Overview

Part 1. Regional economic monitor: Medium-term economic outlook

Southeast Asian economies show resilience, although China will begin to slow gradually

Real growth in Southeast Asia as well as the People's Republic of 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-2013). 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 (Table 0.1).

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 investments 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, owing 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.

Growth in Emerging Asia (Southeast Asia, People's Republic of China and India) 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.

Table 0.1. **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

Notes: 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.

The main results of the MPF-2013, discussed in detail in Chapter 1, 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.

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 larger economies in the euro area, such as Spain and Italy, continue to face difficulties in accessing market financing. The United States (US) economy still has not fully recovered from the recession; its housing and labour markets remain weak, and fiscal uncertainties remain at the forefront.

Table 0.2. **Southeast Asian countries' indirect trade exposure to G3**
(percentage of exports)

Source Country	Export Market	Indirect export exposure to euro area	Indirect export exposure to US	Indirect export exposure to Japan
Indonesia	Euro area		0.3	0.1
	US	0.7		0.2
	Japan	1.8	3.3	
	China	2.9	3.6	1.6
Malaysia	Euro area		0.2	0
	US	1.0		0.3
	Japan	1.3	2.3	
	China	5.0	6.1	2.8
Philippines	Euro area		0.2	0
	US	1.6		0.5
	Japan	1.4	2.6	
	China	5.5	6.7	3.0
Singapore	Euro area		0.2	0
	US	0.5		0.2
	Japan	0.1	0.2	
	China	1.0	1.3	0.6
Thailand	Euro area		0.1	0
	US	0.6		0.2
	Japan	0.7	1.2	
	China	2.3	2.8	1.3
Cambodia	Euro area		0	0
	US	0.1		0
	Japan	0	0	
	China	0.3	0.3	0.1
Viet Nam	Euro area		0.3	0.1
	US	0.6		0.2
	Japan	0.8	1.5	
	China	1.6	1.9	0.8

Note: The cut-off date for data is 15 October 2012.
Source: OECD Development Centre's estimates.

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.

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 would have ripple effects on Asia, with subsequent spillover effects on private investment and consumption spending.

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 Emerging Asian countries and subsequently exported to one of the G3. The indirect channel is estimated to be non-negligible for Southeast Asian countries and 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. The indirect channel through China has been growing over the years, indicating that Southeast Asian countries are becoming more dependent on China as a key trading partner (Table 0.2).

Private consumption and investment will be the main drivers of growth

Private consumption is likely to be especially robust over the medium term and the main contributor to overall growth in many countries of Emerging Asia. 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. Government policies are becoming increasingly supportive of private consumption. Furthermore, increasing government spending on health and social safety net programmes in much of Emerging Asia will continue to encourage consumption spending by freeing up household resources and by reducing their need for precautionary savings.

In many Emerging Asian countries, investment growth should be as or more rapid over the next five years compared to the five years leading up to the global financial crisis. Government infrastructure spending is slated to be an important contributor to overall investment growth in a number of Southeast Asian countries. Another important factor is recent movements in the environment for private investment in the region.

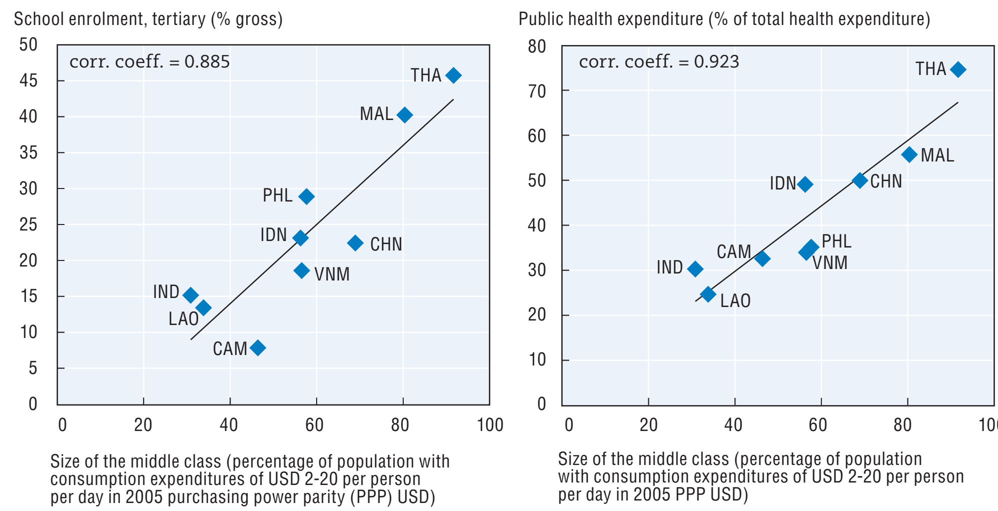
Middle-class growth in the region has been among the most rapid in Asia and has boosted consumption growth

Rapid growth in Southeast Asia, China and India over the past two decades has produced a remarkable expansion in the middle class. The rising middle classes have also encouraged strong consumption growth.

Middle-class development is affecting the structure of demand in Emerging Asia. 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 automobiles and other major consumer durables than do poor households. This increased demand for consumer durables and other consumer goods is also helping to spur innovations. Middle-class households also tend to spend a higher portion of their income on education and health services, and to purchase more sophisticated services, than do poorer households (Figure 0.1).

Middle-class growth is spurring the development and broadening of financial instruments and services in Southeast Asia, China and India. Middle-income households are more likely to have some debt and to have access to some consumer and housing finance. Hence, the 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. At the same time, the need for precautionary savings to insure against destitution from economic setbacks diminishes as household incomes rise into the middle-class ranges.

Figure 0.1. **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/10.1787/888932773312

Middle-class growth has several other important economic implications, including:

- Boosting demand for government services, in terms of quality and quantity. Roadways and related infrastructure need to be improved and expanded to accommodate the growing population of automobiles and other motor vehicles. Larger houses and apartments equipped with refrigerators and other electrical appliances increase demand for electricity and clean water and waste treatment facilities. Greater and more sophisticated health and education services are likely to be required.
- Changing priorities for social safety net development and, to some extent, making that development more feasible.
- Increasing migration as middle-class households are more likely to migrate in search of opportunities outside their home area and spend more on education and other human capital development in their effort to rise economically.

Emerging Asia needs to strengthen fiscal capacities through improved mobilisation of revenues

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 foreign direct investment (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. This ratio provides a rough indication of the effectiveness of country tax systems in mobilising revenues.

In Asia, overall tax "effort" by this measure is the lowest in China and the highest in Viet Nam. All ratios except for that of Viet Nam are below the median of the respective income group to which the countries belong. 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.

Three areas of tax reforms have particular potential to improve revenue mobilisation and the overall efficiency of the tax systems in many countries in the region. First, reforms to the value added tax (VAT) have great potential for substantial increases in revenue in many countries. Broadening the VAT base and improving revenue collection could raise revenues by several percentage points of GDP in Indonesia, Malaysia and the Philippines. 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. Thailand could also raise significant further revenue by increasing its comparatively low VAT rate to a level more in line with the rest of the Emerging Asia region.

In addition to reforms of the main tax sources, a number of other taxes are relatively under-used in some or many countries in Southeast Asia, China and India, such as real estate taxes and environmental tax instruments (ETIs). 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.

Management of capital inflows continues to be an important issue

Southeast Asian countries and China are likely to continue to face potential risks of volatility of capital inflows in the medium term, depending on the external economic environment. Further development and regional integration of domestic financial markets will help to better reap the benefits from capital flows and reduce the risks they can pose to domestic economic stability. Emerging Asian countries have made considerable progress since the global crisis in strengthening the financial soundness and governance of their banking systems. Over the longer term, however, 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.

Corporate bond markets in particular need to be developed further in Southeast Asia. The limited development of corporate bond markets has left their private sectors more dependent on bank financing than comparable emerging economies in other regions. Countries also need to strengthen legal and regulatory rules critical to all capital markets, including corporate bond markets. These include stronger disclosure requirements in the capital markets and measures to better protect minority shareholders, corporate governance reforms and reforms to bankruptcy codes.

Managing the extensive dollarisation and further strengthening of the financial sectors are the main challenges for CLMV countries

In Southeast Asia, dollarisation is most extensive in Cambodia, followed by the Lao PDR and Viet Nam. The experiences of Cambodia, Lao PDR and Viet Nam in conducting monetary policy illustrate the complications posed by dollarisation. Holding around 90%, 50% and 20% of M2 in foreign currency deposits in Cambodia, the Lao PDR and Viet Nam, respectively, allows businesses and individuals to cushion the effect of high inflation and macroeconomic instabilities and imposes a certain degree of dollarisation in these economies. However, a high degree of dollarisation also entails substantial costs.

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. Largely for these reasons, the adjustment to major external shocks can be more prolonged and painful when dollarisation is extensive. The potential fall in the exchange rate and the resulting contraction in economic activity from a loss in confidence in the domestic currency could be especially great for Cambodia, Lao PDR and Viet Nam, given their extensive dollarisation.

Part 2. Structural policy country notes: Medium-term policy challenges

Many Southeast Asian countries are searching for "new growth and development strategies"

The global financial crisis has underscored the need for Asian economies to rethink their past growth models. The export-oriented growth strategies, successful in earlier decades, have shown their weaknesses. Excessive dependence on external demand has made many Asian countries vulnerable to fluctuations in global demand and to other external shocks. Domestic demand will be an important engine for medium-term growth in the region.

Many Southeast Asian countries are searching for new growth and development strategies which are more focused on domestic demand and better adapted to changing international market conditions. Policy makers in the region recognise the need to adapt their development strategies and indeed have included several new elements that reflect a shift towards a new growth model in their medium-term development plans. These elements include human capital development, social and labour market policies, policies to promote greener economies and policies to address economic and social disparities. Implementation of the new development strategies will require the adoption of a comprehensive package of reform measures (Table 0.3). Overall, enhancing productivity through structural policy reforms will be key to the success of the new development strategies in the region.

Table 0.3. **Medium-term development plans of Southeast Asian countries**

Country	Period	Theme/vision
Cambodia	**2009-13**	For growth, employment, equity and efficiency
Indonesia	**2010-14**	Towards the realisation of an Indonesia that is prosperous, democratic and just
Malaysia	**2011-15**	Charting development towards a high-income nation
Philippines	**2011-16**	In pursuit of inclusive growth
Singapore	**2010-20**	Highly skilled people, innovative economy, distinctive global city
Thailand	**2012-16**	Philosophy of a Sufficiency Economy
Viet Nam	**2011-15**	Strong and sustainable growth by improving the quality and competitiveness of the economy

Source: OECD Development Centre based on national sources.

This Outlook includes notes on seven countries, namely Cambodia, Indonesia, Malaysia, the Philippines, Singapore, Thailand and Viet Nam. The policy areas discussed in each note are identified in the national development plan of the country concerned. Each note also discusses relevant experiences in OECD countries, providing useful insights and suggesting "best practices" that may be of use for ASEAN policy makers. These structural policy country notes address two key questions: what kinds of elements will be important for the new development strategies in Southeast Asia; and how does each country incorporate its new development model into its medium-term plans?

New development strategies will differ from country to country

The policy challenges facing each country depend to a large extent on their level of development (Table 0.4). For instance, **Cambodia** faces the challenge of building and upgrading its infrastructure to bring its agriculture sector into the commercial mainstream. Milled rice exports could become an engine of growth and thereby help to reduce poverty, but not until the export procedures have been streamlined and the milling process made more efficient. Productivity is a weakness not only in agriculture but in most other sectors. Human capital development would help to boost productivity, but Cambodia's education and technical and vocational education and training (TVET) systems need to be reformed. Enrolment rates at all levels are very low. The result is a mismatch with economic needs and a large unskilled labour force. The banking sector offers a relatively brighter picture. Its capital base is sound and growth has been brisk, with microfinance business burgeoning. Cambodia's central bank must build its capacities and modernise its infrastructure so that it can support economic growth. The central bank also needs to establish effective supervisory processes that can ensure customer protection and the stability of the financial sector.

Table 0.4. **Summary of medium-term policy challenges and responses in Southeast Asia**

Cambodia	**Agriculture**	Build agricultural productivity and tap the export potential
	Human capital development	Increase enrolment rates at all levels of education and strengthen TVET to build a skilled labour force
	Reform of financial sector	Strengthen the banking sector and prudential measures
Indonesia	**Infrastructure**	Narrow the regional divide by enhancing connectivity and the capacity of local government
	Education	Strengthen the capacity of local government to provide education infrastructure
	Social security reform	Accelerate health-care reform, focusing on coverage and access to health-care services
Malaysia	**Human capital development**	Strengthen TVET and the education system to address skills shortages
	Labour market	Address weaknesses in labour market functioning
	SME development	Enhance productivity of SMEs
Philippines	**Infrastructure**	Improve road transport, power and energy infrastructure and strengthen public and private investment
	Labour market	Focus sharply on job creation strategies
	Education	Improve access to quality education and training by strengthening the K+12 programme
Singapore	**Labour market**	Manage foreign worker dependence by increasing the productivity of local workforce
	SME development	Sustain SME growth through fostering entrepreneurial environment
	Innovation	Enhance the innovation capabilities of local enterprises
Thailand	**Education**	Raise the quality of education and reduce disparities
	Health-care system	Achieve a more equitable health-care system
	Green economy	Foster green growth through investment and fiscal reforms
Viet Nam	**Human capital development**	Reform training and education to better meet demand for skilled labour
	Development of banking sector	Strengthen the banking system by establishing effective supervision
	SOEs reform	Strengthen market-based reforms and monitoring of SOEs

Source: OECD Development Centre.

Indonesia faces a number of challenges which centre on the key question of equality. It must build and upgrade its infrastructure primarily to close the development gap between urban and rural areas and the west and east of the country. As a vast sprawl of scattered islands, connectivity is a key first step in its infrastructure policy. The same gaps – west-east, urban-rural – affect education and, by the same token, human resource development. A widely available health-care system needs to be established. Indonesia's expenditure on health care is among the lowest in Southeast Asia. Access to health care and public confidence in the healthcare system are both limited. The government has undertaken far-reaching social security reform, including to the health-care system, but much is still to be done to create a sustainable and equitable system.

Malaysia will need to address some important long-standing economic weaknesses in the medium term in order to progress toward becoming an advanced economy within the next decade. Skill shortages and mismatches and the deficiencies in the education system that underlie them and the low participation of women in the work force particularly need to be remedied. Measures to improve small and medium-sized enterprise (SME) productivity and to reduce gaps between rural and urban SMEs will also be needed.

The major policy challenges **the Philippines** faces in its Medium-Term Development Plan are to improve its road infrastructure, increase access to education and development resources, and ensure jobs for all. Both road transport and power are critical to achieve a more closely integrated Philippine economy, thereby helping to attract private-sector investment. Increasing secondary school enrolment and improving the standards of teachers and pupils are vital reforms, without which there can be no adequate human and economic development or job creation.

Singapore is aiming to reform several structural policies to be a hub of the global economy. Political pressure is forcing Singapore to rethink the liberal immigration policy that was part of its drive to be a global city. The government is tightening entry conditions for foreign workers while encouraging foreign entrepreneurs and investing heavily in developing the human capital of indigenous workers. It is also encouraging businesses to upgrade their technology and production methods. As part of that effort, the government has lent strong backing to SMEs. Research and Development (R&D) has been an important component of Singapore's policy of productivity-driven economic growth. Combined public and private R&D expenditure has put Singapore among the most R&D-intensive countries. Nevertheless, Singapore lags behind in private R&D spending.

Thailand faces challenges to further improve its education and health-care systems while addressing the accumulated environmental damage from its rapid growth. The country has made impressive progress in providing education and health care to most of the population. However, significant disparities in access remain, especially for poorer households and between rural and urban areas, that need to be addressed. Education quality needs to be improved, particularly the quality of teachers, and rising health-care costs need to be contained through reforms to improve efficiency in the delivery of services. Thailand also needs to address environmental damage from past growth and achieve greener growth in the future by reducing carbon emissions and other forms of pollution. This will require commitment to greener growth by government, business and the public, and new policies including increased use of fiscal incentives to encourage more environmentally friendly activities and behaviours.

Viet Nam will need to meet several challenges in the medium term to sustain rapid growth and realise its development potential. As in several other countries in the region, the supply of skilled labour needs to be increased and better adapted to the needs of industry through reforms to the vocational training and education systems, including further encouragement of workplace training. Reforms to the financial system and to state-owned enterprises need to be broadened and accelerated. The bad loans of the commercial banking sector need to be addressed in the medium term but reforms to improve their governance and to strengthen regulatory oversight are crucial to ensure that banks function effectively and prudently in the future. Ownership diversification of state-owned enterprises (SOEs) needs to be broadened and governance and oversight improved. Reforms to allow all businesses to compete on equal terms will be especially critical to ensuring that SOEs can compete as fully market-based enterprises.

Part 3. Thematic focus: Narrowing development gaps

Narrowing development gaps between countries are key challenges in ASEAN

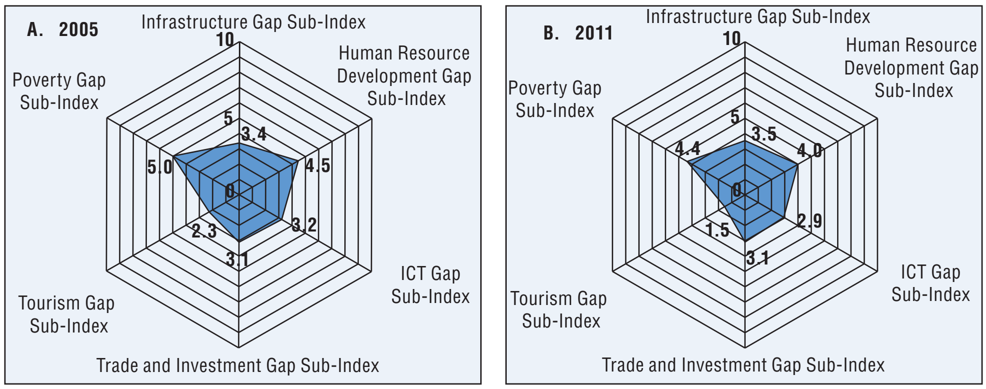
At the 9th ASEAN Summit Meeting, held in Bali in 2003, ASEAN leaders adopted ASEAN Concord II, a joint statement in which they set out their vision of an integrated ASEAN community. In 2007, ASEAN leaders declared that they envisioned regional economic integration as culminating in the end-goal of the ASEAN Economic Community (AEC) in 2015. Narrowing social disparities and economic development gaps between countries are key challenges facing ASEAN. The Initiative for ASEAN Integration (IAI) was launched in 2000 with precisely the purpose of narrowing the developments gaps among ASEAN member countries.

Development disparities need to be examined from various angles in addition to income level

GDP per capita – one measure of income disparity among countries – rose faster between 2005 and 2011 in the ASEAN 6 countries (Brunei Darussalam, Indonesia, the Philippines, Singapore, Malaysia and Thailand) than in CLMV. The result was a widening of the income gap between the two country groupings. Although Viet Nam's per capita GDP was just behind that of the poorest members of ASEAN 6 – the Philippines and Indonesia –Cambodia's was only USD 2 200 and Lao PDR's USD 2 800 in 2011. Myanmar lagged even further behind with an estimated GDP per capita of USD 1 300. However, even within the ASEAN 6 countries there are wide disparities. At over USD 48 000, Singapore and Brunei record the highest GDP per capita, while the rest (Indonesia, Malaysia, the Philippines and Thailand) have less than half that level.

Income level differences are just one aspect of disparities, which need to be examined from various angles. In order to monitor the progress of efforts to reduce disparities in development, the ASEAN Secretariat and the OECD Development Centre jointly developed a set of indicators – the ASEAN-OECD Narrowing Development Gaps Indicators (NDGIs) (Figure 0.2). The NDGIs measure gaps in six policy areas – namely infrastructure, human capital development, information and communication technology (ICT), trade and investment, tourism and poverty – identified in the IAI's Strategic Framework and Work Plan 2 (2009-15). For each policy area a sub-index of 10-15 key variables was constructed to quantify the development gap (see Chapter 3 for more details).

Figure 0.2. **Narrowing Development Gap Indicators (NDGIs): disparities between ASEAN-6 and CLMV**



Note: Each sub-index of the NDGI, whose value ranges from 0 to 10 base points – where 0 denotes no gap and 10 the widest gap – is built from multiple variables within six key policy areas shown above.
For more detailed information, see www.oecd.org/dev/asiapacific.

Source: ASEAN Secretariat and OECD Development Centre.

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The indicators show that significant discrepancies in socio-economic development persisted in 2005-11 between ASEAN 6 and the CLMV countries. The main findings to be drawn from the ASEAN-OECD NDGIs, which are discussed in detail later, are as follows:

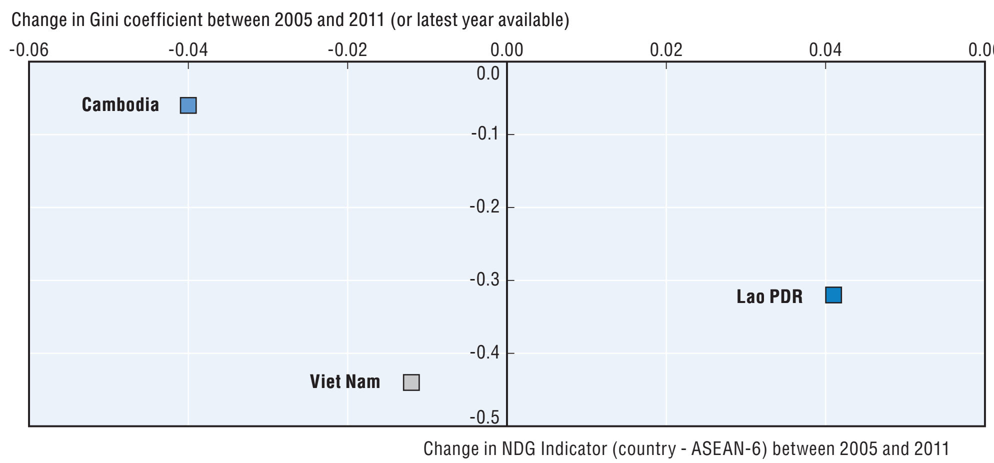
- Disparities are at their widest in poverty and human resource development. Greater efforts are consequently required in these areas and regional support should prioritise CLMV.
- Disparities in tourism and ICT between ASEAN-6 and CLMV countries were the narrowest in 2005 and continued to be so in 2011, which suggests that efforts undertaken by ASEAN member countries to accelerate development in both fields have been successful. However, there is room for improvement in all countries: they should seek to attract more international visitors and expand access to Internet technology.
- Between 2005 and 2011, disparities in poverty, human resource development, ICT, and tourism gradually narrowed. However, over the same period, the infrastructure and trade and investment development gap indicators showed no improvement. Many regional projects designed to increase connectivity in transport and energy need to be strengthened. Legal and regulatory structures for investors must be made more transparent and logistical procedures more efficient.

Disparities both among and within countries need to be addressed

The region faces an issue of dual disparities – i.e. disparities both among and within countries. Examination of recent patterns in income inequalities within countries, as measured by the Gini coefficient, reveals different trends among ASEAN countries. Between 2005 and 2011, inequality eased in Cambodia and Viet Nam and grew in Lao PDR, even though it started from a very low level. Patterns of change in income inequality also vary in ASEAN-6 economies. Indonesia and Malaysia became more unequal, while the Philippines and Thailand managed to reduce inequality to a certain extent. Income inequality in Singapore seems to have been stationary at a relatively high level since 2005.

Study of the relationship between disparities among countries and within countries yields some interesting observations (Figure 0.3). Viet Nam has been the most successful CLMV economy both in reducing income disparities at home and in closing the gap between the ASEAN-6. Lao PDR and Cambodia show different growth and development paths. Lao PDR has successfully caught up with ASEAN 6 countries at the cost of increasing domestic inequalities, while Cambodia has been slower to make ground on ASEAN-6 but effective in reducing income disparities within the country.

Figure 0.3. **Disparities "among countries" and "within countries" in Southeast Asia**



Note: Change in Gini coefficient between: 2004 and 2008 for Cambodia; 2002 and 2008 for Lao PDR; 2004 and 2008 for Viet Nam.
Source: OECD Development Centre.

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The diversity of CLMV countries' export focus and markets in global value chains can help narrow development gaps

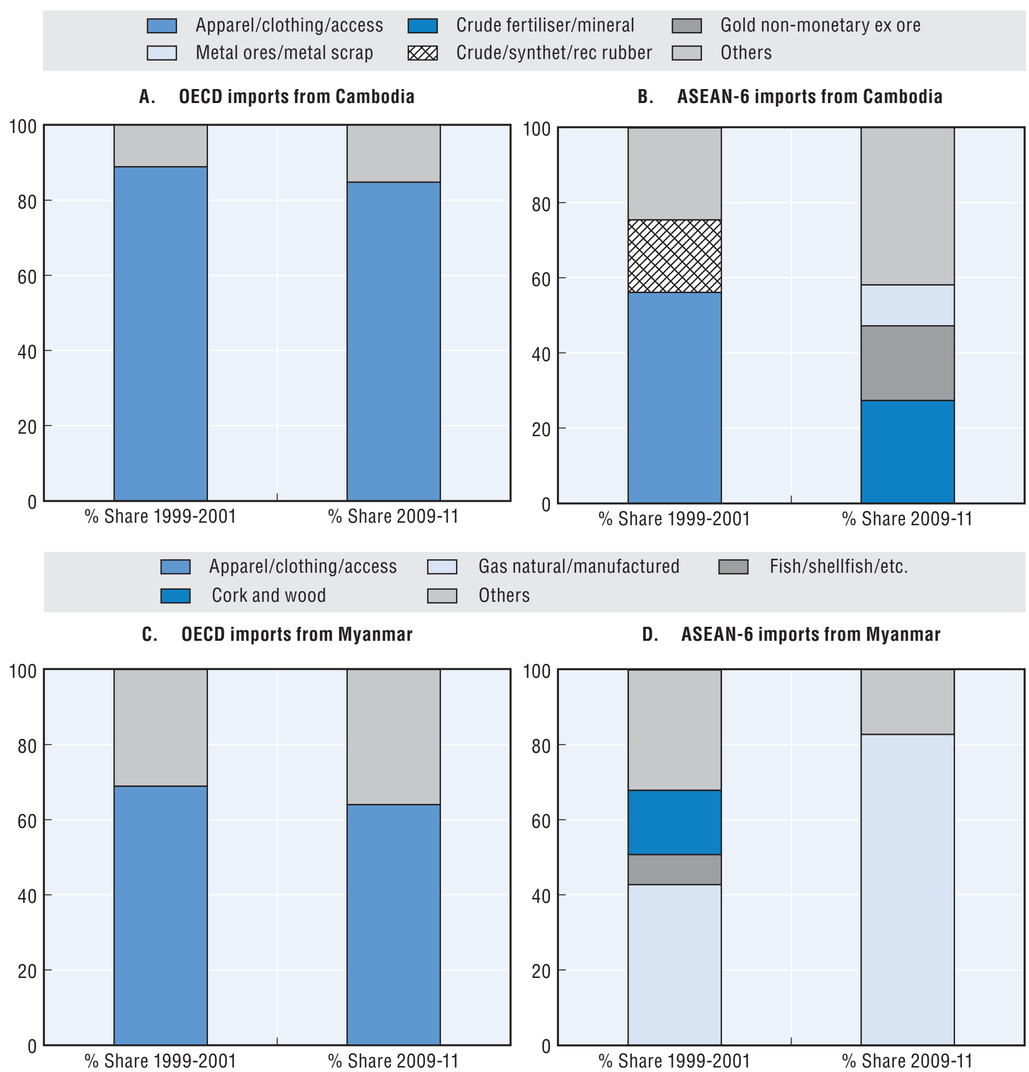
The variety of exports of CLMV countries may be unexpected given the historical dominance of apparel. The apparel sector has been the single most important CLMV manufacturing industry and has a strong export orientation. Historically, the rapid growth of an export-oriented apparel sector has played a critical role in generating more income and providing better jobs, so contributing to industrial development. It has also helped to increase off-farm income-generating activities for women, who typically account for the bulk of the apparel labour force in these countries.

Since transition and integration, the product pattern of specialisation has undergone major transformations in the CLMV countries. It has now become quite distinct from one country to another. Cambodia, for instance, remains highly specialised in apparel exports which accounted for almost three-quarters of its total merchandise exports in 2009-11. On the other hand, specialisation has shifted towards natural resource-based products, particularly hydropower generation in Lao PDR and gas extraction in Myanmar, with both activities assuming prominent places in exports to neighbouring markets. At the same time, exports of food and industrial materials have continued to grow in the regional markets, whereas apparel exports have become less buoyant, and are principally targeted at the OECD-area market where they enjoy preferential tariff treatment (Figure 0.4.)

More recently, the increased importance of ASEAN-6 countries as major trading partners has significantly altered the product patterns of specialisation in the CLMV countries. There are some signs of a new division of labour in East Asian supply chains, with Viet Nam becoming an export production platform not only in traditional labour-intensive products, but also in machinery and equipment. In Viet Nam, both SOEs and foreign-funded firms have played an important role in the country's industrial growth. In contrast, Cambodia finds itself in the special position of being the economy that has specialised most heavily in apparel exports shipped to the OECD market. The growth of Cambodia's apparel sector has been fuelled by export-oriented FDI, as the country's preferential market access and low-cost labour has attracted foreign investors.

Figure 0.4. **Composition of imports from CLMV countries**

(share of total imports, %)



Source: OECD Development Centre's calculations based on UN Comtrade.

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Opening up of CLMV countries has supported growth but further reforms will be needed

The strong trade and FDI growth in the CLMV countries has been a result of their open-economy reforms. The institutional and policy reforms undertaken in trade and investment have improved the business environment and attracted both domestic and foreign investors in export-oriented industries. At the same time, greater openness has revealed further weaknesses in the economy which will necessitate more in-depth reforms at later stages.

For instance, to realise its investment potential, Cambodia needs to take some specific measures. Particularly important is further budget prioritisation in order to address critical infrastructure bottlenecks (such as reliable and affordable access to electricity) and encourage private-sector participation in infrastructure development. Other concrete measures are the implementation of anti-corruption legislation and the new rice-growing development policy to support rural development. Such reform commitments can help eradicate absolute poverty and reduce the relative poverty still prevalent in the country. Lao PDR has recently undergone a major transformation from subsistence to commercial agriculture such as sugar cane and rubber production in Luang Natha Province and maize production in Oudomsay Province. The regulation of cross-border trade continues to be a major challenge to local authorities in Lao PDR – even if the national regulatory environment for trade and investment has seen considerable improvement in recent years.

Reducing inequality within CLMV countries is critical to narrowing development gaps in the region

Although, in recent decades, the CLMV countries have progressively reduced poverty, many of their inhabitants are living with inequality. The interaction of trade, technology and market-oriented reforms is actually one driver of inequality, yet that is no reason to reverse the openness, technological progress, or reform processes now underway.

The response should be to direct infrastructure investment to lagging regions and remove barriers to migration to the fast-growing regions. Three sets of policy measures are recommended to address the constraints and challenges that need to be faced to alleviate rising inequality.

- An efficient fiscal policy should be implemented. Because CLMV economies draw their fiscal revenue from a small base, they should broaden their tax bases and improve their tax administration. CLMV governments should also develop better targeted social protection schemes and conditional cash transfers that would be granted to the poor on condition that they invest in the human capital of their children.
- Each CLMV government should intervene to address the economic development and capacity-building needs of regions that lag behind the rest of the country. Measures should include building transport and communication infrastructure to improve regional connectivity. Access to public services should be improved and barriers to migration from poor to prosperous areas removed.
- Last, the CLMV countries should act to narrow the labour income gap created by technology which, because it favours capital at the expense of labour, is a key driver of rising inequality. Employment policy should incorporate measures to create more productive, better-paid jobs for a much wider section of the population.

Since the CLMV economies are still based chiefly on agricultural output, it is essential to increase productivity in the sector and sustain it at a high growth rate through structural transformation. Governments should implement agricultural policies that increase production per hectare and include provisions that ensure the rural poor enjoy access to irrigation, electricity, transport, new technology and improved seeds, as well as to agricultural extension and financial services – all of which are vital for boosting farm productivity.

Measures taken at regional, subregional and country levels need to be consistent in promoting the ASEAN Economic Community

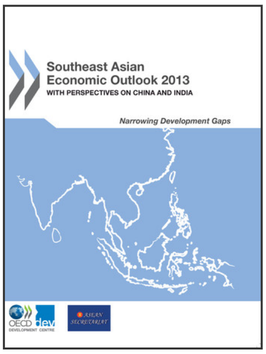
While many of the reported development gaps have narrowed over time, some – poverty and human resource development, for example – are still relatively wide and require critical attention from national policy makers.

At the regional and subregional levels, ASEAN has busily undertaken numerous initiatives to foster regional co-operation and to share experience in each key policy area. However, greater efforts are needed in the push for greater social and economic integration, particularly in infrastructure and in trade and investment. The slow pace of infrastructure development, for example, may be attributed chiefly to resource constraints and a lack of consensus in implementation. As for regional attempts to attract investment and liberalise trade, progress has been slow because countries continue to prioritise and pursue their own agendas rather than the common goal. ASEAN needs to step up and strengthen monitoring and enforcement mechanisms to ensure that progress stays on track.

At the country level, policy areas such as human resource development and poverty alleviation lag behind. Disparities in these areas are harder to fix and policies tend to be longer term in nature.

In human resource development, the common issues that almost all ASEAN needs to address are low labour productivity; skills mismatches; large informal sectors; and unequal, inequitable access to higher education and its uneven quality. Low labour productivity stems partly from the fact that in some countries, chiefly CLMV, a large proportion of the workforce is still employed in the agricultural sector where productivity is low. As disparities in poverty also remain wide, more vigorous policies are needed to speed up poverty alleviation.

Measures taken at regional, subregional, and country levels are not always consistent with one another. The result is slow progress at the ASEAN level, especially as national strategies and interests take precedence. To harmonise policies and initiatives at all three levels and speed up the narrowing of social and economic gaps, a better understanding of country sensitivities and differences is critical.



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