CHAPTER ONE

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

Abstract

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

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

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

Introduction

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

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

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

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

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

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

The projected growth for ASEAN countries highlights the fact that some are at an earlier stage of development, while others are at a stage where further rapid gains in productivity become more difficult to achieve. Indonesia is projected to lead the ASEAN-6 countries with a growth rate of 6.4% over 2013-17, significantly above its average after the 1997 Asian crisis (5.1% over the 2000-07 period) and equal to that recorded in the two decades prior to that crisis. This favourable outlook for Indonesia reflects the significant improvement in the country's standing with international investors and the ambitious

infrastructure investment and economic reforms specified in Indonesia's medium-term development plan. Projected growth in Singapore, Malaysia, the Philippines and Thailand compares favourably to growth for other developing countries at a comparable stage of development, due in part to the comparatively high national savings rates in the Southeast Asian countries.

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

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

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

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

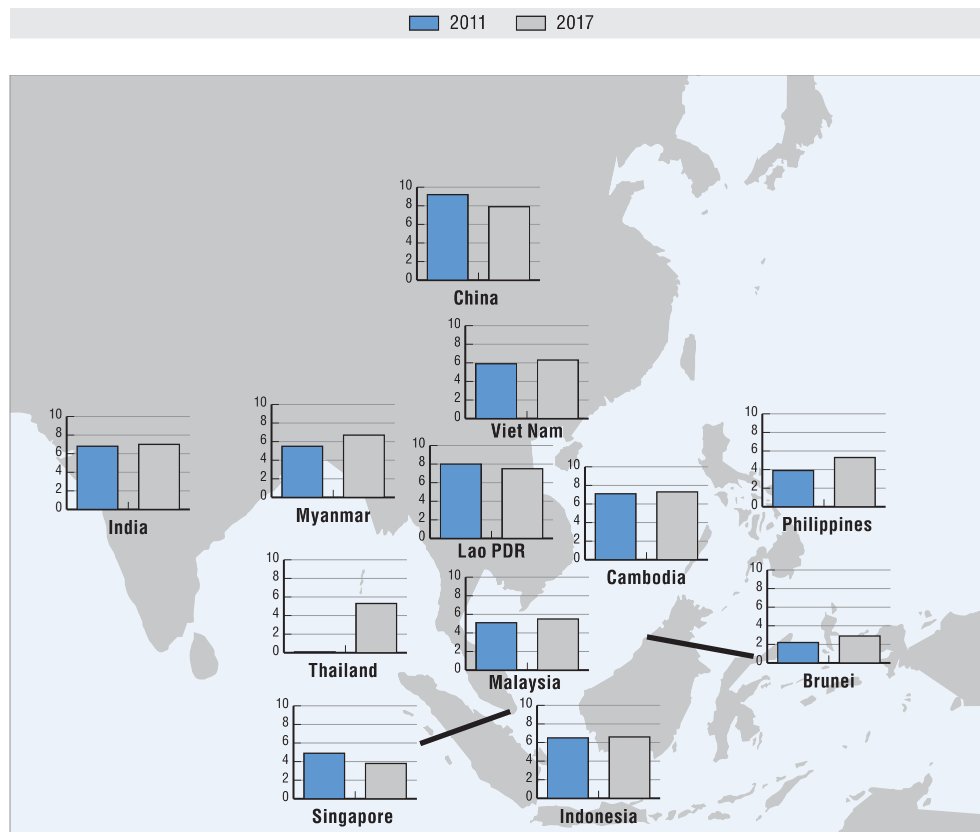
Growth in Emerging Asia as a whole is projected to be 7.4% by 2017, though slower than its pre-crisis rate (8.6% over the 2000-07 period). This moderated growth momentum is largely due to weakening in the two big giants (China and India) in the region. Growth in China is projected to slow somewhat from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

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

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

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

(annual percentage change)



Source: OECD Development Centre, MPF-2013.

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Near-term macroeconomic developments and prospects

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

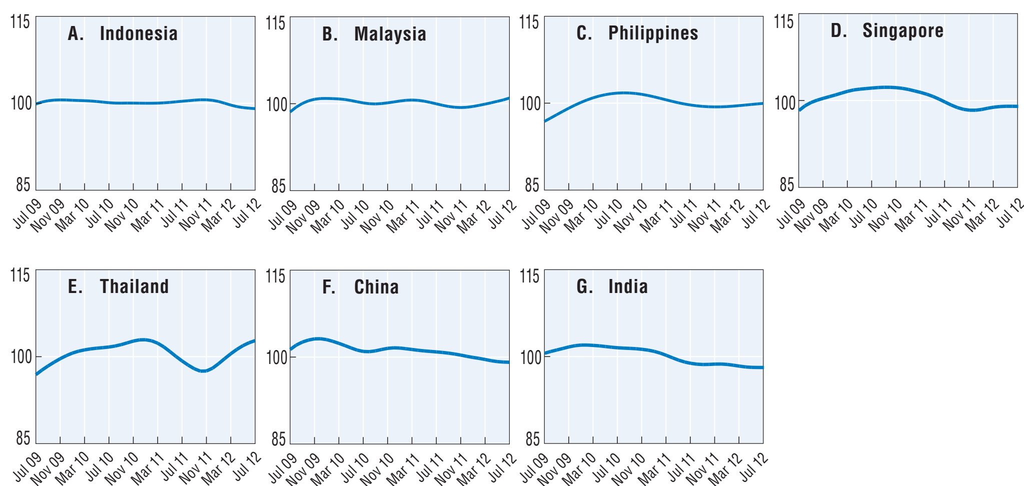
Growth in the region has been facing headwinds from weakening external demand …

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

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

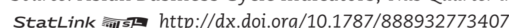
Figure 1.2. **Business cycle composite leading indicators of Southeast Asia, China and India**

(100=threshold point)



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

Source: Asian Business Cycle Indicators, *This Quarter in Asia vol.9* and OECD Composite Leading Indicators.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Box 1.1. **Growth slowdowns in China and India**

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

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

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

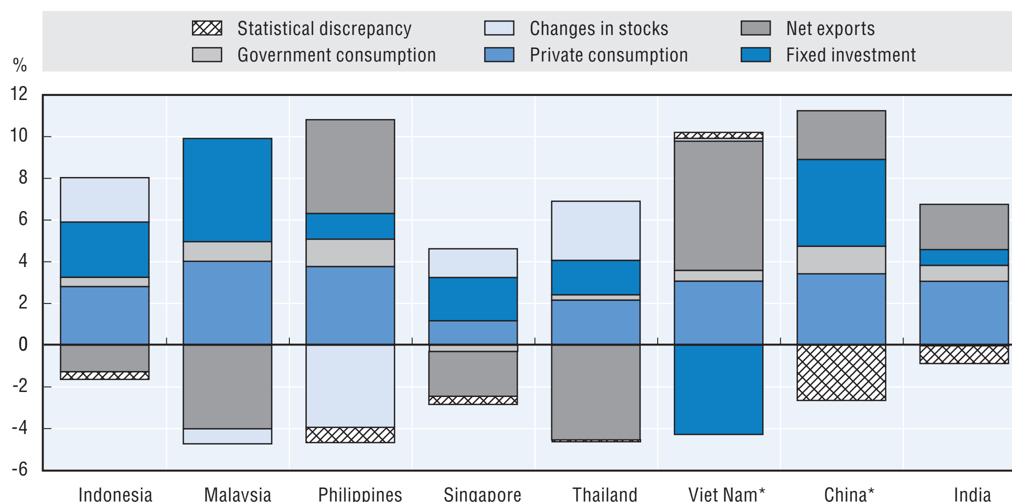
Macroeconomic policies in India have had to focus on reducing high inflation and the large budget deficit. Headline consumer price inflation dropped during the last four months of 2011 but has since rebounded to nearly 10% on a year-on-year basis. After being raised progressively by nearly 350 basis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

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

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

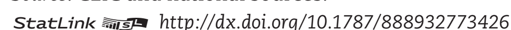
Figure 1.3. **Contributions to growth in Southeast Asia, China and India in the first half of 2012**

(percentage of GDP)



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

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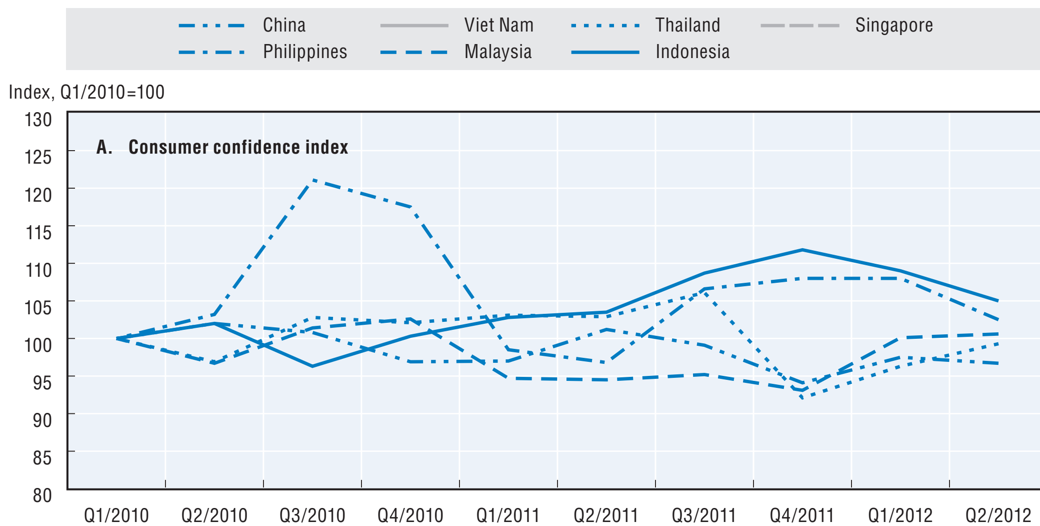
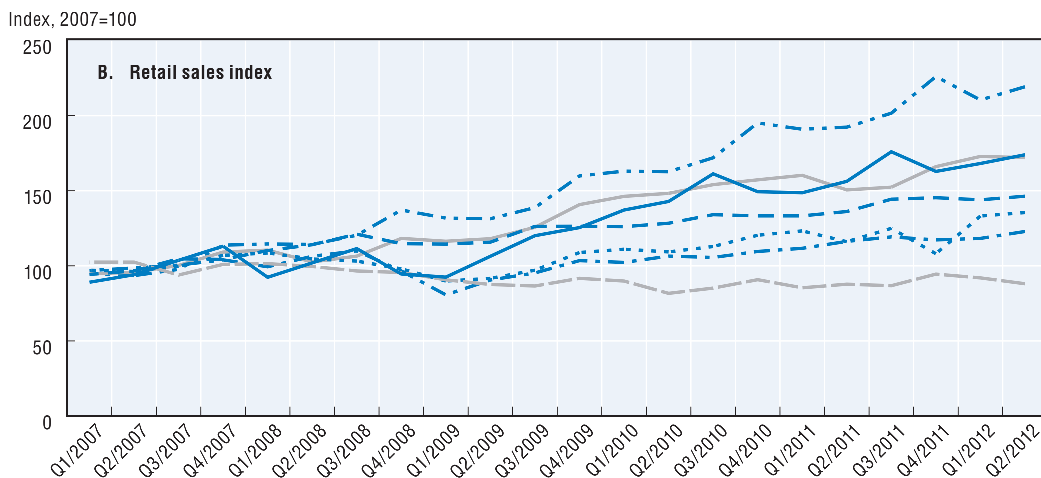
Consumption has been underpinned by strong employment growth and falling inflation and is being increasingly supported by spending of the growing middle class. Retail sales have continued to be strong in most Southeast Asian countries, except for Singapore, and consumer confidence has remained high or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

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



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

Source: CEIC.



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

Source: CEIC.

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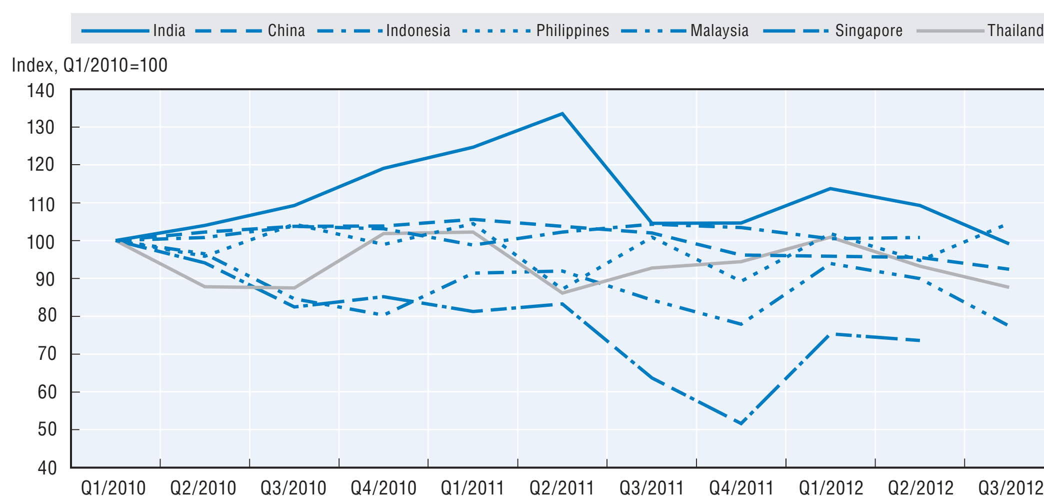
Investment growth in Emerging Asia has also been quite robust on average since the 2007 global crisis, buoyed in some cases by infrastructure investments contained in the fiscal stimulus packages adopted in the wake of that crisis. While public investment spending has slowed as the stimulus has wound down, private investment has remained strong and business sentiment surveys in some cases suggest it may remain strong in the near term despite the weakening of external demand (Figure 1.5). Comparatively low interest rates and sound financial positions of domestic lenders are favouring private investment. Investment prospects in Southeast Asia have been further boosted

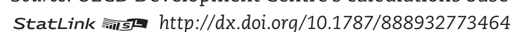
by the improving foreign perceptions of their financial soundness and competitiveness (Box 1.2). Although industry profits have fallen off in China as aggregate growth has slowed, the impact on investment spending should be at least partly offset by recent steps to ease monetary policy.

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



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

Source: OECD Development Centre`s calculations based on CEIC.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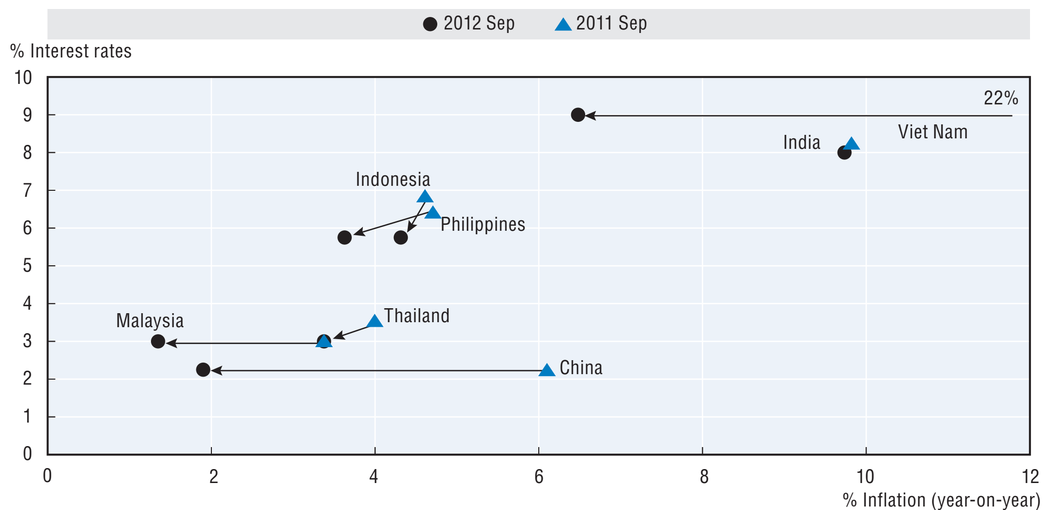
Most Southeast Asian countries have enjoyed room to use monetary policy to support growth relatively well

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

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

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



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

Source: CEIC, Datastream and national sources.

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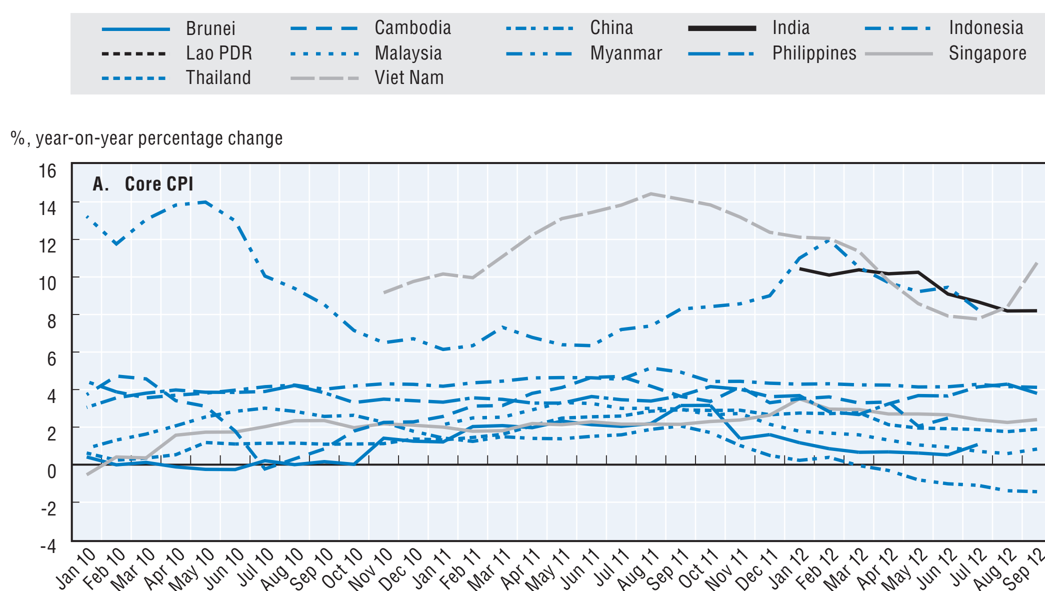
The different monetary policy responses largely reflect the easing of inflation pressures to acceptable levels in the first group of countries versus continuing concerns over inflation in the others. After accelerating in 2010 under the pressure of surging international commodity prices, headline inflation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

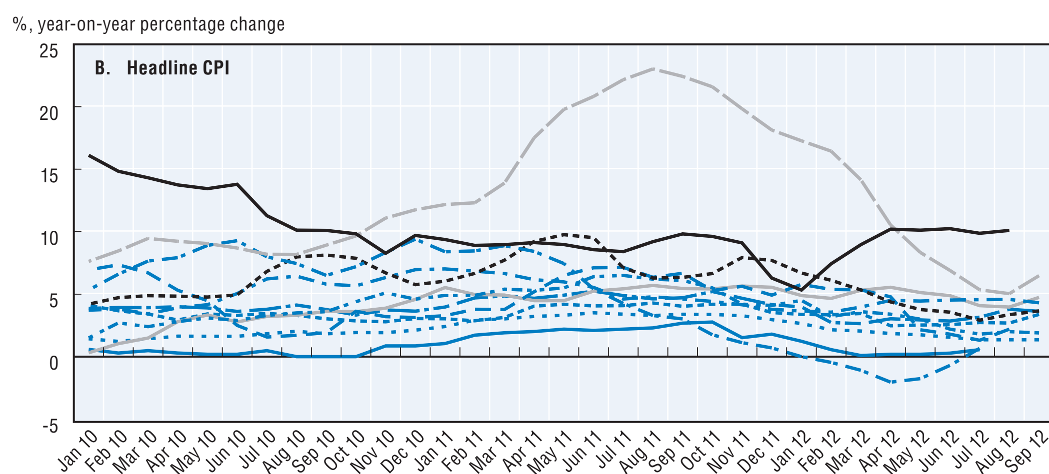
Fiscal policies in most ASEAN countries were mildly contractionary or neutral in 2011 as countries continued to wind down their fiscal stimulus programmes. As discussed in more detail later, fiscal balances are in deficit in most Southeast Asian countries. Deficits in Cambodia and the Philippines have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

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



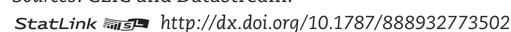
Notes: For Brunei core inflation refers to weighted average of Non-Food and Non-Housing, -Water, -Electricity, -Gas & -Other Fuels and Non-Transport consumer prices.
For Cambodia core inflation refers to weighted average of Non-Food and Non-Housing & -Utilities and Non-Transportation consumer prices.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

Sources: CEIC and Datastream.



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

Sources: CEIC and Datastream.



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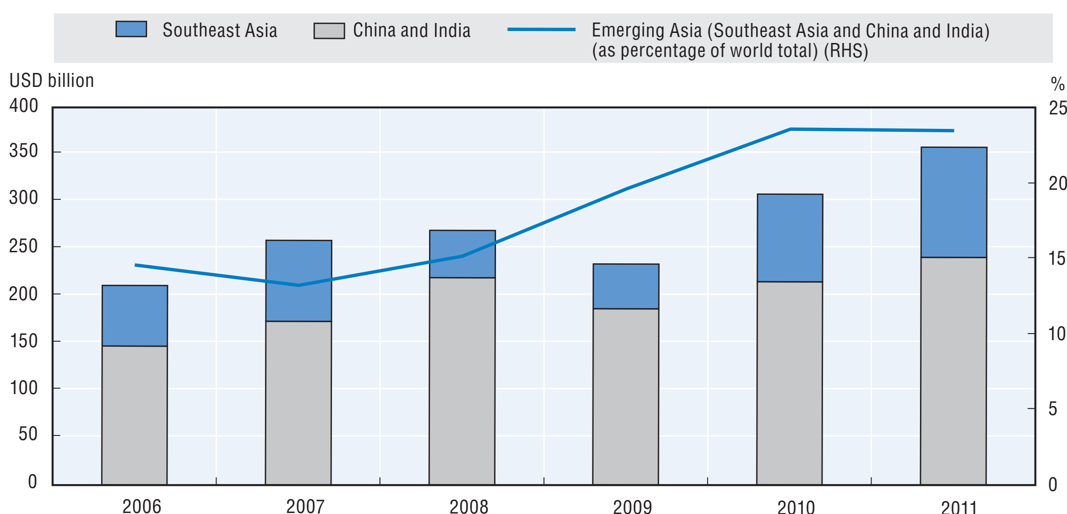
There is some room for further macroeconomic policy stimulus in Southeast Asia to support real growth but it is limited. Indonesia, Lao PDR, the Philippines and Thailand have adopted expansionary budgets for 2013, with considerable increases in infrastructure spending. However, budget consolidation is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

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

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



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

Source: UNCTAD World Investment Report 2012.

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

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

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

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

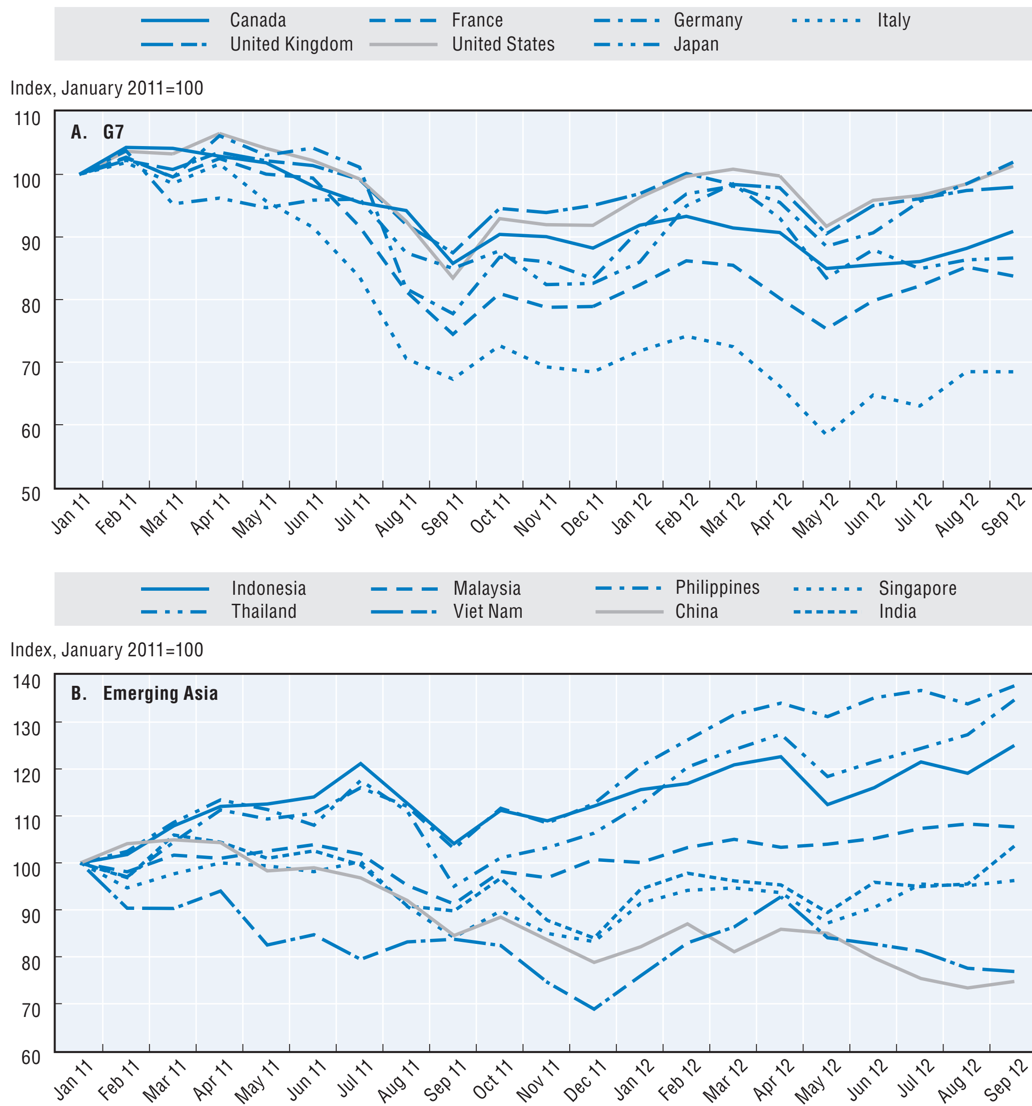
The impact of global uncertainty, in particular from the euro area, has become apparent but remains limited overall

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

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

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

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



Source: CEIC.

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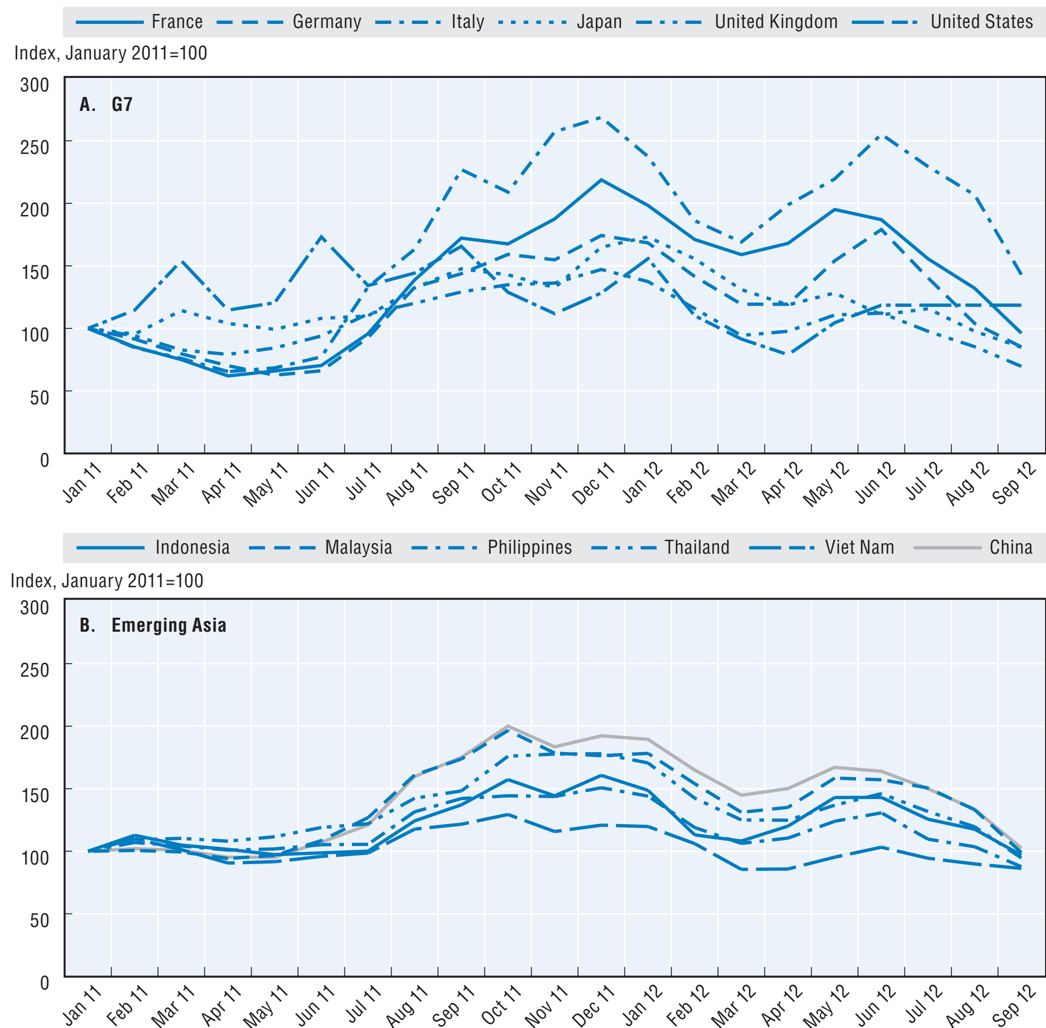
Figure 1.10. **Credit default swap premiums in the G7 and Emerging Asia**



Source: Datastream.

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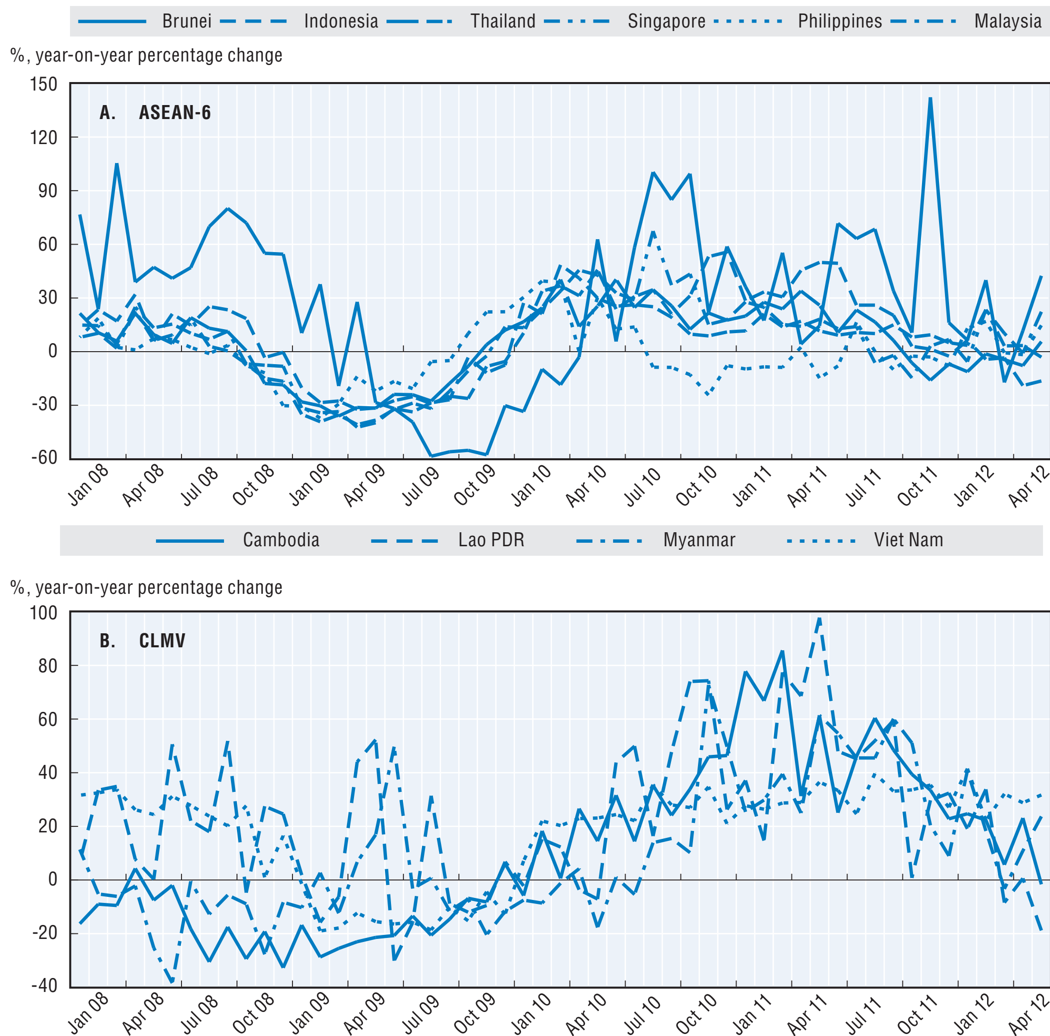
The main channel of impact has been through trade…

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

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



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

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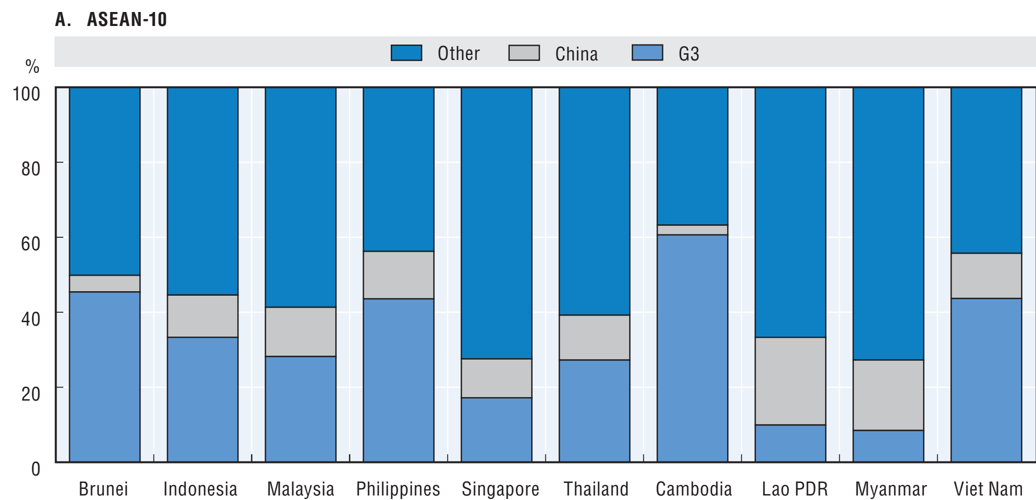
However, the degree to which the Southeast Asian region is affected may differ by country, depending on how reliant the country is on the G3 and the type of goods exported. In 2011, the G3 economies accounted for 27% of Southeast Asia's total direct exports to the world, with Cambodia having the largest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

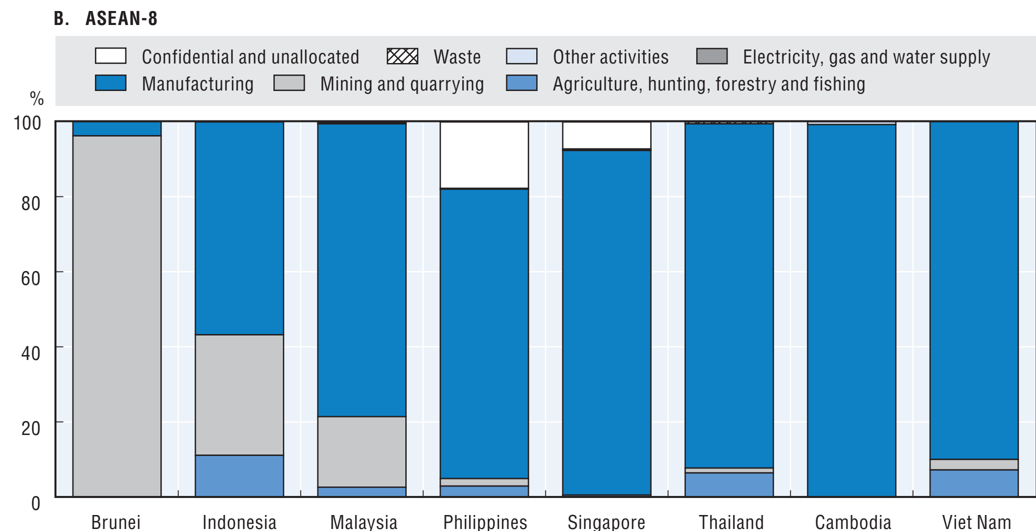
Figure 1.12. **Export structure of ASEAN to G3 economies, 2011**

A. ASEAN-10



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

B. ASEAN-8



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

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

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

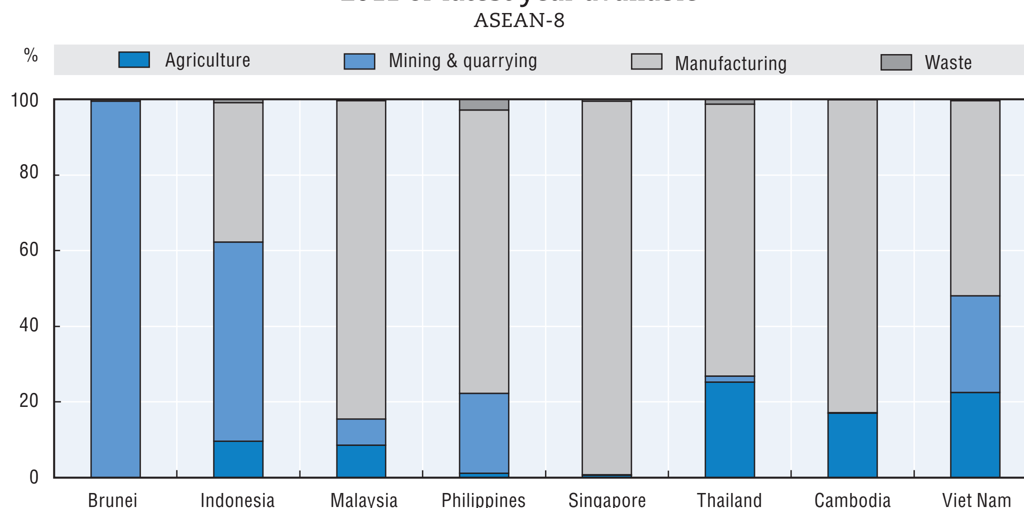
Source country	Export market	Direct export exposure	Indirect export exposure to euro area	Indirect export exposure to US	Indirect export exposure to Japan
Indonesia	Euro area	8.7		0.3	0.1
	US	8.1	0.7		0.2
	Japan	16.6	1.8	3.3	
	China	11.3	2.9	3.6	1.6
Malaysia	Euro area	8.4		0.2	0
	US	8.3	1.0		0.3
	Japan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

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

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

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

ASEAN-8



Within manufacturing:

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

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

Source: OECD Statistics.

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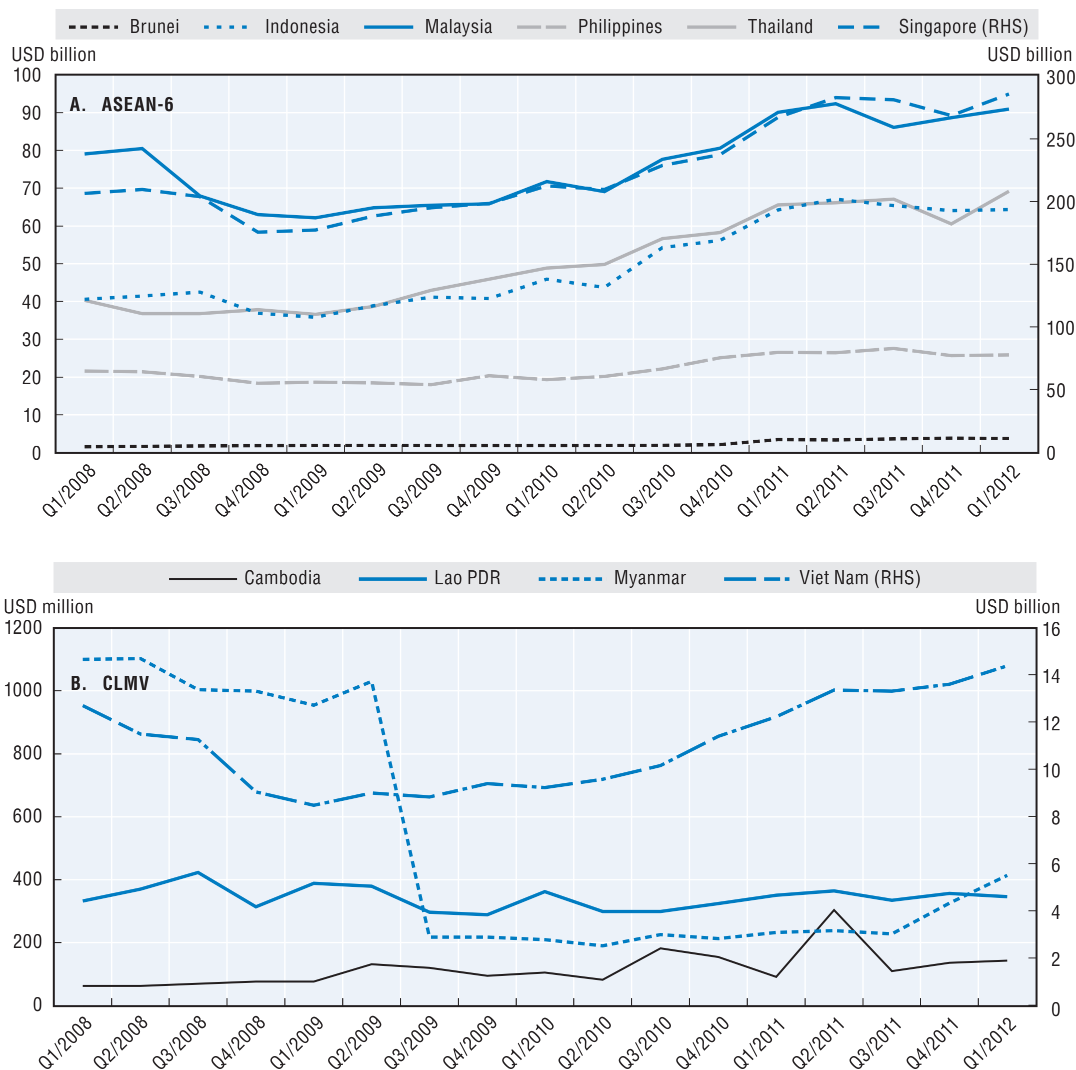
...although credit to ASEAN exporters continues to remain healthy for the moment

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

Foreign claims statistics from the Bank of International Settlements (BIS) show that there has been some deleveraging from European, US and Japanese banks in ASEAN countries towards the end of 2011, although foreign claims have picked up slightly again

in the first quarter of 2012 (Figure 1.14). Meanwhile, Asian banks have replaced G3 banks in providing credit and have thus strengthened their market presence in Asia. Current sentiments suggest that the overall supply of credit to SMEs remains healthy although banks are now more cautious in their lending strategies and are monitoring existing borrowers and their portfolio performances. While there has been a reported increase in the number of loan defaults, overall loan portfolios are still healthy. There are concerns among banks that if global uncertainties persist and the slowdown in economic activities continues, the number of non-performing loans may increase beyond the healthy range.

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



Source: BIS.

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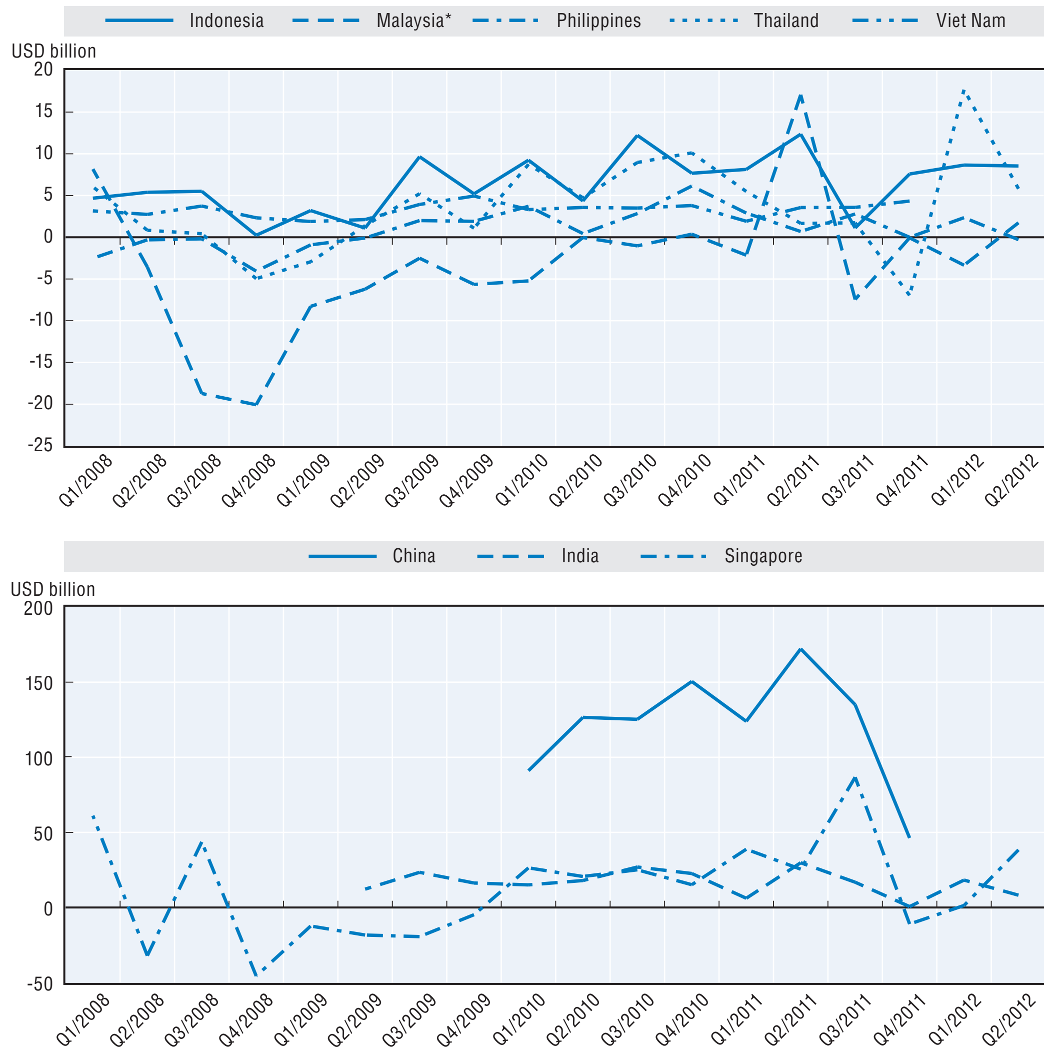
Despite increased volatility in the financial markets, Southeast Asia continues to remain an attractive destination for investment

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

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



Note: *Net capital flows for Malaysia.

Source: CEIC.

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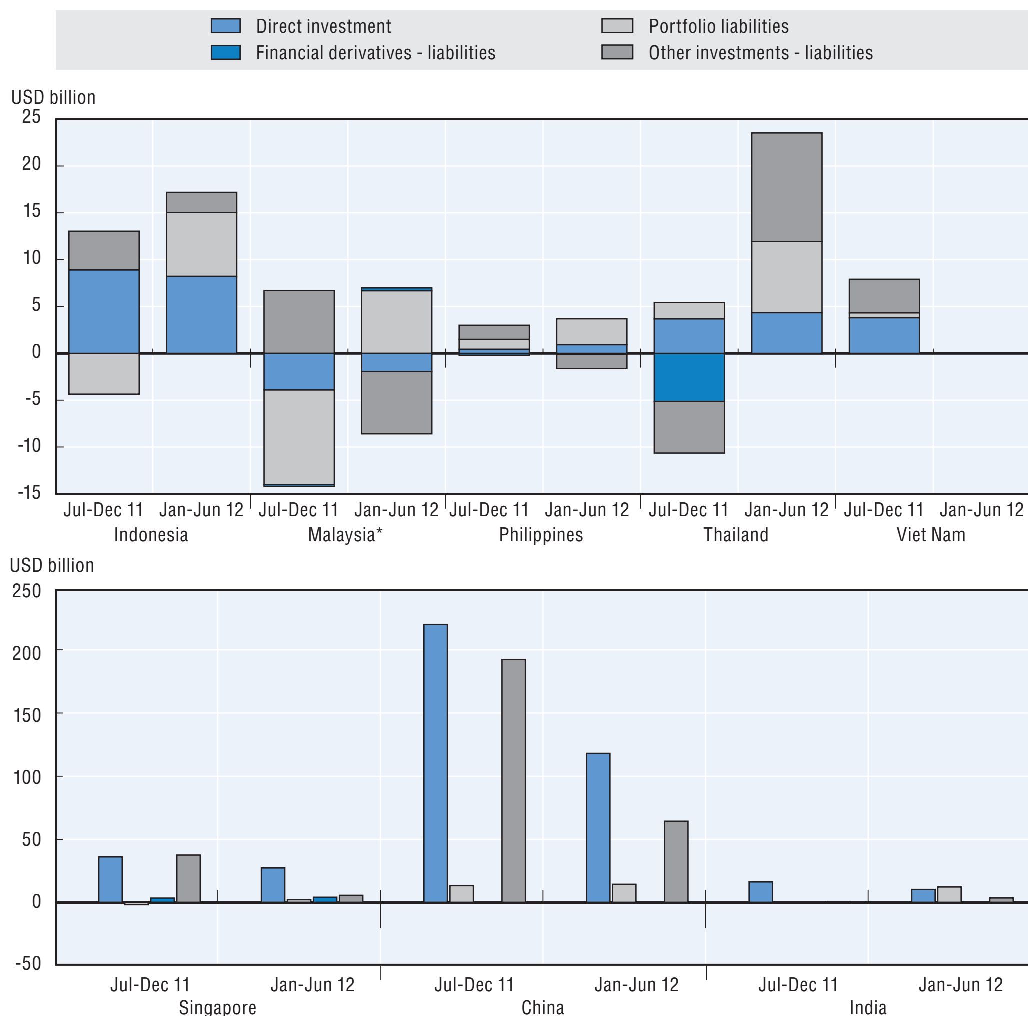
Total portfolio inflows into the ASEAN 5 (Indonesia, Malaysia, the Philippines, Singapore and Thailand) were down by nearly 42% for 2011 as a whole compared to 2010, with Singapore, Malaysia and Indonesia recording sharp declines, although net inflows rose slightly in the Philippines and Thailand. Portfolio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

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



Note: *Net capital flows for Malaysia.

Source: CEIC.

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However, it is not clear which direction capital flows will take in Asia with the recent round of uncoordinated monetary easing by major central banks in the United States, the euro area and Japan. Based on the experience in the aftermath of the Lehman collapse in late 2008, a flight to the USD could occur in the event of an escalation of global uncertainties, leading to severe shortages of USD globally and prompting capital restrictions and the opening of US Fed lines of credit in several Southeast Asian countries. On the other hand, given Asia's relative resilience and fiscal strengths, capital inflows

could increase from abroad from investors looking for a safe haven and higher yields. This could also prompt governments to take steps to keep easy money from flowing in and driving up their currencies or fueling speculative activities. Therefore, regardless of capital inflows or outflows, challenges remain for Southeast Asian governments in employing the required tools to manage capital flows without destabilising the domestic economy.

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

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

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

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

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

Box 1.3. (contd.)

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

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

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

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

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

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

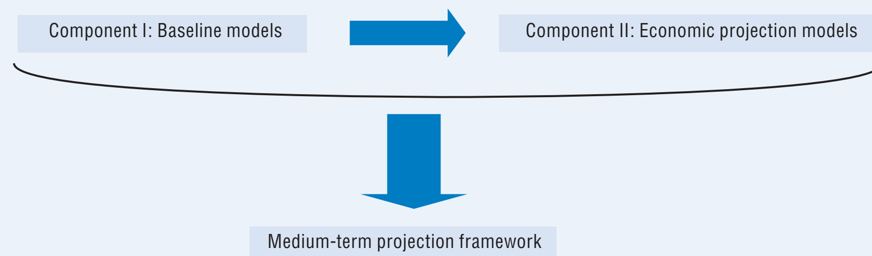
In Southeast Asia, the robust private consumption growth recorded over 2011-12 is projected to continue and in many ASEAN countries and China it will be higher than in the years 2000-07. Overall, private consumption is projected to account for more than half of total aggregate real growth over the medium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

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

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

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

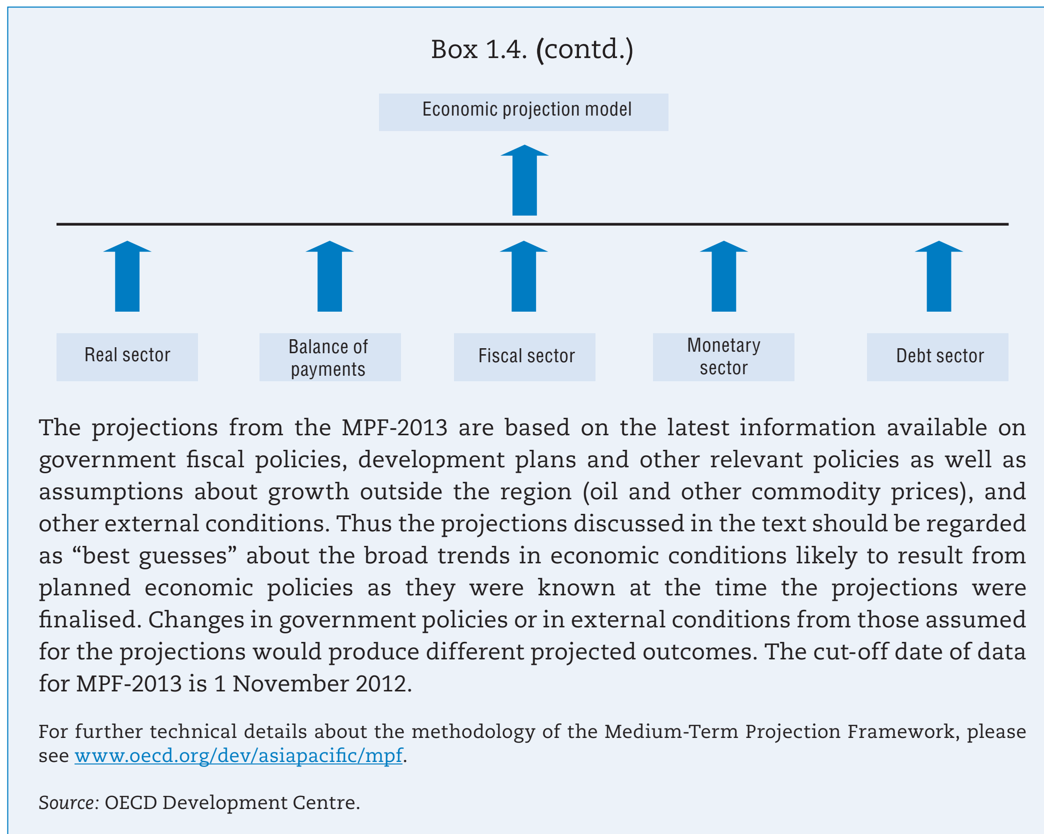
The MPF consists of two components: *i)* a **baseline ('supply side') model** that determines potential output; and *ii)* an **economic projection model** determining the path of actual GDP, its major expenditure components, along with inflation, fiscal balances, the current account balance and related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



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

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

Box 1.4. (contd.)



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

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

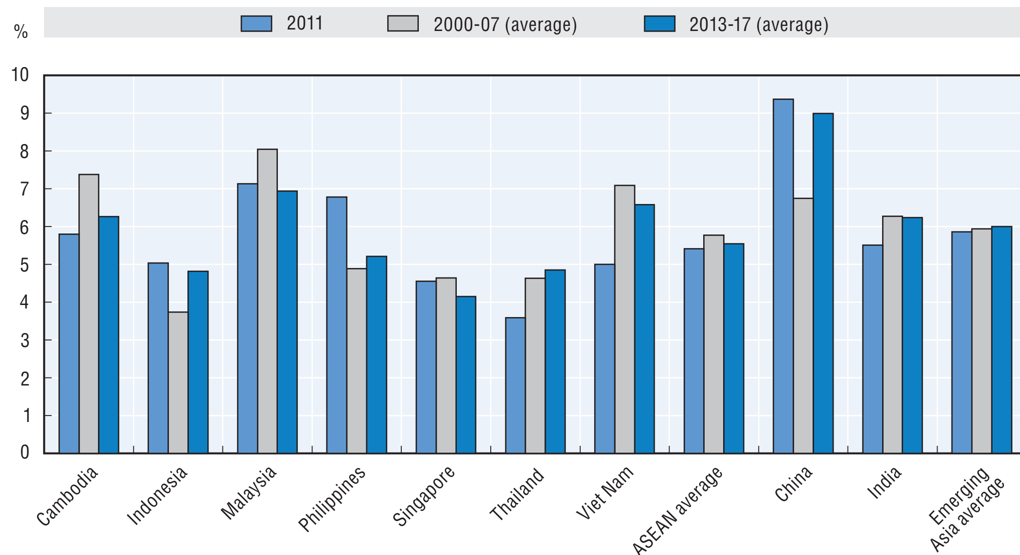
Source: OECD Development Centre.

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

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

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

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



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

Source: OECD Development Centre, MPF-2013.

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At the end of 2008, China launched a government-funded project called "home appliances going to the countryside" which aimed to expand sales of household electrical appliances in rural areas at prices 13% lower than those in cities. According to statistics from the Ministry of Commerce of China, in 2011, the sales of household electrical appliances across the country amounted to 92.48 million units, creating direct consumption of more than CNY 342 billion (USD 54.4 billion). These incentive policies have provided dramatic strength for numerous enterprises to get through difficulties. However, the market contracted sharply in some regions after the expiration of this policy at the end of 2011.

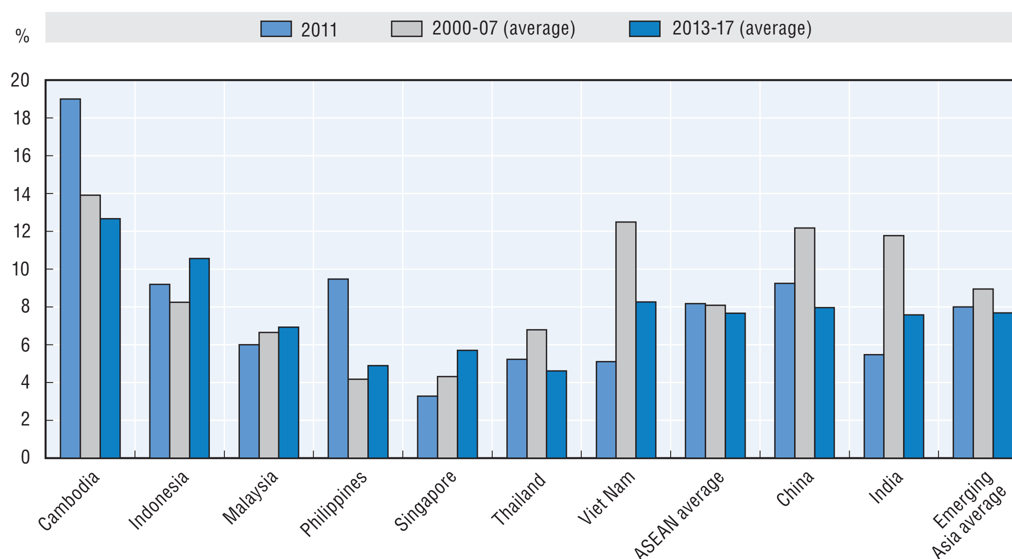
Macroeconomic policies have also helped to support consumption by cushioning the effects of shocks to real growth and by maintaining, in most cases, low and fairly stable inflation rates. Surges in inflation in Viet Nam in 2008 and again in 2010 depressed consumption growth by eroding household purchasing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

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

The environment for private investment has improved

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

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



Note: ASEAN average includes Cambodia, Indonesia, Malaysia, Philippines, Singapore, Thailand, Viet Nam. Emerging Asia average includes seven countries of ASEAN, China and India.
Source: OECD Development Centre, MPF-2013.

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

infrastructure spending is planned in Thailand, Lao PDR and Cambodia to repair damage from the recent flooding and to improve flood control and other infrastructure needed to reduce damage from future floods.

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

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

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

Current account surpluses of larger Southeast Asian countries will narrow

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

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

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

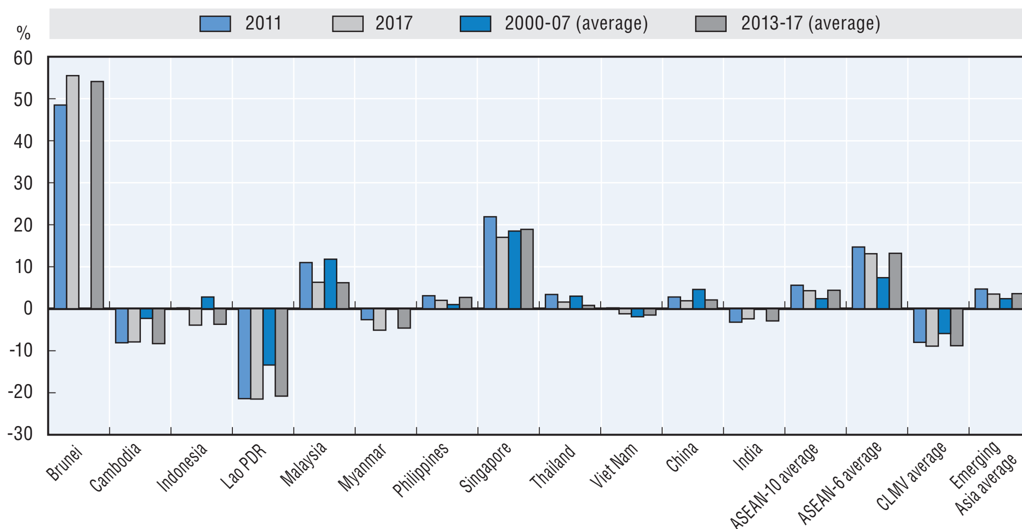
In the medium term, except for Indonesia which is projected to record a small deficit relative to GDP by 2017, many ASEAN-6 countries such as Malaysia, the Philippines, Singapore and Thailand will remain in current account surplus while the CLMV countries remain in deficit. China's current account surplus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

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

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

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

(percentage of GDP)



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

Source: OECD Development Centre, MPF-2013.

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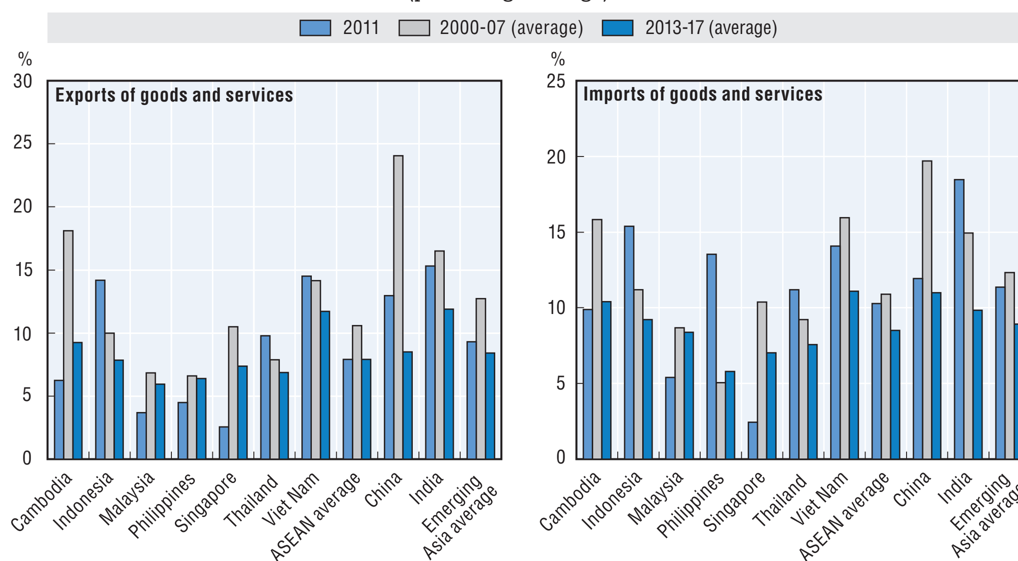
Figure 1.20. **Exports and imports of goods and services of Southeast Asia, China and India**

(percentage change)



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

Source: OECD Development Centre, MPF-2013.

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

Strong growth will be underpinned by effective macroeconomic policies

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

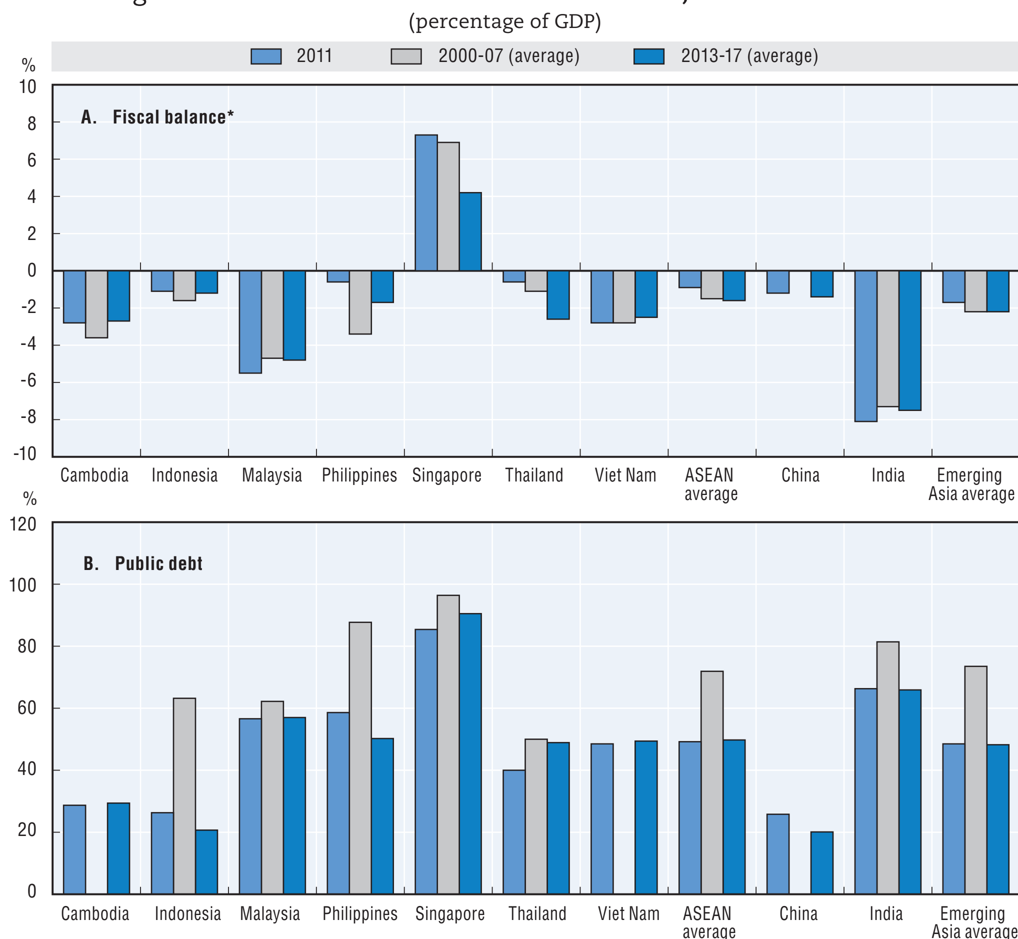
According to officially announced budget plans, most countries in the region will continue to reduce their fiscal deficits, although at a somewhat slower pace than in 2009-10 (Figure 1.21). Malaysia, which suffered a downgrade in its international credit rating in 2010 because of a surge in its budget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

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

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

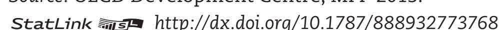
Figure 1.21. **Public finances of Southeast Asia, China and India**

(percentage of GDP)



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

Source: OECD Development Centre, MPF-2013.

 *http://dx.doi.org/10.1787/888932773768*

The economic outlook is subject to both upside and downside risks

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

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

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

Key policy challenges to sustaining healthy growth in the medium term

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

(Probit estimation)

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

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

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

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

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

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

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

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

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

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

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

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

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

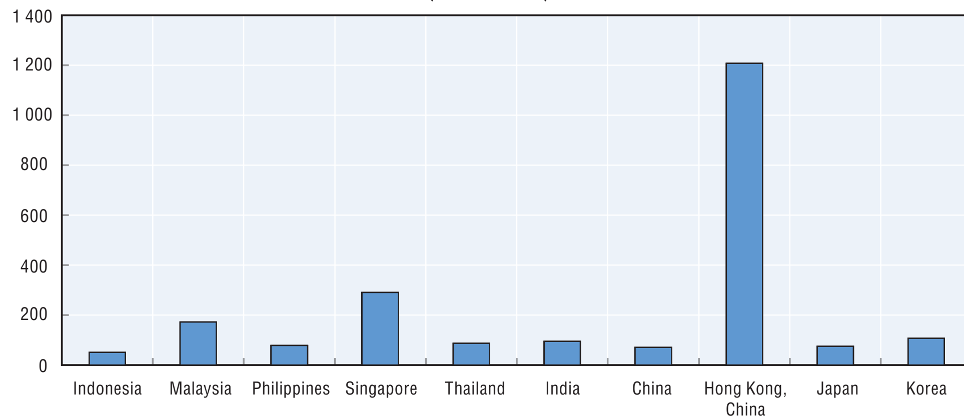
India's stock market has been the biggest beneficiary of financial reforms in that country and its development has helped to catalyse financial innovations in other areas. Notably, the experience gained in reforms to the stock market helped in the establishment of a currency futures market in 2008 (OECD,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

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

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

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

(ratio of GDP)



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

Source: World Federation of Exchanges.

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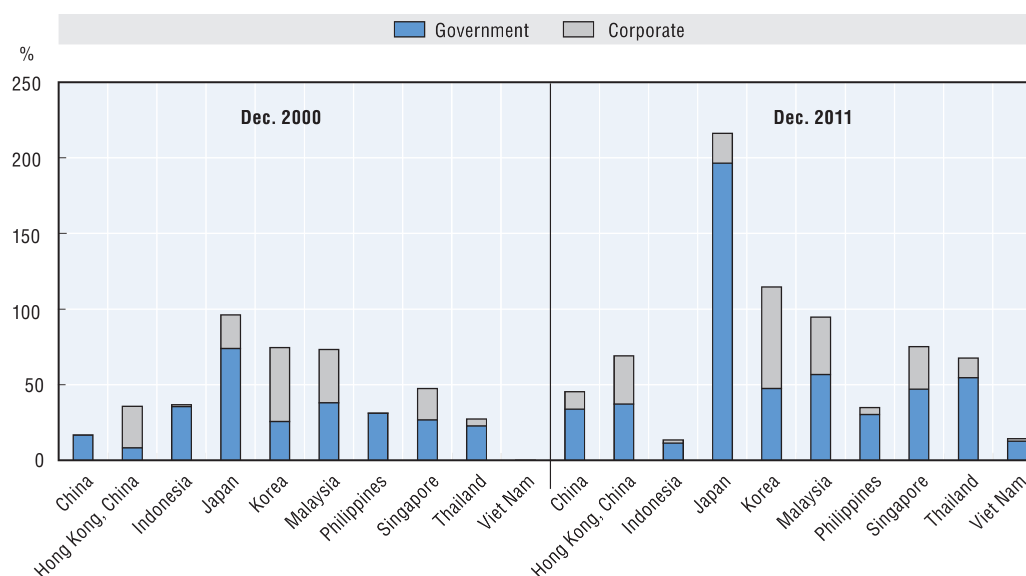
Development of equity markets in Emerging Asia has been hampered by weaknesses in corporate governance, in regulatory norms concerning disclosure and predatory market practices such as insider trading (especially their enforcement) and in corporate governance. Stock market development in smaller ASEAN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

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

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

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

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



Source: Asia Bonds Online.

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

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

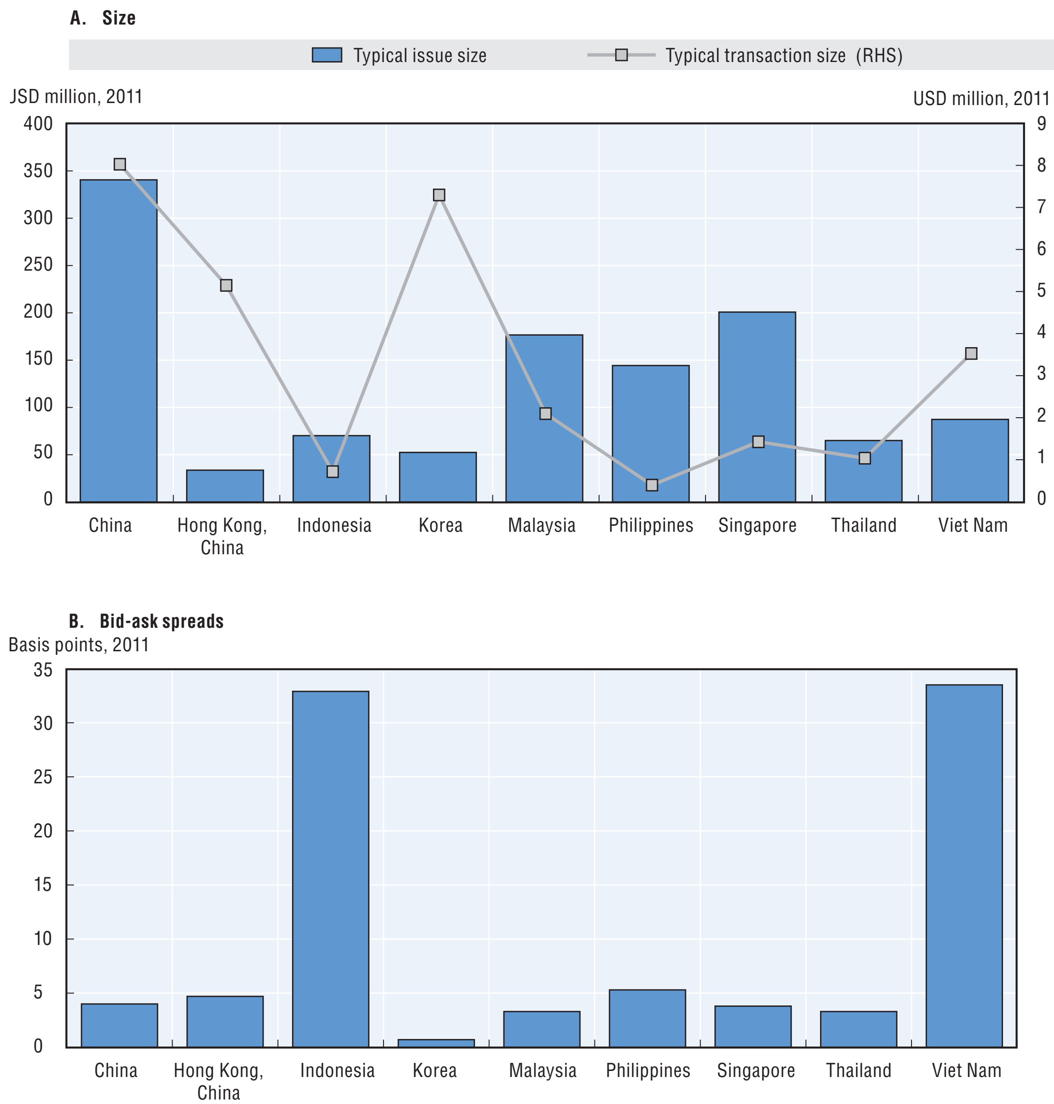
The limited development of corporate bond markets in the Emerging Asia region is also manifest in other performance dimensions. Market liquidity, as measured by bid-ask spreads and turnover, is comparatively low (Figure 1.24). Issuers are relatively concentrated and the average size of issues in relation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

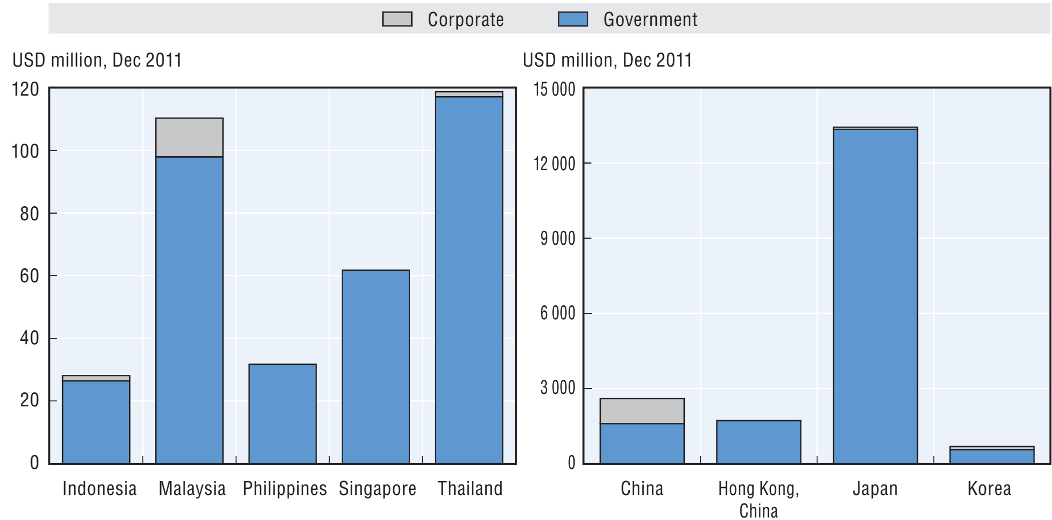
The limited development of the corporate bond markets in Emerging Asia is partly attributable to macroeconomic and structural characteristics that affect corporate bond markets in all countries but whose overall configuration in Asia has tended to limit their size (see Eichengreen and Luengnaruemitchai,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

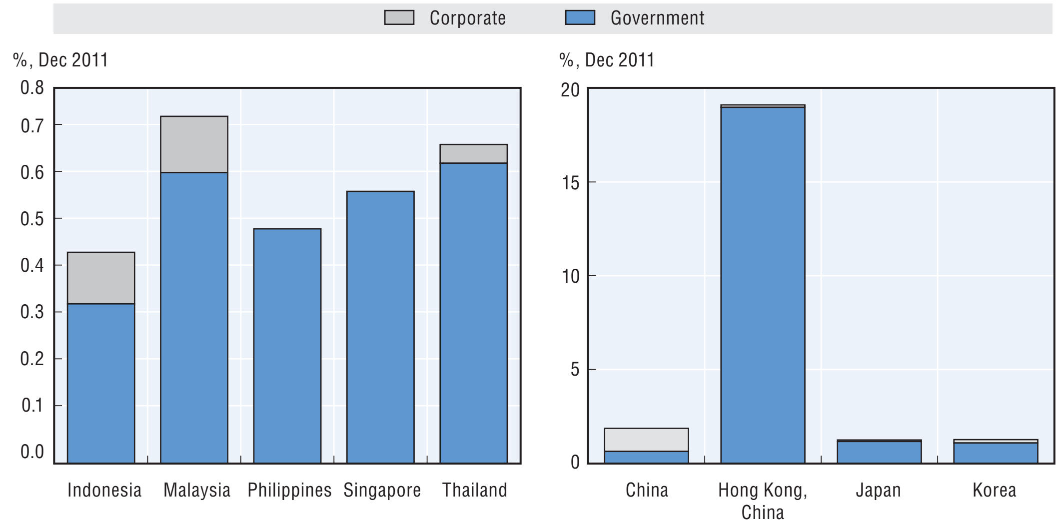
- The limited size of some of the ASEAN economies has made it difficult to reach the scale required for greatest bond market efficiency. The optimal scale of corporate bond markets is greater than that for equity or government bond markets (Goswami and Sharma, 2011). Some evidence suggests that in developing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

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

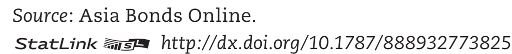
Figure 1.24. **Bond market indicators in Asia**







Source: Asia Bonds Online.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Significant progress has been made in improving the underpinnings of corporate bond markets

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

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

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

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

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

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

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

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

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

Conditions are favourable for an acceleration of corporate bond market development

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

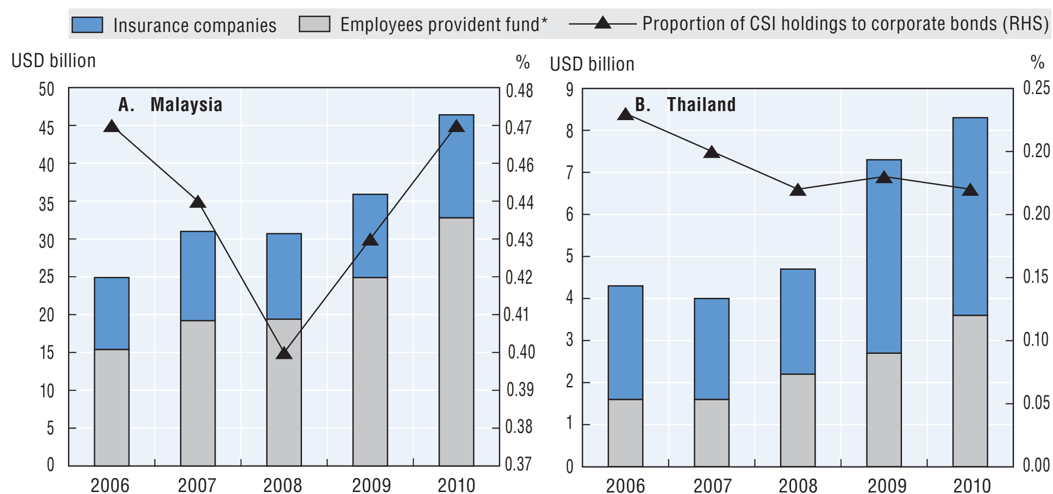
However, a number of more durable factors suggest that Southeast Asian corporate bond markets may be on the verge of an acceleration in their development. Emerging market debt is still underweighted in the portfolios of major investment funds in the OECD, suggesting that its share is likely to continue to trend upward. Southeast Asian bond markets are in a good position to benefit from this trend given the recent improvement of the international credit ratings of Indonesia and the Philippines, and the continued relatively favourable standings of the other ASEAN 5. Mutual funds have been growing rapidly, especially in China, India and Malaysia. While mutual fund investments are still concentrated in government debt in most countries, they are likely

to further diversify into corporate debt over time. This has already been occurring in Malaysia, where holdings of corporate bonds by insurance companies and pension funds have nearly doubled since 2006 and now amount to 46% of total corporate bonds outstanding (Figure 1.25).

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

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

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



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

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

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

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

Box 1.7. **Economic conditions behind dollarisation**

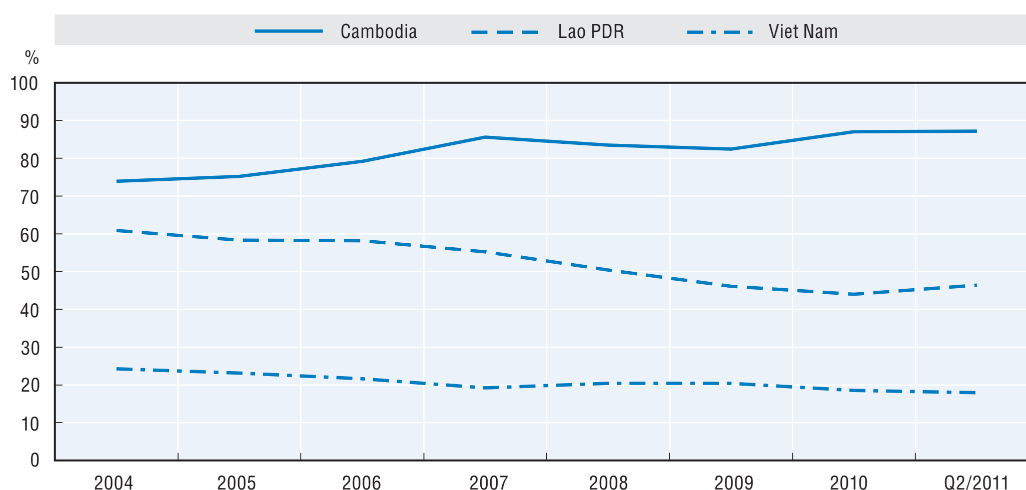
Generally, dollarisation develops in economies when the purchasing power of the official currency becomes very unstable to the point that use of a more stable alternative is preferable despite the generally higher transaction costs involved. Countries with extensive dollarisation tend to be relatively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

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

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

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

Figure 1.26. **Dollarisation in Cambodia, Lao PDR and Viet Nam**
(Ratio of foreign currency deposits to M2)



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

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

Dollarisation has had some benefits but has complicated monetary policy

Dollarisation can bring some benefits. Dollarisation allows individuals and businesses to at least partly avoid risks from high inflation and other instabilities in

macroeconomic policies and thereby somewhat reduce the costs they impose on the economy. Dollarisation can reduce incentives for governments to run unsustainable fiscal deficits since the governments cannot as easily finance budget shortfalls by printing money.

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

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

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

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

In the Lao PDR, dollarisation has helped to limit capital flight from the economy and has fostered development of the domestic financial system by allowing residents to deposit their foreign currency in domestic banks. Nonetheless, lower demand for domestic money and the very limited financial intermediation in the economy has meant

that financing the budget by borrowing from the central bank has become more costly in terms of inflation. During the Asian financial crisis in 1997-98, the Lao PDR experienced difficulty as the kip rapidly depreciated in response to the high inflation during that period. Moreover, the economy has been vulnerable to solvency and liquidity risks due to currency mismatches and sudden losses in business confidence. As in Cambodia, de-dollarisation would help to improve the effectiveness of macroeconomic policies but is only achievable over the longer run through restoration of confidence in the domestic currency and greater stability in its exchange rate in relation to the US dollar and the Thai baht.

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

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

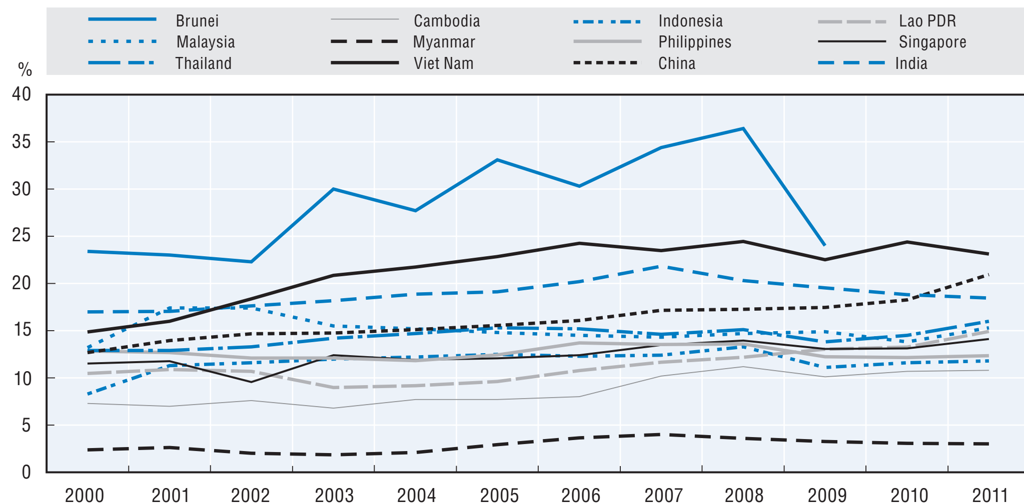
- In principle, the central bank could promote greater use of the domestic currency through the banking system, for example by providing bank refinancing in national currency for domestic operations. Development of markets for local currency denominated financial assets would also help to encourage a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

Fiscal capacities need to be strengthened through better revenue mobilisation

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

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

(total tax revenue to GDP)



Note: Data refer to revenues of central government, except for China and India, where data refer to general government.
Source: CEIC, ADB Key Indicators 2012 and IMF WEO database.

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

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

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

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

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

(percentage of total tax revenues)

Source: CEIC and OECD Development Centre staff calculations.

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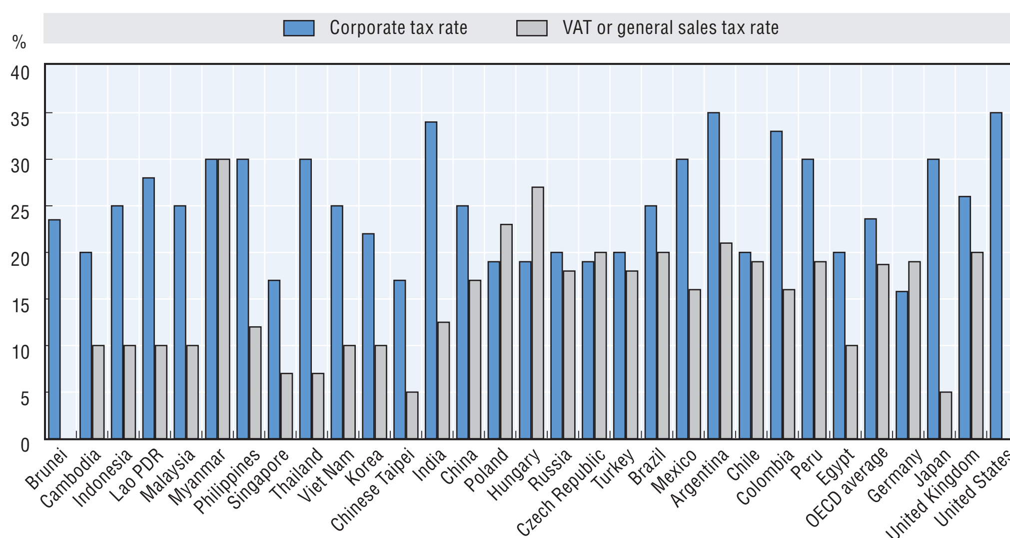
Southeast Asian countries tend to be more reliant on indirect tax revenues and less reliant on direct taxes on corporate and personal income than OECD countries. Total direct taxes are less than total indirect taxes in most of the region and in China, whereas they are more than twice indirect taxes in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

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

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

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

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



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

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

Sources: OECD and www.taxrates.cc.

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

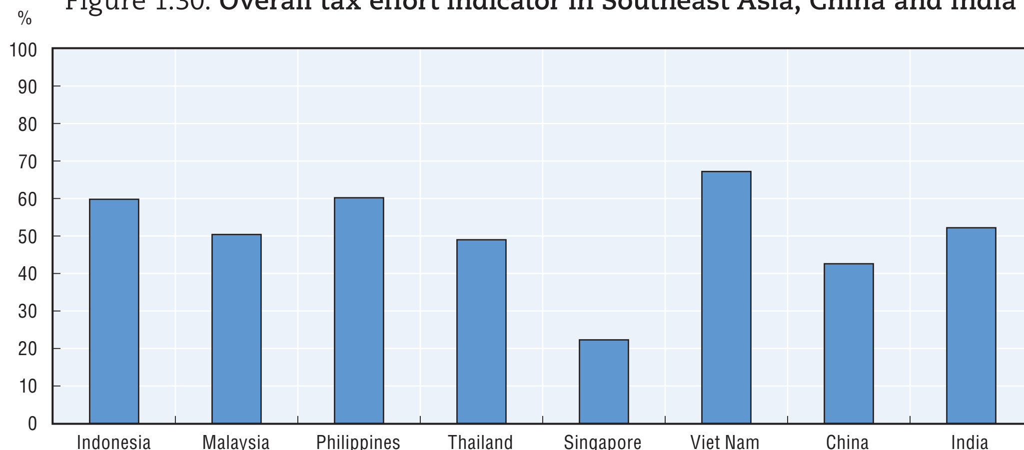
Tax systems are underperforming in revenue generation

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

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

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

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



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

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

Reforms in several areas could substantially improve revenue mobilisation

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

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

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

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

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

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

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

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

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

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

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

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

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

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

The low productivity of corporate tax systems owes much to the extensive use by developing economies, especially those most dependent on international trade, of tax and other preferences to attract foreign businesses and other forms of FDI. These preferences take a wide range of forms, including "tax holidays" exempting foreign

businesses in a country from various taxes for a certain period of time, exemptions from import duties, preferential tax rates after the holiday expires, and exemption from or expedited treatment from government regulations. These tax concessions are typically applied to firms locating in special economic zones or free trade areas established to encourage inward FDI and export businesses.

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

Better targeted subsidies would also improve fiscal capacities

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

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

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

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

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

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

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

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

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

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

Emerging Asia's expanding middle class: opportunities and challenges

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

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

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

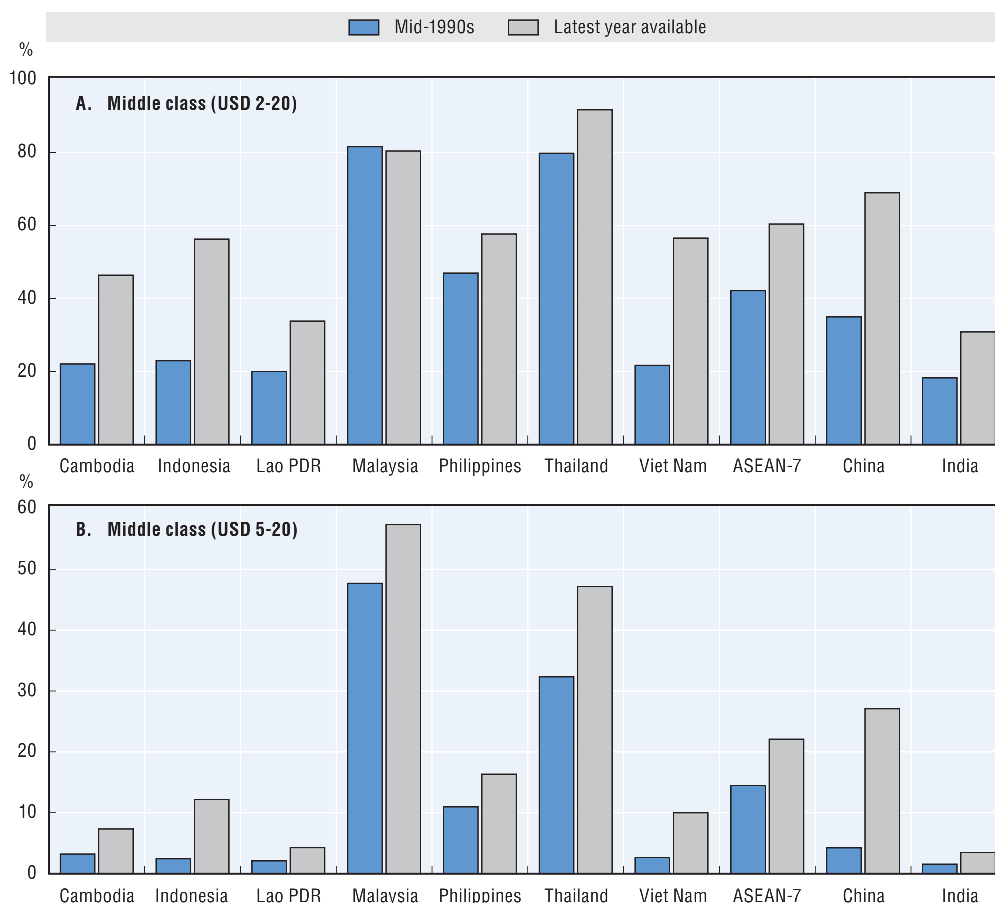
Middle-class growth in the region has been among the most rapid in Asia and has boosted consumption growth

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

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

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

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

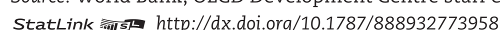


Notes: ASEAN-7 includes Cambodia, Indonesia, Lao PDR, Malaysia, the Philippines, Thailand and Viet Nam. Mid-1990s: Cambodia, 1994; Indonesia, 1996; Lao PDR, 1997; Malaysia, 1995; the Philippines, 1994; Thailand, 1996; Viet Nam, 1998; China, 1996; India, 1993.

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

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

Source: World Bank; OECD Development Centre staff estimates.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Box 1.8. **Defining the middle class in developing economies**

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

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

Box 1.8. (contd.)

Different approaches to defining the middle class

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

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

Data for measuring the middle class

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

Source: Chun, 2010; Kharas, 2010.

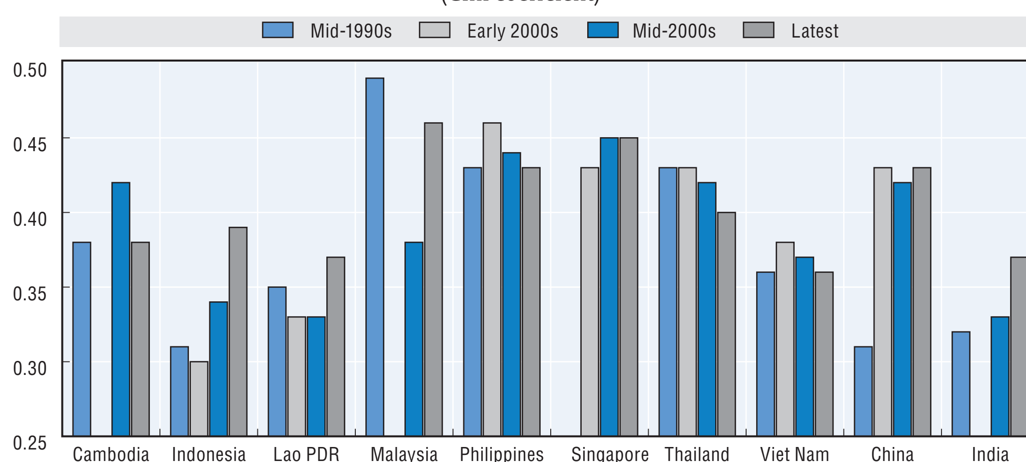
Not surprisingly, middle-class population shares are generally greatest in those developing Asian countries with the highest levels of per capita income, notably, in Southeast Asia, Malaysia and Thailand. The positive relation between middle-class size and per capita income is also reflected in the gaps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

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

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

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

(Gini coeffcient)



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

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

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

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

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

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

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

Middle-class growth has important economic implications

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

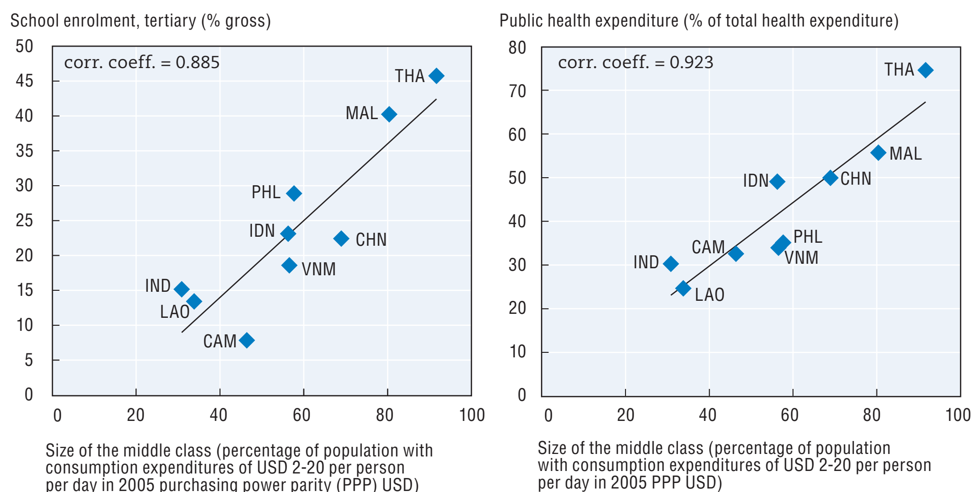
These differences are having significant effects on the economies of ASEAN and other developing Asian economies as well as important implications for government policies.

Middle-class development is already affecting the structure of demand in these countries. Middle-class households, particularly those in the higher portion of the middle-income range, tend to devote a larger portion of their income to purchases of major consumer durables – such as automobiles and motorcycles, televisions,

refrigerators and air conditioners – than do poor households (ADB, 2010; Banerjee and Duflo, 2008). For example, less than 1% of poor households own an automobile in China, India and the Philippines, but the portion rises to about 1.2%, 3.0% and 18.5%, respectively for households with incomes between USD 4 and USD 20 per person/day. Nearly four-fifths of households in China and India, and nearly one-third in the Philippines own a refrigerator, compared to less than one-sixth of poor households. The higher portion of refrigerators and household durables is partly a reflection of the fact that middle-class households typically have larger residences, in terms of rooms and square metres, than poor households.

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

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



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

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

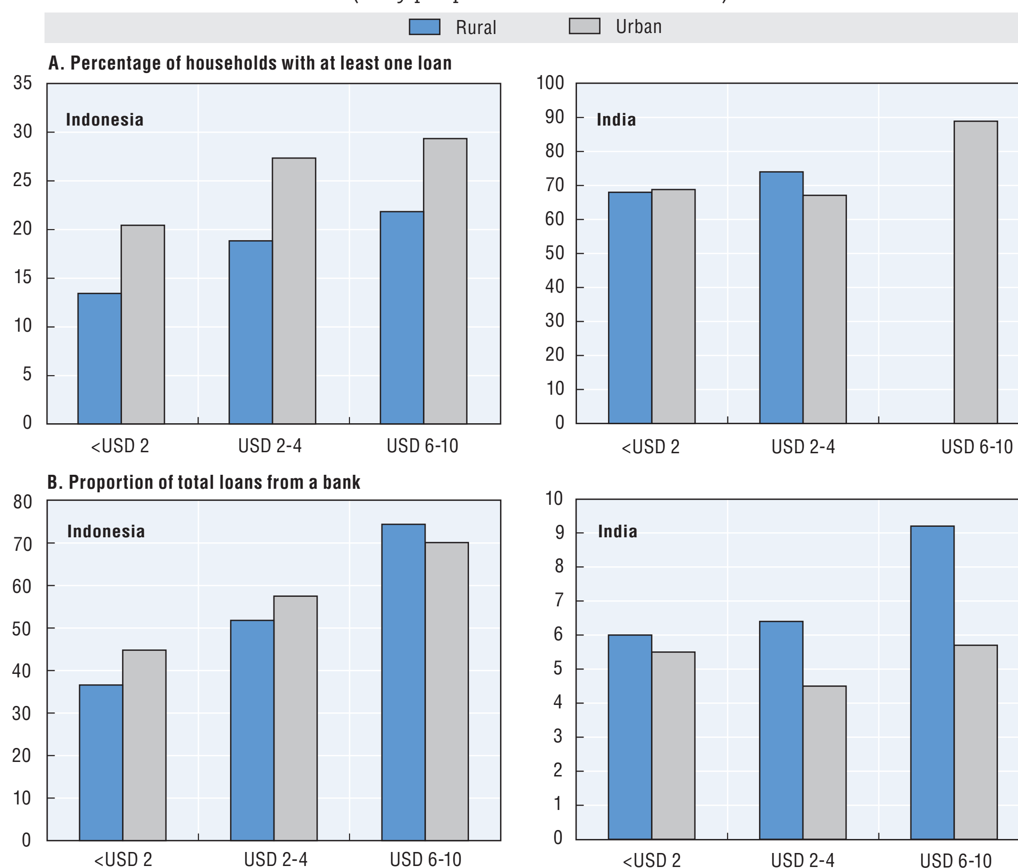
Source: OECD Development Centre.

StatLink http://dx.doi.org/10.1787/888932773996

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

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

Figure 1.34. **Household borrowing in Indonesia and India, by income segment**
(daily per person income at PPP rates)



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

StatLink http://dx.doi.org/10.1787/888932774015

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

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

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

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

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

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

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

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

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

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

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

Conclusion

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

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

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

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

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

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

Notes

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

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

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

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

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

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

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

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

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

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

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From:

Southeast Asian Economic Outlook 2013

With Perspectives on China and India

Access the complete publication at:

https://doi.org/10.1787/saeo-2013-en

Please cite this chapter as:

OECD (2013), "Medium-term economic outlook for Southeast Asia, China and India: Prospects and assessments", in *Southeast Asian Economic Outlook 2013: With Perspectives on China and India*, OECD Publishing, Paris.

DOI: https://doi.org/10.1787/saeo-2013-7-en

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