

EXECUTIVE SUMMARY

The year 2015 marks a watershed in global policymaking. Building on the Millennium Development Goals (MDGs), the world is set to adopt sustainable development goals in 2015. Subsuming unattended MDGs, the success of the sustainable development goals will depend on how effectively the Asia-Pacific region makes economic growth more inclusive. The *Economic and Social Survey of Asia and the Pacific 2015* analyzes the economic growth performance of the region, along with its outlook and challenges countries face in sharing the benefits of growth with all people.

The region stands out for its economic growth achievements, albeit in a somewhat uneven manner. Real incomes per capita in developing economies of the region have doubled on average since the early 1990s. Particularly impressive is a seven fold increase in real income per capita in China since 1990, as well as its tripling in Bhutan, Cambodia and Viet Nam over the same period. Besides other policies, this economic growth performance has helped lift millions of people out of extreme poverty— ahead of the 2015 MDG deadline— and reduced by half the proportion of people whose income is less than \$1 a day.

With expectation of only a slight increase in the region's economic growth rate in 2015 and 2016, the region has to be more vigilant in ensuring that it does not lose sight of the goal of reducing extreme poverty as well as working towards ensuring that the gains of prosperity are evenly shared. This is critically important as even during the high growth period there was pervasive, sharp and growing inequality of incomes and opportunities. Rural-urban and geographical gaps in socioeconomic development also remain and inequalities among women and men are enhancing the vulnerabilities of those on the margins of society.

The *Survey for 2015* advocates continued policy focus on economic growth but underscores that there has to be recognition that while growth is necessary, it is definitely not sufficient for achieving “development”. Preparing the region to adopt and adapt the sustainable development goals calls for nurturing better understanding of the dynamics of inclusive growth –what it stands for, how governments need to internalize its elements into domestic policy frameworks, and how it can be reinforced by focusing on sustainable development.

The first chapter of the *Survey for 2015* offers perspectives on Asia-Pacific's macroeconomic outlook and performance and outlines the key economic challenges facing the region together with key policy options available to policymakers. To reflect the diversity of the Asia-Pacific region, the second chapter analyzes the recent developments in five subregional groups and their issues and challenges, which offers an opportunity to share experiences and policy considerations. Finally, the third chapter focuses on analyzing the trends and policies adopted in the region on promoting inclusive growth, with the objective of distilling key recommendations drawn from lessons learnt.

Economic growth outlook and policy challenges

Economic growth in Asia and the Pacific continues to fare well in the global context, but is expected to increase only slightly to 5.9% in 2015 from 5.8% in 2014. This slowdown in the rate of expansion of economic growth is happening at a time when lower oil prices could potentially have lifted growth in oil importing countries if the enabling environment was right. Unless reforms are vigorously pursued, downside risks to the growth trajectory could increase.

Since the region's economic growth outlook is primarily influenced by domestic and intraregional factors, rather than external factors, countries have the opportunity to change the growth dynamics. The role of private consumption and investment in the region is expected to be much more pronounced in driving economic growth than exports, the prospects for which remain less upbeat. Generally, the economic growth of the region's developing economies is below potential and below pre-crisis level as a range of structural weaknesses remain, such as infrastructure shortages, the excessive commodity-dependence of some economies and low productivity. The fragile global economic recovery continues to be an additional drag for the region's growth prospects.

Since demand continues to increase due to growing populations and incomes, it is critical to enhance the supply potential of developing economies by focused efforts on improving the availability and quality of infrastructure. Urbanization throughout the region is, in any case, generating additional demands for infrastructure. Growing demand for infrastructure development calls for not only exploiting further the traditional sources of finance, such as tax receipts and overseas development assistance, but looking at tapping broader sources of financing, such as regional capital markets by ensuring development of local currency bond markets, and encouraging public-private partnerships to leverage financing and skills. A supportive legal and regulatory environment together with enhanced capacity to evaluate infrastructure projects can go a long way in achieving this objective. The emergence of new development banks, such as the Asian Infrastructure Investment Bank, will also be able to contribute to the infrastructure development in the region.

A combination of somewhat reduced economic activity and lower international oil prices has improved the inflation outlook, which is expected to decelerate to 3.3% in 2015 from 3.9% in 2014. The dramatic decline in international oil prices has allowed space for reforms of fuel subsidies which, with proper fiscal management, can be deployed to support infrastructure investment and inclusive growth measures. Both these considerations require some lead time to structure interventions and thus there is no major positive impact of declining oil prices on growth yet. Savings from fuel subsidies should not distract attention from tax policy reforms which is the only sustainable approach to strengthening public finances critical for macroeconomic stability and for generating adequate resources for development spending.

Lower inflation has allowed room for monetary accommodation. This is evident from a string of interest rate reductions in many regional economies. Liquidity thus generated, if effectively intermediated, could stimulate economic momentum. Reductions in interest rates by Asia-Pacific central banks are happening at a time when the United States is entering into a monetary tightening mode. However, the United States is still watching its own economic dynamics before proceeding with more determined action. The continued monetary easing by Japan and the eurozone, on the other hand, is keeping the benchmark rates low for their respective economies. Within the Asia-Pacific region, particularly in emerging markets, there remain concerns regarding the volatility in capital flows and exchange rates triggered by the global monetary stance. A comforting factor this time round is improvement in current account balances of oil importing countries due to declining oil prices, though recovery in exports is lagging despite appreciation of the dollar. However, risks of asset price volatility, driven by investor sentiments to United States monetary tightening, remain and could complicate macroeconomic and financial stability in the region.

Developing economies in the region have strengthened their capacities to implement macroprudential policies, such as caps on loan-to-value ratios, limits on certain segments of credit growth and capital and reserve requirements, which offer approaches to manage the implications of capital flow volatility. Unlike interest rate adjustments and interventions in the foreign exchange market, the macroprudential measures directly target the source of instability of capital flow volatility, namely the domestic asset markets in which capital flows are invested, and thus help in containing market disruptions. However, countries with weak fundamentals will have greater difficulty in mitigating risks.

So far, currencies in the Asia-Pacific region have generally depreciated less than the global trade-weighted average. This is because either the Governments are intervening in the foreign exchange markets and/or there remains a continuing institutional investor interest in developing economies in search of high yields.

Against this backdrop of declining commodity prices, evolving global and regional monetary policy developments and volatility in financial markets, it is worth highlighting that policymakers must not underestimate the risks associated with complex and deep financial market inter-linkages with the rest of the economy. Among many lessons that can be drawn from the experiences of the recent global financial and economic crisis, this is perhaps the most important. Therefore, the monetary policy stance in the region will need to be calibrated much more cautiously in going forward.

Many economies in the region excessively depend on certain commodities for fiscal revenues and foreign inflows. The vulnerability of such economies increases considerably in an environment of declining commodity prices. Increased financialization of commodities further exacerbates the difficulties. Among other structural measures, policymakers in these economies could consider fiscal rules that factor in the dynamics of business cycles and target a “cyclically adjusted fiscal balance” to better plan for contingent risks associated with the potential revenue shocks stemming from large movements in commodity prices. Also, a consumer price index-based inflation target may not be appropriate for countries susceptible to terms-of-trade shocks. A production-oriented index could serve as a better indicator and be used as a nominal anchor for inflation expectations.

Perspectives from subregions

The Asia-Pacific region, given its wide diversity, does face some unique and some common trends and challenges.

The relatively high income bloc of East and North-East Asia has to cope with the slowing demand from China and other intraregional trade hubs. China, accounting for around 40% of output of this subregion, has witnessed a moderate growth in investment as the economy shifts towards more consumption-led growth. Japan’s household spending also dipped following an increase in the consumption tax. Stimulating intraregional trade calls for enhancing trade connectivity and lowering barriers to trade. The region is grappling with policies to boost domestic demand but their success would be constrained by the current high debt levels and rapidly ageing populations in some key economies of the subregion.

Unlike other subregions, North and Central Asia is facing low economic growth but high inflation. Weighed down by lower global oil prices and geopolitical tensions, the economy of the Russian Federation barely grew in 2014; it is expected to contract over 2015 and 2016. As the country accounts for 80% of the output in North and Central Asia, subregional growth performance and prospects are also bleak. Inflation has also increased in several economies as declining commodity prices led to subdued foreign exchange earnings and the weakening of currencies. The subregion needs to initiate concerted policy reforms to diversify and reduce reliance on natural resources or workers’ remittances for economic growth. This would involve creating a dynamic, entrepreneurial private sector and strengthening the linkages between resource and non-resource-based sectors.

The Pacific island developing economies are set to experience faster growth due to strong energy exports in Papua New Guinea, post-cyclone reconstruction activity in some countries and expected increases in tourism and remittance receipts. However, economic performance in the subregion remains highly vulnerable to frequent natural disasters. To better cope with associated economic challenges, the subregion needs a more vibrant business sector, which would expand the economic base, reduce youth unemployment and support government revenue that could be spent on boosting service delivery in rural areas and outer islands. Enhancing infrastructure networks and human and institutional capacity are also critical to overcome medium-term challenges.

Economic growth in South and South-West Asia edged up in 2014, mainly led by stronger macroeconomic performance in India, but it remained far below its pre-crisis pace. The consumption-led growth was fuelled by favourable farm incomes, workers’ remittances and monetary easing. The near-term outlook is optimistic, but conditional on continued domestic reform efforts in large economies, which would unleash the subregion’s high potential for growth. Limited intraregional trade within this subregion, however, could

limit the positive spillovers into relatively smaller economies. Moreover, given the sizeable macroeconomic imbalances in many subregional economies, a key reform area has to be the broadening of the tax base and the stemming of tax evasion. These steps would lower public borrowings that have added inflationary pressure and constrained financing to the private sector. Larger fiscal space due to tax reforms would also help address severe power shortages, which are the key growth constraint for the subregion. An appropriate framework for public-private partnerships and enhanced corporate governance in public enterprises are also needed to tackle the persistent energy crisis.

Economic growth slowed in South-East Asia in 2014 primarily due to monetary tightening and weak commodity exports in Indonesia and political unrest in Thailand. Although the near-term outlook is projected to improve, exacerbating medium-term growth constraints are shortages of public infrastructure and skilled labour. The subregion needs to effectively mobilize part of its available savings to reverse the declining trend in outlays on public infrastructure, and enhance the quality of education and vocational training to match the needs of job markets.

Inclusive growth in Asia and the Pacific

Understanding the economic growth dynamics and prospects of the Asia-Pacific region together with recognizing its achievements in terms of higher growth and poverty reduction remain an important endeavor. However, development and overall human welfare is a multidimensional concept that is about more than just increasing the levels of income and reducing the levels of poverty. As highlighted in the first *Human Development Report*: “The purpose of development is to offer people more options. One of their options is access to income [...] But there are other options as well, including long life, knowledge, political freedom, personal security, community participation and guaranteed human rights”.

Inclusiveness of economic growth is a multidimensional concept. Yet, while the term “inclusive growth” has been widely used by Governments, international organizations and other stakeholders in recent years, there is still a lack of consensus on its concept and dimensions. Keeping in view the broad social objective of human well-being, *inclusiveness* as defined below encompasses the dimensions of *economic inclusiveness*, *social inclusiveness* and *environmental inclusiveness*.

To enhance inclusiveness there is need to focus on and analyse people’s wellbeing – the ultimate objective of any society – by focusing on: (a) increasing the average standard of living of the population (captured by average real income per capita); (b) reducing income inequality; (c) reducing levels of extreme poverty; and (d) expanding and broadening equality in opportunities, such as access to public goods.

Trends and patterns of inclusive growth in the region

Identifying and analysing underlying trends and patterns of inclusiveness within each of the three dimensions of development enables an assessment to be made on how inclusive overall growth has been within each of these dimensions. In the *economic* dimension, for instance, trends in GDP growth, poverty, income inequality and employment show that, while rates of extreme poverty have declined by half or more in most economies in the region due to higher GDP growth, poverty measured at the \$2 line is still very high. Moreover, there are large divergences in poverty rates within countries, usually across gender, but also between rural and urban areas, with extreme poverty in rural areas usually being higher than in urban areas. At the same time, it is noticeable that increases in the levels of real income have not always been distributed evenly within countries. On the contrary, income inequality has increased in many countries in the region, especially in the major developing countries, particularly in urban areas. Thus, since the 1990s, the population-weighted mean Gini index, a measure of income inequality, for the entire region rose from 33.5 to 37.5.

Another important factor of *economic* inclusiveness includes the availability of productive and decent employment as this is a decisive factor in lifting the poor out of poverty and reducing income inequalities. In most developing countries economic growth has not necessarily resulted in commensurate employment

growth given sector concentration and lack of labor demand in the productive sector. Agriculture, the sector contributing to livelihood for large proportions of the population, is shrinking and delivers low yields. The growing significance in the region of the services sector and industry, while partly compressing the contribution of agriculture to the region's GDP, has had a positive effect on diversification but needs to be accompanied by job generation. Addressing the neglect of the rural sector is thus crucial in order to reduce poverty and inequality.

To assess and promote inclusiveness in the *social* dimension, countries need to go beyond “inequality in income” and promote “equality of opportunity” through broadening access to quality education and adequate health-care services. Differences in access to education across the sexes, across income quintiles and across rural and urban sectors, have impacted opportunities for empowerment and economic productivity. Gender gaps are often more pronounced in rural areas, girls usually receive less education, particularly in lower-income quintiles, and gaps in education between boys and girls are primarily an issue of income. This situation also holds true for the quality of education, with the poor attending mainly inadequately maintained overcrowded public schools, which can over time aggravate intergenerational inequality.

To reduce prevailing disparities in distribution, improvement in the health status of the poor is critical and helps to increase their income-earning potential. While access to well-funded, high-quality health services should be available to the entire population, there are large disparities between urban and rural sectors, as well as across income quintiles. For instance, in several countries in the region there is a tendency to concentrate services in urban areas, which is a major reason explaining the lack of progress in the reduction of maternal mortality and infant mortality. Moreover, people often may not be able to afford health-care services even though they are available.

Economic growth without due consideration to environmental quality impacts both the ecology and imposes high costs to economies, while lowering the resilience of vulnerable populations given their environmentally degraded surroundings. Therefore, when moving up the development ladder, efforts must be made to safeguard the environment, and to increase access to basic services, such as electricity, clean drinking water and sanitation. Indeed, better access to these services also contributes to better health conditions. It is, therefore, important to consider *environmental* factors when considering just how inclusive growth has been. In this regard, while disaggregated data are less readily available, general improvements have been observed in, for instance, access to improved sanitation and water facilities, as well as access to cleaner energy – indicators that have important environmental impacts – with important differences, however, between rural and urban areas.

Overall inclusiveness

Any judgment call on whether growth has been inclusive in Asia and the Pacific becomes clouded once the multidimensional character of inclusiveness is considered. For example, while a country may have made significant advances in terms of social development, its success in accelerating poverty reduction or reducing income inequality may be less obvious. Indeed, even within each category of the three dimensions of development it may not be clear whether growth has been inclusive. For instance, in many countries significant declines in poverty rates have been accompanied by significant increases in income inequality.

Methodological and definitional perspectives on sustainable development, contained in the Rio+20 outcome document, offer an opportunity to compute a composite *index of inclusiveness*. This index consists of three sub-indices, one for each of the three dimensions of inclusiveness. Evidence for countries that have data to compute these sub-indices shows that between two periods of time, the 1990s and the period from 2000 to 2012, although growth across countries in the region has in general been more inclusive, significant divergences in inclusiveness exist within countries, between the sexes, across the rural and urban sectors and between regions. Particularly worrying is that the gap between the “haves” and the “have nots” within countries is widening. These dynamics, if they persist, will ultimately lead to a vicious cycle in which the better off benefit more from public services, such as health care and education, than

do the less well off, which in turn increases their employment prospects, thereby widening the gap even further between them and those less well off.

A number of reasons have been put forward to explain the widening of income inequalities. These include market-oriented reforms that countries have embraced as they integrated more closely with the global economy. Although such reforms have resulted in higher economic growth rates, they have affected income distribution within countries by, for instance, contributing to a declining share of labour income in output and a widening of income inequality due to a more unequal distribution of capital. Other factors include procyclical fiscal policy stances, increased financialization of the international economy and the privatization of State-owned enterprises.

Policy considerations to improve inclusiveness

Some of the key policy considerations to make growth more inclusive include the need for countries to make expenditure more development-oriented, particularly by ensuring more equal access to education and health care and by providing stronger social safety nets. Moreover, access to financial services also needs to be broadened, particularly in rural sectors, to narrow the income gap between agricultural households and non-agricultural households. Countries will also need to support the infrastructure for sustained and inclusive growth by, for instance, providing important public infrastructure that will attract more investment into the rural sector.

Critically, greater efforts must be made to foster employment. In many countries this means giving greater attention to the development of small and medium-sized enterprises in general, and the rural sector, especially agriculture, in particular, by, for instance, fostering rural industrialization through small-scale industries.

While the private sector has an important role to play in making growth more inclusive, greater efforts are particularly needed of the public sector to lay the appropriate framework and create an enabling environment, especially as addressing *income inequalities* is a key entry point for increasing inclusiveness.

In conclusion, while growth in Asia and the Pacific has overall been inclusive across countries, between the 1990s and the period 2000-2012, the gap is widening between the “haves” and the “have nots” within countries. For instance, economic inclusiveness is largely a result of countries’ success in reducing rates of extreme poverty, masking the fact that compared with the 1990s, in most countries the richest 20% of the population are capturing a larger share of income than the poorest 20%. It also masks deterioration in labour markets, with fewer people being in formal employment. Similarly, despite a general improvement in access to health care and education, in all countries since the 1990s, opportunities within countries are determined largely by one’s economic circumstances, or those of one’s parents. Thus, concerted actions of the public and private sector are needed to address such concerns.