SUSTAINING RECOVERY AND DYNAMISM FOR INCLUSIVE DEVELOPMENT

Economic and Social Survey of Asia and the Pacific 2010

UNITED NATIONS ESCAP

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ESCAP's Economic and Social Survey of Asia and the Pacific 2010

Executive Summary

The 2010 edition of the oldest and most comprehensive annual review of economic and social development spanning all economies in this vast and diverse region, the* Economic and Social Survey of Asia and the Pacific 2010 *assesses the critical issues, policy challenges and risks that the region faces in the months ahead as it leads the world economy in recovery from a dire recession. It also outlines the elements of a policy agenda for regaining the region's dynamism through inclusive and sustainable growth.

By early 2010, following the first global economic contraction in modern history, the contours of a V-shaped rebound were evident in the Asia-Pacific economies – assisted in large part by a number of unprecedented fiscal stimulus packages. But the rebound remains fragile and uneven, with a number of downside risks. While 2009 was a year of emergency crisis management, 2010 will be a year when economic policy making will be even more complex. Turning the rebound into a sustained recovery will mean keeping up the momentum while maintaining macroeconomic stability in the face of rising inflationary tendencies and the potential for asset bubbles.

The crisis has also drawn attention to the underlying global and regional structural imbalances built up over decades. Redressing these multiple imbalances and development gaps, and achieving a sustained recovery after the withdrawal of the fiscal stimuli, will require moving towards fairer, more balanced and sustainable patterns of development. Asia and the Pacific is unlikely to be able to return to business as usual. Instead it will increasingly have to drive its own development and create new sources of economic growth from within the region.

In this radically altered global panorama, the Asia-Pacific region is now emerging as a central participant in international economic relations. To fulfil this potential, however, it will need to implement an ambitious set of policies. *The Economic and Social Survey of Asia and the Pacific 2010* explores this complex environment and – lest the V-shaped rebound induces complacency – outlines the elements of a coherent regional policy agenda.

2009: an uneven pattern of impacts

Even at the height of this crisis, Asia and the Pacific displayed a new-found resilience. Its developing economies achieved an annual growth rate of 4.0%, making it the fastest-growing region in the world. However, almost all of this growth came from the two most populous countries: China, which grew by 8.7%, and India, by 7.2%. Indeed, excluding these fastgrowing sub-continental economies, the Asia-Pacific developing economies contracted in 2009 by 0.6%.

These contrasting performances resulted from many different factors. The first concerned the extent of dependence on developed country markets. All the worst-affected countries had shares of exports to GDP that exceeded 60%, and the greater the share of these exports that were absorbed by the developed markets the greater was the economic contraction. Related to this, the countries most exposed to global trade perturbations were those, including many in East and South-East Asia, whose exports involved regional production networking arrangements – for products such as apparel, machinery, electronics, and motor vehicles. They saw their exports plummet almost twice as rapidly as in the 1997 crisis. On the other hand, countries such as Bangladesh, which exported simpler products such as low-cost garments, became more competitive and gained market share. There is also evidence that intra-regional trade has continued to expand, especially through exports to China and India.

The second factor concerned the extent of exposure to the exit of portfolio capital as investors sought to cover their losses in the western capital markets. This brought pressures on exchange rates and created financial instability as well as liquidity problems in countries that did not have adequate reserves. Although, compared with the 1997 crisis, more countries had strong foreign exchange reserves, some had to arrange bilateral swaps, as the Republic of Korea and Singapore, or seek liquidity from the IMF, as Pakistan and Sri Lanka. Nevertheless, it is by no means clear what is an optimum stock of foreign reserves since, as the crisis revealed, holding foreign reserves idle also entails both costs and risks. *Survey 2010* proposes a yardstick for gauging such vulnerabilities.

The third factor explaining the contrasting experiences was the varying capacity to respond. The countries best able to mount rapid and large counter-cyclical spending programmes were those that entered the crisis with strong macroeconomic fundamentals; in particular, stable inflationary trends, sound fiscal balances and low ratios of public debt to GDP. The massive additional fiscal spending helped reduce the impact of lower exports and the falling demand for services such as tourism, as well as reduced growth of migrant remittances. Even more important, the stimulus also afforded some protection to the vulnerable workers who had lost their jobs, typically the unskilled and very often women in the manufacturing sector and in the informal economy.

A quantitative analysis reported in *Survey 2010* shows that the stimulus packages certainly had an impact – offsetting to some extent the loss of exports. For the key economies of the region, *Survey 2010* shows that for each $1.00 lost in exports there was an average loss of $0.88 in GDP – though the figure ranged from $1.1 in Japan, to $0.4 in Malaysia and Singapore, and to $0.7 for China. If the only variable affecting GDP had been a shortfall of exports, then GDP growth in 2009 would have dropped by 7.8 percentage points. However, the actual shortfall in 2009 was only 4.2 percentage points – thanks largely to the region's fiscal stimulus packages. The forecasts also suggest that Asia and the Pacific is unlikely to see a return to pre-crisis export growth rates. In the medium term the region will need to look beyond expansionary policies and instead seek new engines to sustain the region's dynamism.

The outlook for 2010: a sharp rebound, with downside risks

The outlook for 2010 has improved significantly. The Asia-Pacific developing economies are forecast to grow by 7.0% in 2010 compared to 4.0% in 2009, led by the self-sustaining motors of China, growing at 9.5%, and India at 8.3%.

But the road ahead has a number of potential pitfalls. One concerns protectionism. Many developed countries, facing anaemic growth coupled with high unemployment, may restrict trade. This has led to prominent trade disputes that pit developed countries against large exporters from this region. Another concern is that greater liquidity in the global financial system is finding its way to Asia-Pacific emerging markets – causing exchange rates to appreciate, stoking inflationary pressures, and leading to the formation of asset bubbles. There are also echoes of the food-fuel crisis of 2007, with food prices rising again in some countries and causing special hardship for the poor.

Policy-makers are thus faced with tough balancing acts on both monetary and fiscal policy. While they will want to tighten monetary policy to restrain inflationary pressures they will need to maintain real interest rates at par with global levels – to keep their exchange rates competitive and to encourage domestic economic growth. And while they will inevitably have to move toward fiscal consolidation they will have to judge the timing and sequencing carefully if they are not to choke off economic recovery and trigger the need for further stimulus packages. Another policy consideration will be to manage portfolio capital inflows through various types of capital control. The benefits of maintaining open capital accounts, if any, are ambiguous. Instead there is a growing consensus that capital controls should be seen as important components of the policy toolkit.

As argued by the APEC leaders at their November 2009 Summit in Singapore, the advanced economies are unlikely to be able to return to 'growth as usual' or 'trade as usual'. Even if the advanced countries achieve a substantial economic recovery their demand for imports from Asia and the Pacific will not return to pre-crisis levels. This is because in order to unwind the global imbalances, many of the developed economies will need to restrain debt-fuelled consumption. The Asia-Pacific countries, for their part, will therefore need to seek new sources of growth – 'rebalancing' their economies in favour of greater domestic and regional consumption.

Survey 2010 explores different imbalances and gaps – macroeconomic, social, developmental, and ecological – and considers the potential of closing them for creating additional aggregate demand that could serve as new regional impulses for growth.

Imbalances, gaps and new sources of growth

In the past, the global imbalances have assisted the Asia-Pacific region by providing expanding markets for exports, and augmenting foreign exchange reserves. But these imbalances are not sustainable. They have resulted in growing trade and current account imbalances which the United States in particular, with its high levels of accumulated debt, will have to unwind.

There are also macroeconomic imbalances within the region – notably between the economies of East and South-East Asia and those of South Asia. In East and South-East Asia net exports have been increasing as a proportion of GDP growth while in South Asia they have been increasingly negative. In the case of East Asia this reflects a declining share of consumption in long-term growth, and in the case of South-East Asia, a declining share of fixed investment. In South Asia's case, on the other hand, the share of investment has been rising along with growing net imports.

Perhaps the most disturbing aspect of the global imbalances is the anomaly of capital flowing from Asia-Pacific developing countries to finance consumption and investment in rich countries such as the United States. This has happened largely because Asia and the Pacific lacks a well developed regional financial architecture that might have enabled the countries running current account surpluses to deploy these productively in other parts of the region.

At the same time, Asia and the Pacific has large socioeconomic and development gaps. Although the region as a whole has achieved rapid economic growth that has helped lift millions of people out of poverty it is still home to over 950 million people living under the $1.25 per day poverty line. Moreover, development has been very uneven, across subregions and between countries. This is reflected in varying patterns of progress towards the Millennium Development Goals – with South-East Asia leading the way and South Asia and the Pacific Island economies lagging behind. There are similar gaps in the levels of infrastructure development; this is evident from the composite infrastructure development scores presented in *Survey 2010.* Some economies register high scores, including: Singapore; Japan; New Zealand; Republic of Korea; Australia; Brunei Darussalam; Hong Kong, China; and Macao, China. Others still have considerable infrastructure gaps, particularly the least developed, landlocked and small island economies, such as Papua New Guinea, Nepal, Lao People's Democratic Republic, Solomon Islands, Cambodia, Bhutan, Vanuatu, and Mongolia. If the countries of the region invest in closing these socio-economic development gaps they cannot only lift levels of human development but also boost regional aggregate demand – making economic growth more inclusive and sustainable. This will demand high and sustained levels of investment that will rely on creating a new regional financial architecture that can be used to mobilize the necessary resources – from within the region and beyond.

The Asia-Pacific region also has serious ecological imbalances. These are evident, for example, in the degradation of key natural resources, such as forests and fresh water, the unsustainable use of energy, and a rapid growth of carbon emissions. Although some of these imbalances may not appear to have immediate economic consequences, they will make it much more difficult to sustain economic growth in the long term. If countries can invest in addressing these imbalances they will not only preserve the natural environment, on which so many poor people depend, but also maintain the basis for long-term growth. And in the short term they will also provide an immediate economic stimulus and thus further alleviate poverty.

In sum, therefore, as the countries of the region take steps to address macroeconomic, developmental and ecological imbalances they have an opportunity to create new motors of inclusive growth that will help them regain their economic dynamism. The region has close to one billion people living in poverty, which combined with wide development gaps, gives it considerable headroom for augmenting aggregate demand through boosting private consumption and investment. Similarly, the Asia-Pacific economies have the opportunity to develop new and greener industries and businesses based on innovations that will save energy and materials. In so doing they can provide more affordable products for the poor while maintaining growth and promoting environmental sustainability.

Survey 2010 argues, therefore, that in the aftermath of the global economic crisis, inclusive and sustainable growth is not only desirable but also a necessary condition for regaining the region's dynamism. It then goes on to outline a policy agenda at national and regional levels that might assist in unleashing the latent potential of domestic and regional demand to address the three imbalances in an integrated manner.

A regional policy agenda for inclusive and sustainable growth

Survey 2010 explores ways of increasing aggregate demand and supply – establishing the region on a more inclusive and sustainable path of development and boosting regional connectivity. For this purpose it proposes an agenda with five prongs. The first four may assist in expanding domestic consumption while addressing socio-economic and ecological imbalances. The fifth deals with regional consumption.

1. Strengthening social protection

If poor households can rely on systems of social protection that will automatically trigger social safety nets at times of adversity they will be able to maintain food intake and continue to use education and health services. Just as important, at normal times they will have less need to maintain precautionary savings and can use more of their income for consumption. By serving as automatic stabilizers, systems of social protection not only support households at times of crisis but also enhance opportunities for individual development.

The Asia-Pacific region now has a number of examples of ambitious social security programmes. Thailand has a universal health-care programme – formerly called the '30 baht' scheme, but now free. India has the National Rural Employment Guarantee Act (NREGA) which provides a guaranteed 100 days of employment each year to adult members of rural households and also has gender-sensitive provisions. The Philippines has the Pantawid Pamilyang Pilipino Program (4Ps), which provides conditional cash transfers to poor households for their health and educational needs. Despite these efforts, a common agenda built around social protection has been slow to emerge. Social policy institutions often remain rooted in out-dated assumptions about the household, how individuals are cared for, and its coping mechanism in times of crises. Rather than using short-term measures, interventions need to sustain a trajectory from poverty to security, as basic rights.

2. Promoting agriculture and rural development: fostering a second green revolution

In Asia and the Pacific the majority of poor people live in the rural areas and derive most of their income from agriculture – so are likely to benefit from agricultural growth. Since the 1970s such growth was based largely on the Green Revolution which helped the region achieve significant yield increases – though the high input intensity also caused well documented problems. Now, as the region aims for more balanced economic growth, it needs a second, more knowledge-intensive green revolution that combines advances in science and agricultural engineering with the region's unique traditional knowledge to make agriculture more environmentally resilient. But countries will also need to make agriculture more socially inclusive by returning ownership of land and resources to farmers, especially women, and economically empowering the poor. This will mean setting appropriate prices for key inputs and establishing institutions to help small producers achieve economies of scale in marketing and in accessing international markets. In the past, governments may have tried to achieve this through state or parastatal agencies, but in future they may choose to encourage community-based organizations and farmers' self-help groups. International partnerships and South-South cooperation can also help foster such a green revolution while also addressing concerns for food security.

3. Supporting new engines of growth: green innovations

Green Growth emphasizes environmentally sustainable consumption and production that foster low-carbon, socially inclusive development. For this purpose, countries can take an industrial policy approach – encouraging strategic collaborations between government and industry to promote investments in environmentally-friendly technologies and products. Because of market failures such investments may not be immediately profitable, so many environmentally-friendly technological innovations will initially need government support. The public support can also help develop and commercialize products that serve to raise the wellbeing of the poor and the rural areas generally by encouraging affordable and environmentally-friendly technologies such as the rural solar home electricity systems popularized by Grameen Shakti in Bangladesh. A number of Asia-Pacific countries including Japan, China, India, and the Republic of Korea are promoting such innovations as a part of their national action plans on climate change. China, for example, has become the top investor in clean energy, with investments reaching $34.6 billion in 2009, while the Republic of Korea plans to spend $84 billion over five years to develop environmentally-friendly industries and use them as engines of growth. Governments can also encourage the adoption of environmentally-sound practices and technologies through appropriate regulations and systems of incentives and taxes.

In the developing countries the introduction of these innovations can be accelerated if the developed countries that already have a range of environmentally-friendly technologies, transfer them and relax some of the provisions of intellectual property rights, and also provide some of the necessary finance – following the principle of common but differentiated responsibilities established in the United Nations Framework Convention on Climate Change.

But the developing countries can also help each other in the area of sustainable consumption and production by sharing experiences and best practices. A number of Asia-Pacific developing countries now have capabilities in a range of technologies, such as biofuels production, waste management and solar and wind power. For example, Waste Concern, an NGO in Bangladesh which has developed a system of decentralized treatment plants for managing solid waste, with ESCAP support, is promoting similar approaches in cities in Pakistan, Sri Lanka, and Viet Nam.

4. Enhancing financial inclusion

A well functioning financial system is crucial to economic growth, but this will not be enough to ensure expanded aggregate demand. If the poor are to release their pent-up demand they will need access to a more diverse and appropriate range of financial products and services. This would include savings, credit and insurance products tailored to their requirements – on more favourable terms and with less stringent demands for collateral. This has been shown to have clear benefits. Households that can take advantage of micro-finance and micro-insurance, for example, are in a much stronger position to increase their incomes – and boost their levels of nutrition and standards of education. Moreover, women in such households tend to have greater autonomy in decision making and are better able to improve the well being of their families. To date however, across most developing countries in Asia and the Pacific, financial services are used by only a small proportion of the population. The poor are typically excluded from the formal financial sector and from the services of commercial banks. Barriers exist on both the demand and supply sides. Governments will therefore need to ensure an institutional and regulatory environment that fosters an inclusive, fairer and more efficient banking system and expands and safeguards the options for the poor.

5. Evolving a regional framework for cooperative action

With some of the world's largest and fastest-growing economies, Asia and the Pacific can become an even greater economic powerhouse if it develops a more integrated regional market. But this should be on the basis of a new development paradigm that is more inclusive and sustainable. Thus far, for historical, political and topographical reasons, the region has been better connected with Europe and North America than it has been with itself. *Survey 2010* identifies four priorities that can leverage complementarities across the region and lay the foundations for a more inclusive and sustainable path of development:

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

(b) Integrated trade and transport policies – The region has improved its highway and railway networks, but it cannot use the infrastructure effectively without the legal and regulartory bases for vehicles, goods, and people to move across borders and transit countries. Currently, many international movements are hindered by slow and costly processes, formalities and procedures. The cost of red tape is considerable and often wipes out the benefits of tariff reductions enacted over the past two decades. In future the region will need an integrated, multimodal transport system. For this purpose, it can, for example, build intermodal transfer points, also known as dry ports, where goods, containers or vehicles can be transhipped using the most efficient mode of transport – along with facilities for product grading, packaging, inspections and the processing of trade documentation. The areas surrounding dry ports can then emerge as growth poles, bringing new investment and employment opportunities to impoverished hinterlands while reducing the pressure on coastal areas. Building on its Asian Highway and Trans Asian Railway Networks, the ESCAP secretariat is now helping the region develop a network of dry ports while improving trade and transport facilitation. ESCAP, along with the ADB is collaborating with ASEAN in developing a connectivity master plan.

(c) ICT superhighways – Expanding markets and business opportunities and creating a more unified economic space will depend crucially on better intraregional ICT connectivity to reduce the digital divide and accelerate cross-border information and communication flows. One of the main tasks will be to offer greater international bandwidth – particularly for the landlocked developing countries and the Pacific island developing countries. As well as boosting economic development such connectivity can also be used to establish systems for emergency early warnings and disaster response.

(d) Regional financial architecture – The economic crisis highlighted the lack of regional response options. Most of the measures had to be taken by national governments. So far the cooperation has been largely limited to the Chiang Mai Initiative that has now been

multilateralized with a reserve pool of $120 billion for meeting the temporary liquidity needs of the ASEAN+3 countries. The region now needs to further develop its financial architecture, which would include systems of intermediation between its large savings and its unmet investment needs. One option would be to create an infrastructure development fund managed by a regional institution. If this secured just 5% of the region's reserves of nearly $5 trillion it could have start-up capital of $250 billion, as well as the ability to borrow from the region's central banks. This pooling of reserves could assist the region in meeting some of its investment needs for transport, energy, water and telecommunications – estimated at more than $800 billion per annum.

Another area where regional financial architecture could make a positive contribution is in exchange rate coordination. As the economies of the region increasingly trade with each other they will need a currency management system that facilitates trade and macroeconomic stability.

If governments had access to a well endowed regional crisis response and prevention facility they would feel less need to build up large foreign exchange reserves to protect their economies against speculative attacks and liquidity crises, and could thus free up reserves for more productive investments. Enhanced regional cooperation should not, however, be regarded as an alternative to full participation in global economic relations. Rather it should be seen as a complement to it, filling in the gaps and establishing the building blocks for global multilateral cooperation.

The development of a regional financial architecture would also assist in policy coordination and in providing an Asia-Pacific perspective on various global proposals that are emerging in the G-20, the United Nations and other forums. These include, for example, an SDR-based global reserve currency, a global tax on financial transactions to moderate short-term capital flows, and international regulations for the financial sector to curb excessive risk taking.

Asia and the Pacific now has an historic opportunity for cooperation, and in recent months some of the region's major economies have started a process of deeper mutual engagement – though if they are to carry through their more ambitious plans they will need to add greater detail to general statements of intent.

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