional arrangements suitable for co-operation on macro-prudential issues, now centred on the European Systemic Risk Board that was established in 2010. But these are at a much earlier stage of development in Asia. Co-operation on financial matters has been mainly carried out under bilateral memoranda of understanding (MOU) among country regulatory agencies (Lim et al., 2011). The degree of participation through these MOU varies among the Emerging Asian countries. A high-level Committee on Monetary and Financial Stability (MFSC) was formed in 2007 under the Executive Committee for East Asia and Pacific Central Banks (EMEAP). This committee now focuses on information sharing and joint monitoring of global and regional financial developments but could be developed further into a forum for closer for closer and more effective co-operation on country macro-prudential policies.

Exchange rate policies will need to change toward greater flexibility

The need to ensure that monetary policy is capable of maintaining macroeconomic stability is very likely to require significant changes in the exchange rate policies of China and the middle-income ASEAN countries to allow for greater exchange rate flexibility. Greater flexibility is also likely to be needed to allow the changes in relative prices implied by the shifting industrial structures to occur and to adapt to capital account liberalisation.

Exchange rate regimes in China and the middle-income ASEAN countries have evolved considerably since the late 1990s. The currency pegs to the US dollar, which significantly limited monetary policy autonomy and encouraged destabilising currency mismatches, were abandoned after the 1997 crisis by the ASEAN countries. In their place, countries have adopted alternative arrangements that have allowed greater scope for market forces to determine the path of exchange rates (OECD, 2010a).

According to the *de facto* classifications[22] used by the IMF, the exchange rate regimes of Indonesia, the Philippines, Thailand and Indonesia allow the greatest flexibility among those in the Emerging Asia region while those of China and Viet Nam are the least flexible (IMF, 2012; Rajan, 2011). In the Philippines, Thailand and Indonesia, exchange rates are allowed to vary with market forces but those forces are significantly influenced by central bank purchases and sales of foreign exchange in the markets (foreign exchange intervention) – although without any explicit target for the exchange rate path. This system is classified by the IMF as “floating rate”. Malaysia’s regime (classified as “other managed arrangement” by the IMF) involves more heavy intervention to manage the path of the exchange rate over time. China has been following a regime similar to a formal “crawling peg” (“crawl-like arrangement” under the IMF definition) , under which the exchange rate is allowed to vary within a narrow band on a daily band, with the basis itself (its centre) gradually adjusted in the direction indicated by market forces. Viet Nam effectively adheres to a “stabilised” arrangement in which the exchange rate is kept with a narrow band for a protracted period, although the band may be changed from time to time.[23]

There has also been a shift in exchange rate policies (in some cases only informal and *de facto*) in a number of the countries away from a primary focus on the exchange rate with the USD toward greater focus on a range of currencies based on their importance to the country’s international trade and investment. China’s crawling peg is formally based on a basket of currencies (although the weights are not published); and Malaysia also formally bases its exchange rate policies on a currency basket (Rajan, 2011). Other evidence suggests Indonesia and Thailand have given greater attention in recent years to a basket of currencies in determining their exchange market interventions, although the evidence also suggests that the USD remains of primary importance for the policies of the Philippines and Malaysia (despite its official policy of using a currency basket as reference) (Frankel and Wei, 2008; ADB, 2010).

Despite the move away from fixed exchange rate regimes, the flexibility of exchange rates in China and the ASEAN countries is still significantly less than that allowed by most advanced countries (whose regimes are classified as “free floating” by the IMF). All of the countries conduct considerable and frequent foreign exchange market interventions, although Indonesia seems to have been somewhat less active in trying to manage the exchange rate through intervention than the others (see ADB, 2010). China and Viet Nam (given their more controlled regimes) intervene in the foreign exchange markets almost continuously. Foreign exchange market interventions of the floating exchange rate adherents and Malaysia have often been heavy, with a tendency to intervene more heavily to oppose exchange rate appreciations than depreciations (see Rajan, 2011; ADB, 2010). This asymmetry in foreign exchange intervention, together with the generally upward trend in market pressures on the currencies have contributed (although they are not the main factor) to the marked increase in the foreign exchange reserves of the countries over the past decade.

In addition to foreign exchange market intervention, some countries have occasionally used domestic interest rate movements to counter exchange rate pressures deemed unwarranted or undesirable. For example, a number of countries either raised policy interest rates temporarily, or temporarily halted declines, during the early stages of their economic slowdowns following the 2007-08 GFC when their currencies came under strong downward pressure (OECD, 2010a).

Foreign exchange interventions and other policies to influence exchange rate movements have typically been motivated by one or more of the following objectives:

- To counter "disorderly market conditions" characterised by exceptional volatility and breakdowns in market trading in response to major shocks or great uncertainty. Intervention to counter these conditions is of limited duration and does not attempt to target any path for the exchange rate; and, on average, intervention to counter downward movements is as likely or frequent as intervention to counter upward movements.

- To prevent exchange rate misalignments arising from protracted but temporary forces, such as a surge in capital inflows that pushes the exchange rate above its long-term equilibrium value. Foreign exchange intervention in such cases is likely to continue over a longer period than in the first and may be stronger in one direction than another.

- To maintain a path for the exchange rate that is consistent with some other economic objective, for examples as an "anchor" for controlling inflation (as in Singapore) or to support the competitiveness of a country's export sectors.

The first two considerations have been important influences on exchange rate policies for China and the ASEAN countries. Viet Nam's *de facto* exchange regime seems at least in part motivated by an objective of providing an anchor to help in containing inflation. There is also some evidence that the real exchange rates of China and some other ASEAN countries have been undervalued in relation to their long-term equilibrium as determined by their current account positions and other fundamental economic determinants during certain periods, although not currently (Cline, 2013).[24] It is important to emphasise that prolonged currency misalignments are the result of fundamental macro and microeconomic conditions, such as fiscal imbalances or policies affecting private saving and investment. Foreign exchange market intervention by itself typically has limited and temporary effects on exchange rates. However limiting the flexibility of exchange rates can delay adjustments in (real) exchange rates to changes in their long-term fundamental equilibrium.

The limited flexibility of exchange rates in China and the ASEAN countries comes with potential costs, some of which are already evident. When capital mobility is high, limits on exchange rate flexibility constrain the ability of domestic monetary authorities to control domestic interest rates, thereby restricting their monetary policy autonomy. Admittedly, current restrictions on capital flows in the region have so far afforded monetary policy authorities in the region sufficient autonomy to meet their inflation objectives. However some evidence suggests that domestic interest rates in the Philippines and Thailand were significantly influenced by changes in interest rates in the United States during 1999-2007 (Kim and Yang, 2012). Large scale foreign exchange market intervention can also be difficult to sterilise – which is necessary if domestic monetary control is to be preserved – particularly when, as now, the development of domestic financial markets is limited.

Two other considerations suggest that China and the middle-income ASEAN countries will need to increase the flexibility of their exchange rate regimes over time. First, given that its effects are limited and temporary, foreign exchange market intervention cannot maintain a real exchange rate at a level significantly different from its fundamental equilibrium level for more than a short time – much shorter than is likely to be needed to affect a country's competitiveness. Maintaining a "competitive" exchange rate that protects domestic labour intensive industries or allows them a longer time to adjust to rising wages or other domestic costs – even if it were deemed to be desirable – would require changes in other fundamental domestic policies, for example in labour market policies or taxes. The budgetary and other costs of such policies to influence the real exchange rate would need to be weighed those of alternatives, for example expenditures on retraining of workers in declining industries, as well as the benefits of using the funds to meet other objectives. Attempting to delay adjustment of the real exchange rate to its fundamental equilibrium could also interfere with the shift the need for relative prices to adjust to induce the reallocation of resources toward higher-productivity sectors in which a country was gaining in comparative advantage.

Second, the liberalisation of capital flows, which will be necessary to the further development of domestic financial markets and to which ASEAN countries are committed to achieve under the AEC, will require increasing flexibility in exchange rate regimes. The trade-off between domestic monetary autonomy and exchange rate flexibility will become increasingly acute as capital mobility increases; as will the scale required for foreign exchange market intervention to limit exchange rate movements for more than a very short (say, daily) interval. Such intervention, as well as capital controls, cannot provide lasting solutions for problems such as protracted surges in capital inflows, which ultimately have to be addressed by more fundamental policies (Filardo and Genberg, 2012; OECD, 2010a). The extent to which they can provide temporary solutions will also decline as capital mobility increases.

In this area as in others discussed earlier, regional co-operation could greatly help to facilitate the transition both toward more flexible exchange rate regimes and in capital account liberalisation (see Park and Tagaki, 2012; Filardo and Genburg, 2012). Particularly given the close trade and investment ties among Asian countries, and their both competing and complementary nature, co-operation in these areas would help to reduce potential adverse "externalities" whereby countries liberalise first experience exchange rate appreciations that damage their competiveness *vis-à-vis* their neighbours. This in turn would improve incentives of individual countries to proceed with the liberalisations and perhaps speed up their accomplishment for the region as a whole.

Conclusion

Emerging Asian countries have had impressive success in sustaining rapid growth and development over several decades. All of these countries have the potential to join Japan, Korea and Singapore by rising into the ranks of high income, advanced, economies, in some cases within the next one or two decades. However the fact that many other countries have had rapid growth and development in the initial stages only to see their progress falter and to remain in the middle-income "trap" provides a warning that difficult challenges will need to be overcome.

Success will require extensive and profound changes in the countries' economic and industrial structures, in the orientation of their growth, and in their economic policies. All the countries share the need to gradually shift their industrial structures toward higher productivity and higher technology sectors. Growth will need to become more extrinsic, that is driven on the supply side by productivity increases underpinned by infrastructure development, human capital accumulation and innovation. On the demand side, growth will need to become more dependent on domestic demand and less dependent on exports. Manufacturing and regional GVC will remain important but will need to be restructured and reoriented toward greater focus on meeting regional demand and supported by further development of service sectors, especially "modern" services such as ICT, finance, and business services.

Institutional development will be the key to success in making these changes. Educational and other institutions to provide human capital, foster innovation, and facilitate infrastructure development are typically weaker in developing countries than in more advanced economies as are legal and regulatory frameworks for competition, corporate governance, and business entry and exit, and need to be strengthened if development is to be sustained. Institutions critical to effective macroeconomic and financial stabilisation likewise need to be strengthened. Achievement of the necessary institutional changes presents difficult challenges that not all initially rapid growing countries have been able to make.

While sharing these overall challenges, the specific priorities differ among the countries according to their current state of development, their comparative advantages, and historical heritages. The need to improve access to education and strengthen education and vocation institutions is especially acute in Indonesia and Thailand, while Malaysia's focus is on strengthening links between academic and research institutions and industry. China and Viet Nam particularly need to facilitate the development of the private sector and better define the ultimate of state owned businesses in the economy – although the former is much further along in this transition. In many Emerging Asian countries, regulatory reforms to reduce barriers to SMEs and services sector development are of high priority. Exchange rate regimes will need to become more flexible.

Institutional development at the regional level, among the ASEAN countries and with larger groupings such as Emerging Asia, will also be very important. The various initiatives to liberalise trade in goods and services and investment flows among the countries in the region have the potential to create mutually reinforcing "virtuous circle" of institutional strengthening to support development.

Notes

1. Development also needs to be sustainable in terms of its use of natural resources and the environment. Issues concerning sustainable development are, however, beyond the scope of this chapter.
2. Participation in regional value chains is measured by the sum of foreign value-added used in a country's exports plus the value-added supplied by the country to the exports of partners, as a share of the former's total exports (see UNCTAD, 2013).
3. Viet Nam's participation in GVC in some electronics areas has been increasing, however. See UNESCAP, (2009). GVC in textiles tend to be "buyer driven" in the sense that they are organised and largely serve large retailers in advanced countries, as opposed to "producer driven" GVC that are typically organised by large MNCs in manufacturing (Gereffi and Memodovic, 2003).
4. The domestic value-added content share of exports is about 70% for China and Thailand, somewhat lower at 58% for Malaysia, and nearly 90% for Indonesia. The differences partly reflect the position of the countries in the production chains, with countries in the "middle" tending to have lower ratios while countries that participate mainly at the "bottom" through resource exports tend to have higher value-added content shares (see UNCTAD, 2013).
5. Foreigners are afforded only very limited participation in professional services in Indonesia, Malaysia and Thailand. Professional services score as relatively restricted to foreigners in many advanced as well as developing countries due in part to licensing requirements.
6. The *Doing Business* indicators are focused on assessing conditions for small and medium-sized businesses but they are based on factors important to all businesses.
7. The Indonesian government has encouraged bank consolidation through mergers and other means in order to improve efficiency and financial soundness through its Indonesian Banking Architecture Programme (API) begun in 2004. The programme encourages mergers among smaller banks and acquisitions by larger, sounder banks.
8. State-controlled banks, which are mainly development banks, account for about 12% of banking system assets in the Philippines and about 14% in Thailand. In Malaysia, government-linked investment companies (GLICs) own substantial stakes in the leading banks, although there is no direct government ownership control.
9. Among the top two tiers of China's banking system – the SOCB and joint stock banks (Tier 1) and city commercial banks (tier 2) – only two, China Minsheng Bank and Taizhou City Commercial Bank, are controlled by private entities.
10. Although private as well as state-owned banks became insolvent in the wake of the 1997 crisis, the latter were more severely impaired and required a disproportionate share of the government's funds devoted to recapitalising the banking system. See Srinivas and Sitorus, 2004.
11. The comparatively low portion of firms in Indonesia that identify access to external credit as an obstacle may reflect a comparatively small average size and high proportion of less sophisticated SMEs, which are less likely to want or need external financing or more likely to look to informal sources to get it. The World Bank *Getting Credit* rankings are based on indicators of the strength of legal rights of creditors and borrowers given by collateral and bankruptcy laws and on the availability of the information on borrowers through credit registries.
12. The same analysis estimates that the gap for all informal as well as formal SMEs (including micro enterprises) is between USD 2.1 trillion and USD 2.5 trillion, or nearly 14% of developing countries aggregate GDP and nearly one-third of total credit outstanding to SMEs.
13. Indonesia has two government-controlled credit guarantee institutions, Perum Sarana Pengembangan Usaha (Perum Sarana) established in 2000 and wholly government owned and PT Asuransi Kredit Indonesia (Askrindo), established in 1971 and jointly owned by BI and the MOF. Credit guarantees in Malaysia are provided by the Credit Guarantee Corporation Malaysia Berhad (CGCMB), established in 1972 and majority owned by BNM with commercial banks holding minority interests; and in Thailand by the Small Industry Credit Guarantee Corporation (SICGC), majority owned by the MOF and established in 1991.
14. Markets for futures and options have been established in China, India, Malaysia and Singapore but are subject to limits on access and other restrictions.

15. Companies' demand for external financing in ASEAN countries was also depressed for some time by the decline in investment in the aftermath of the 1997 Asian financial crisis.

16. The figures for Malaysia and Singapore include assets the publicly mandated Provident funds. Assets of other pension funds other than the Provident Fund in Malaysia amount to about 16% of total financial system assets. Pension fund assets are also quite low in relation to GDP in Korea, as well as a number of European countries, including Germany and France. A large portion of retirement savings in these countries are placed with other institutional investors, including insurance companies and securities funds managed by banks.

17. The Association of Asian Credit Rating Agencies has been engaged in parallel efforts since 2001 to harmonise standards and procedures across countries (see Spiegel, 2009).

18. The ADB study (ADB, 2013b) has recommended that remaining current account and FDI restrictions be removed as soon as possible and that liberalisation of banking and portfolio flows should start with inflows. It further recommends that the more advanced economies also remove controls on capital outflows at an early stage in the liberalisation process, beginning with flows among ASEAN countries based on the mutual recognition principle and subsequently extended to all countries.

19. See, for example, "RI banks not ready for ASEAN turf, says BI", *The Jakarta Post*, 4 December, 2012.

20. It has been suggested that Viet Nam explicitly adopt an inflation targeting strategy to resolve the multiplicity of goals.

21. MOU among regulators in Malaysia provide for collaboration on financial policies but only in some areas. For example, the MOU between the BNM and securities regulator only provides for collaboration on investment banks and is confined to the senior level. A Financial Stability Executive Committee, which includes representation of the deposit insurance company as well as the BNM, also serves to extend the Bank's macro-financial oversight to financial institutions outside its direct jurisdiction. The securities regulator does not participate in the Committee as a regular member but is represented on occasion by invitation (see Lim et al., 2013).

22. The IMF replaced its *de jure* exchange rate regime classification system recently, under which countries were classified largely in accordance with their own designation, with a *de facto* classification based on actual exchange rate behaviour and analytical criteria applied by IMF staff.

23. Viet Nam's official, *de jure*, regime is a crawling peg, however.

24. The Cline-Williamson estimates implied significant undervaluation of the currency of China and several ASEAN countries during 2006-07 when their current account surpluses were much larger relative to their GDP than they are now. Their most recent estimates (Cline, 2013) imply at most a very modest undervaluation of the RMB Malaysian ringett, Thailand baht, and Philippine peso verus the USD – under 10%. These figures are too small to regard as persuasive evidence of systematic major undervaluation.

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Statistical annex

Table A.1. **Real GDP growth of Southeast Asia, China and India**

Annual percentage change

	2012	2018	2014-18	2000-07
ASEAN-6 countries				
Brunei Darussalam	1.0	2.4	2.3	-
Indonesia	6.2	6.1	6.0	5.1
Malaysia	5.6	5.3	5.1	5.5
Philippines	6.8	5.9	5.8	4.9
Singapore	1.3	3.1	3.3	6.4
Thailand	6.5	5.3	4.9	5.1
CLMV countries				
Cambodia	7.2	7.1	6.8	9.6
Lao PDR	7.9	7.5	7.7	6.8
Myanmar	-	7	6.8	-
Viet Nam	5.2	6	5.4	7.6
Average of ASEAN 10	**5.5***	**5.6**	**5.4**	**5.5****
2 large economies in Emerging Asia				
China	7.7	7.5	7.7	10.5
India	3.7	6.1	5.9	7.1
Average of Emerging Asia	**6.4**	**6.9**	**6.9**	**8.6**

Notes: The cut-off date for data is 6 September 2013. Emerging Asia includes ASEAN 10 countries plus China and India. *Excludes Myanmar **Excludes Brunei Darussalam and Myanmar.

Source: OECD Development Centre, MPF-2014. For more detailed information of, MPF, see www.oecd.org/dev/asiapacific/mpf. Emerging Asia includes ASEAN-10 countries, China and India.

Table A.2. **Current account balance of Southeast Asia, China and India**

Percentage of GDP

	2012	2018	2000-07 (average)	2014-18 (average)
ASEAN-6 countries				
Brunei Darussalam	48.5	45.0	-	46.1
Indonesia	-2.8	-2.8	2.8	-2.9
Malaysia	6.5	5.7	11.8	5.2
Philippines	2.8	2.0	1.0	2.4
Singapore	18.6	16.9	18.5	17.9
Thailand	0.7	2.2	3.0	1.0
CLMV				
Cambodia	-8.4	-6.1	-2.3	-7.4
Lao PDR	-21.9	-18.0	-13.4	-19.1
Myanmar		-4.5	-	-4.4
Viet Nam	5.9	3.9	-1.9	4.5
China and India				
China	2.3	1.2	4.6	1.6
India	-5.0	-3.4	0.0	-3.9
ASEAN average	**5.5**	**4.4**	**2.4**	**4.3**
ASEAN-6 average	**12.4**	**11.5**	**7.4**	**11.6**
CLMV average	**-8.1**	**-6.2**	**-5.9**	**-6.6**
Emerging Asia average	**4.3**	**3.5**	**2.4**	**3.4**

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

Source: OECD Development Centre, MPF-2014.

Table A.3. **Consumer prices of Southeast Asia, China and India**

Percentage change, 12-month average

	2012	2018	2000-07 (average)	2014-18 (average)
ASEAN-6 countries				
Brunei	0.5	1.3	0.4	1.4
Indonesia	4.3	5.2	8.7	5.5
Malaysia	1.6	3.2	2.0	2.7
Philippines	3.2	4.0	4.3	3.8
Singapore	4.6	2.8	1.0	3.1
Thailand	3.2	3.7	2.5	3.2
CLMV				
Cambodia	2.9	4.7	3.6	4.3
Lao PDR	4.3	6.4	11.4	5.9
Myanmar		5.8	22.9	5.9
Viet Nam	9.1	7.9	6.0	7.8
China and India				
China	2.7	3.4	1.7	3.0
India	9.7	7.1	4.6	7.8
ASEAN average	**3.7**	**4.5**	**6.3**	**4.4**
ASEAN-6 average	**2.9**	**3.4**	**3.1**	**3.3**
CLMV average	**5.4**	**6.2**	**11.0**	**6.0**
Emerging Asia average	**4.2**	**4.6**	**5.7**	**4.5**

Source: OECD Development Centre, MPF-2014.

Table A.4. **Private consumption of Southeast Asia, China and India**

Percentage change

	2012	2000-07 (average)	2014-18 (average)
Indonesia	5.3	3.7	5.0
Malaysia	7.7	8.0	6.7
Philippines	6.6	4.9	6.0
Singapore	2.2	4.6	3.3
Thailand	6.7	4.6	4.6
Viet Nam	5.3	7.1	5.8
ASEAN average	**5.6**	**5.5**	**5.1**
China	8.0	6.7	8.9
India	4.0	6.3	6.1
Emerging Asia average	**5.7**	**5.8**	**5.7**

Source: OECD Development Centre, MPF-2014.

Table A.5. **Gross fixed capital formation of Southeast Asia, China and India**

Percentage change

	2012	2000-07 (average)	2014-18 (average)
Indonesia	9.8	8.3	9.4
Malaysia	19.9	6.7	6.5
Philippines	10.4	4.2	5.1
Singapore	6.6	4.3	4.3
Thailand	13.2	6.8	5.3
Viet Nam	1.9	12.5	7.2
ASEAN average	10.3	7.1	6.3
China	10.1	12.2	7.9
India	1.7	11.8	7.4
Emerging Asia average	9.2	8.3	6.6

Source: OECD Development Centre, MPF-2014.

Table A.6. **Fiscal balance* of Southeast Asia, China and India**

Percentage of GDP

	2000-07 (average)	2014-18 (average)
Indonesia	-1.6	-1.6
Malaysia	-4.7	-4.5
Philippines	-3.4	-1.6
Singapore	6.9	3.9
Thailand	-1.1	-2.8
Viet Nam	-2.8	-3.9
ASEAN average	**-1.1**	**-1.7**
China	-	-1.6
India	-7.3	-8.0
Emerging Asia average	**-2.0**	**-2.5**

Note: * Fiscal balance of general government.

Source: OECD Development Centre, MPF-2014.

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OECD PUBLISHING, 2, rue André-Pascal, 75775 PARIS CEDEX 16
(41 2013 07 1 P) ISBN 978-92-64-20399-0 – No. 61061 2013

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ISBN: 978-92-64-20399-0
41 2013 07 1 P 1

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