



# Economic Outlook for Southeast Asia, China and India 2014

BEYOND THE MIDDLE-INCOME TRAP



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## Beyond the Middle-Income Trap

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## 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 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).

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

	2012	2018	2014-18	2000-07
<b>ASEAN-6 countries</b>				
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
<b>CLMV countries</b>				
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
<b>Average of ASEAN 10</b>	5.5(*)	5.6	5.4	5.5(**)
<b>2 large economies in Emerging Asia</b>				
China	7.7	7.5	7.7	10.5
India	3.7	6.1	5.9	7.1
<b>Average of Emerging Asia</b>	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. \* Excluding Myanmar, \*\* Excluding Brunei Darussalam and Myanmar.

Source: OECD Development Centre, MPF-2014. For more detailed information on MPF, see [www.oecd.org/dev/asiapacific/mpf](http://www.oecd.org/dev/asiapacific/mpf)

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.

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 2014-18, 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% during 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 healthcare 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 US. 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
<b>ASEAN 10 countries</b>		
<b>Brunei Darussalam</b>	2012-17	Knowledge and innovation to enhance productivity and economic growth
<b>Cambodia</b>	2009-13	Growth, employment, equity and efficiency
<b>Indonesia</b>	2010-14	Realisation of an Indonesia that is prosperous, democratic and just
<b>Lao PDR</b>	2011-15	Socio-economic development, industrialisation and modernisation towards the year 2020
<b>Malaysia</b>	2011-15	Charting development towards a high-income nation
<b>Myanmar</b>	2012-15	Development of industry, balanced development, improvements in education, health and living standards and improved statistical capacities
<b>Philippines</b>	2011-16	Pursuit of inclusive growth
<b>Singapore</b>	2010-20	Highly skilled people, innovative economy, distinctive global city
<b>Thailand</b>	2012-16	A happy society with equity, fairness and resilience under the philosophy of a Sufficiency Economy
<b>Viet Nam</b>	2011-20	A modern, industrialised country by 2020
<b>2 large economies in Emerging Asia</b>		
<b>China</b>	2011-15	Rebalancing the economy, ameliorating social inequality and protecting the environment
<b>India</b>	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**

<b>ASEAN-6</b>		
<b>Country</b>		<b>Policy focus</b>
<b>Brunei</b>	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
<b>Indonesia</b>	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
<b>Malaysia</b>	Education	Improve the quality of education
	SME development	Improve the productivity of SMEs
	Taxation	Widen the tax base and improve tax administration and compliance
<b>Philippines</b>	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
<b>Singapore</b>	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 lifelong learning to increase labour market flexibility
<b>Thailand</b>	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
<b>CLMV</b>		
<b>Country</b>		<b>Policy focus</b>
<b>Cambodia</b>	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
<b>Lao PDR</b>	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
<b>Myanmar</b>	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
<b>Viet Nam</b>	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
<b>TWO LARGE EMERGING ASIAN ECONOMIES</b>		
<b>Country</b>		<b>Policy focus</b>
<b>China</b>	Fiscal policy	Improve fiscal efficiency through institutional reform
<b>India</b>	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 proven 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. 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 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- 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 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 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 12<sup>th</sup> Five-Year Plan (FYP) is to improve the provision of basic public services – notably public education, healthcare 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 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.

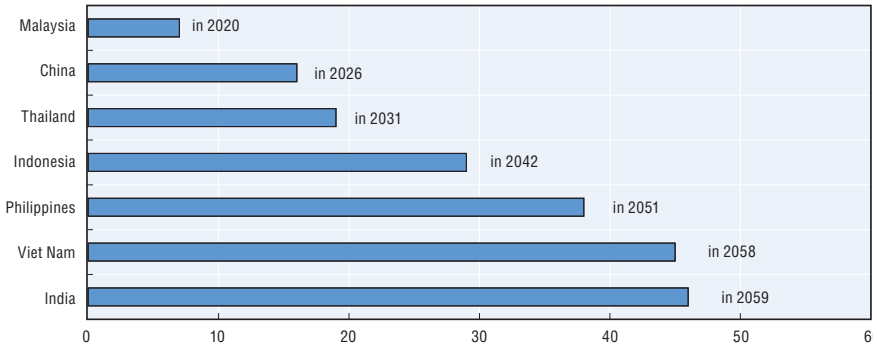
The 2013-14 budget focuses on the poor as part of the overarching goal of creating opportunities for young people to acquire the education and skills that will enable them to get decent jobs or become self-employed. Similarly, the educational focus of the 12<sup>th</sup> FYP is on teacher training, evaluation 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.

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 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.

### 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<sup>1</sup>” underscores the fact that the challenges of sustaining development become more difficult and complex as development evolves.

To sustain development beyond the middle-income trap, countries need to shift away from growth that is driven primarily by factor accumulation. 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***

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***

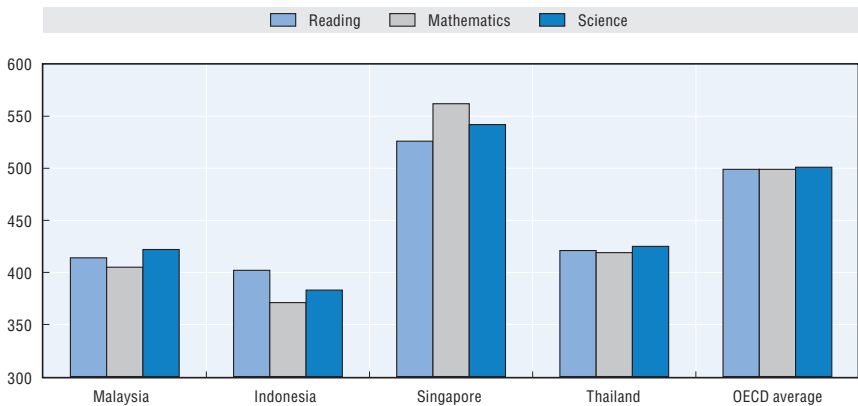
Building and growing institutional capacity in human capital and innovation will be critical to making the changes in industrial structure. Development of human capital and innovation capacity are critical to successfully move up the value chain into higher-productivity manufacturing and service activities. 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 technical and vocational education facilities (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.



## *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 research and development, 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 the 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, due 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 like 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 bureaus; improve the design of credit guarantee schemes; and strengthen capacities of smaller financial institutions and micro-credit facilities to lend to the smallest SMEs.

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 macro-prudential capabilities. Middle-income Emerging Asia macro-prudential 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 macro-prudential 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**

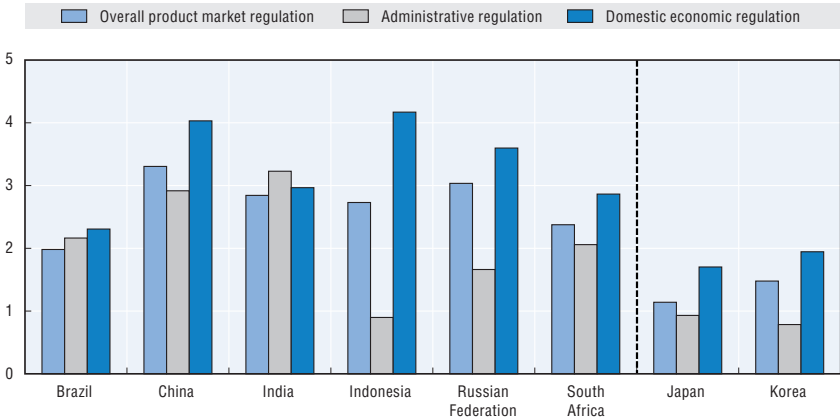
While the manufacturing sector will continue to be important, further economic development of Emerging Asia is likely to depend increasingly on the services sector. Services already account for between 37% and 45% of GDP in the middle-income ASEAN countries and China, and between 30% and 60% of total 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)



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.

Source: OECD, PMR Database.

### 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.

## **ORGANISATION FOR ECONOMIC CO-OPERATION AND DEVELOPMENT (OECD)**

The OECD is a unique forum where governments work together to address the economic, social and environmental challenges of globalisation. The OECD is also at the forefront of efforts to understand and to help governments respond to new developments and concerns, such as corporate governance, the information economy and the challenges of an ageing population. The Organisation provides a setting where governments can compare policy experiences, seek answers to common problems, identify good practice and work to co-ordinate domestic and international policies.

The OECD member countries are: Australia, Austria, Belgium, Canada, Chile, the Czech Republic, Denmark, Estonia, Finland, France, Germany, Greece, Hungary, Iceland, Ireland, Israel, Italy, Japan, Korea, Luxembourg, Mexico, the Netherlands, New Zealand, Norway, Poland, Portugal, the Slovak Republic, Slovenia, Spain, Sweden, Switzerland, Turkey, the United Kingdom and the United States. The European Union takes part in the work of the OECD.

OECD Publishing disseminates widely the results of the Organisation's statistics gathering and research on economic, social and environmental issues, as well as the conventions, guidelines and standards agreed by its members.

### **OECD DEVELOPMENT CENTRE**

The OECD Development Centre was established in 1962 as an independent platform for knowledgesharing and policy dialogue between OECD member countries and developing economies, allowing these countries to interact on an equal footing. As of July 2013, 18 non-OECD countries are full members of the Centre's Governing Board. The Centre draws attention to emerging systemic issues likely to have an impact on global development and more specific development challenges faced by today's emerging and developing countries. It uses evidence-based analysis and strategic partnerships to help countries formulate innovative policy solutions to the global challenges of development.

For more information on the Centre and its members, please see [www.oecd.org/dev](http://www.oecd.org/dev).





# Economic Outlook for Southeast Asia, China and India 2014

## BEYOND THE MIDDLE-INCOME TRAP

The *Economic Outlook for Southeast Asia, China and India 2014: Beyond the Middle-income Trap* presents a medium-term (five year) economic outlook for Emerging Asia, a specific focus on the middle-income trap and an assessment of national structural policy reforms and medium-term development plans. The report highlights the fact that economies in the region will remain resilient in the next five years, supported by the growing strength of domestic demand. It also calls for greater efforts in the push for further economic integration in ASEAN, in particular in the areas of human capital development and poverty.

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Chapter 1. **Medium-term economic outlook for Emerging Asia: Prospects and assessments**

Chapter 2. **Structural policy country notes for Emerging Asia**

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[www.oecd.org/site/seao](http://www.oecd.org/site/seao)

