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Economic Outlook for Southeast Asia, China and India 2014

Beyond the Middle-Income Trap

Summary in English

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Medium-term economic outlook

Despite growth moderating in 2013, Emerging Asia (Southeast Asia, China and India) will continue to play an important role in global economic growth over the medium term . The outlook in the region remains resilient, although the pace of growth is forecast to moderate compared to before the global financial crisis (2000-07).

Growth moderating but outlook remains resilient : Overall, the 12 Emerging Asian economies are forecast to see growth moderating to 6.9% in 2014-18, against 8.6% in 2000-07. This largely reflects moderating growth in the two largest economies – China (7.7% in 2014-18 vs. 10.5% in 2000-07) and India (5.9% vs. 7.1%). By contrast, for the 10 ASEAN countries as a whole, growth in the two periods should remain broadly similar (5.4% vs. 5.5%).

Domestic demand growing : Exports will play a diminishing role in driving growth, giving way to domestic demand and, in particular, private consumption. This will be supported by tight labour markets and wage growth as well as an expansion of the middle class. The region’s investment prospects look strong. Public finances should improve broadly, with fiscal deficits projected to narrow or stabilise.

Volatility in financial markets poses risks : During the early part of the third quarter of 2013, the region saw large capital outflows as investors returned funds to developed economies, especially the United States. The resulting financial turbulence brought back memories of the Asian Financial Crisis of 1997-98, and highlighted the risks posed by unpredictable capital flows and financial instability. These risks are real, but the region is better equipped to manage them than in the 1990s, thanks partly to strong foreign reserves. More could be done, especially to strengthen monitoring of capital flows and the capacity for collective action.

ASEAN needs deeper integration : ASEAN, the ten-member regional grouping, faces challenges in meeting its objective to create a common market by 2015. Development gaps between members remain substantial, and more rigorous policies are needed to narrow them and to reduce poverty. The region would also benefit from greater co-operation to attract investment and liberalise trade.

Structural policy challenges

While the Emerging Asian economies appear well equipped to manage short-term volatility, they need to do more to meet their long-term potential . Further structural reforms are vital. To this end, the 2014 edition of the Economic Outlook for Southeast Asia, China and India offers specific proposals for each country. Some broad themes:

- **Invest in quality human capital** : Education and skills are essential to raising productivity and encouraging innovation and to improving individuals’ economic prospects. Further investment is vital, although challenges vary: India and Indonesia, for example, need to broaden access to basic education; by contrast, adult education is a priority for Singapore.
- **Improve the business environment to boost productivity** : Growth would benefit from measures designed to encourage business. These could include: simplifying business procedures;

Economic Outlook for Southeast Asia, China and India 2014 - ISBN 978-92-64-204003 © OECD 2013

encouraging small to medium-sized businesses, which are strong job creators; creating a level playing field for state- and non-state-owned enterprises; and easing access to credit.

- **Enhance green growth and strengthen disaster risk management** : In some countries, enhancing green growth will be important. For example, Singapore can optimise land use and allocation by following a green growth strategy, while Thailand could improve institutional co-ordination to achieve green growth. Some countries such as the Philippines and Indonesia are at particular risk from natural disasters. Reforms to improve disaster management and to foster environmentally sustainable growth are also vital. A range of other structural reform challenges also exist, including reducing poverty and creating jobs and developing more productive and sustainable approaches to agriculture.

Growing beyond the middle-income trap

Sustaining the economic progress of Emerging Asia will be a challenge and requires a new approach to development . History is littered with examples of economies that jumped from low-income to middle-income status by adopting existing technologies and by raising productivity as workers moved from farm to factory. But many then failed to take the next step forward. Hence growing beyond this "middle-income trap" requires a fundamentally different approach – one based on raising productivity through investment in human capital and innovation and a shift towards an increasingly technology-intensive economy.

Institutions are key : The failure to move beyond the middle-income trap can be largely traced to the failure of institutions to keep pace with the needs of the economy. As they move towards a more advanced stage of development, many of Emerging Asia's economies will need to strengthen their institutional capacities in several key areas:

- Human capital, infrastructure and innovation, to support the transformation to increasingly sophisticated industries;
- Markets and competition, to encourage a favourable climate for investment and business; and
- Financial and macroeconomic stability, to ensure resources are allocated efficiently and avoid costly interruptions to growth and development.

"Factory Asia" needs to evolve : Several factors, including rising wages, may cause a shift in the region's role in global value chains. A rapid rise in regional demand should make up some of this shortfall, and Factory Asia will remain important in global manufacturing. But to take full advantage of such a shift, the region's manufacturers need to move up from assembly towards and into sophisticated activities based on higher productivity and a greater dependence on technology.

Modern services sector needs to grow : Services account for between 37% and 45% of gross domestic product in middle-income ASEAN economies and China, largely unchanged since the mid-1990s. Regulatory barriers that limit entry, stifle competition and inhibit investment are holding back the sector's development, especially in modern services such as finance, business services, and information and communication technology.

Financial system needs to be developed : Much has been done since the late 1990s to put financial institutions and markets on a sound footing. This work should continue to ensure they can effectively manage risk at a time of rapid change. Banks and other financial institutions also need to offer a wider range of financial instruments and services to meet evolving needs, especially those of small businesses.

Regional co-operation can aid national development : The region has taken numerous steps to deepen co-operation and integration. Such approaches can bolster national economies by allowing a more efficient allocation of the region's labour and resources, providing scale for bond markets, for example, and encouraging cross-border banking competition.

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doi: 10.1787/saeo-2014-en