Economic reform: The unfinished agenda

Highlights

- Economic reform is the key to sustaining strong economic growth in emerging countries and restoring it in developed countries. This report assesses progress in recent years, identifies shifting views on the best ways to accelerate economic development, and provides studies of 14 emerging and major economies.

- The pace of reform has slowed in many countries, apparently due to a mixture of complacency, resignation, disillusionment with market-oriented reforms, and political resistance. This follows a ‘golden era’ of reforms in the 1990s which brought accelerated growth and improved living standards in many emerging countries.

- We estimate that failure to pursue vigorous reform is costing emerging countries 1-3ppt of GDP growth. Successful reforms could boost GDP per capita in 2030 by an extra 20% in Korea, Sri Lanka and Taiwan, 40% in Brazil, China, Indonesia, Nigeria and Thailand, and 50% in India.

- While there is considerable agreement on the best way for countries to grow and prosper, there are also important disputes, notably on the role of the state and state-owned enterprises. State-led development has become more prominent.

- In each country study we analyse one key area of reform which would have a major impact. Recurring topics are improving infrastructure, liberalising labour markets and implementing bureaucratic and fiscal-policy reform.

- For markets, economic reform is usually a major positive, boosting returns and smoothing volatility by encouraging economic growth, lowering interest rates and attracting new investors. Markets often move early, responding to expectations for reform ahead of implementation.
1. Economic reforms – An overview

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The focus of this report is reform. The word ‘reform’ comes up periodically to describe what economies need to do to address either short- or longer-term issues. But, it seems, at times of economic difficulty, the word is used on a more regular basis. The current crisis in the euro area is a classic example of this. At a time of great anxiety about how events in the euro area will evolve, increasing pressure is put on the countries on the periphery to undertake reform.

Yet reform can mean many things. Often it is used in general terms to refer to changes that need to be implemented to the so-called ‘supply side’ of an economy, aimed at improving efficiency, productivity or competitiveness, or a combination of all of these. Then again, it could refer to reform of an important economic sector, whether be it health or education.

Among the many challenges of implementing reform is that it can take time, with the benefits showing through after a lag. Moreover, some people may lose, not gain, from the changes that may be necessary for a particular reform to be implemented. In the UK, a former Chancellor is credited with saying that he stopped being in favour of tax reform when he realised there were losers as well as winners. Losers often make more noise and, particularly in a democracy, politicians find reforms do not always help in winning elections.

Perhaps one lesson is that reforms should ideally be implemented when economic conditions are good, not bad. Alas, all too often – and as seen in the euro area now – change is made when things are not going well, thus making an impact at a time when people, firms or economies are not best able to cope.

Another lesson, arising from this, is the importance of framing the case for reform. That is, there is a need for a longer-term vision as to why reform is necessary, why the pain of reform is bearable and what success reform may bring.

Three major structural changes

Deleveraging in the West

The world economy is currently undergoing significant structural change. In our view, there are at least three big changes that need to be highlighted. The first is a negative one, namely the overhang of debt and the need to deleverage in the West. It is difficult to determine exactly how long this may take; Western economies may be only halfway through this process. Although debt levels are high, it is important to stress that debt is not the only problem. Indeed, in some countries, debt is a symptom of a lack of demand and weak economic growth.

There are many important lessons from the financial crisis that are worth bearing in mind in any paper on reform. The crisis has highlighted that it is important to identify and address the right problem at the right time. The way I would stress it is that two wrongs do not make a right. First, it was wrong to keep interest rates too low and governments to be running such high deficits during a boom. But it is wrong to think that the way to address this is through austerity and by reducing deficits when the economy is bust. At a time when the private sector is not spending, there is a need for the public sector to step in, and spend, particularly if it can raise money at cheap rates. (See Standard Chartered Global Insight, 30 June 2011, ‘The seven rules of fiscal policy’). At the very least, austerity measures need to be well-timed and...
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implemented gradually, responding to changing circumstances. But it is also important not to hide from addressing the need for reform, whether of the banking system, or of the pension system, two important areas of reform in the West.

The structural changes the Western economies are undergoing not only leave many of them vulnerable to further economic shocks, but also make it hard to address some of the reform issues now. In this report we leave Europe alone and focus mostly on the so-called emerging economies. We also look at the US and Japan. I say 'so-called' emerging countries because the term 'emerging' has outlived its usefulness. And yet, it is still the commonly accepted term. We think that looking at countries on a region-by-region basis can often be more useful, accepting that there are big differences within regions, as well as between regions.

The rise of emerging markets

As a group, emerging economies are not decoupled from events in the West. Indeed, ahead of the crisis, one of our catch-phrases was "emerging economies are not decoupled, but better insulated". So it proved. They were not immune to fall-out from problems in the West, but they had room for policy manoeuvre to respond and rebound. After the global recession of 2009, emerging economies helped drive about two-thirds of the pick-up in global growth in 2010, and have played a dominant role since. But they are still not decoupled, as the recent slowdown in exports testifies.

However, we would now say that they are "not decoupled, but better diversified". This diversification reflects some structural changes across the emerging world, such as rising domestic demand as the middle class emerges, and increasing South-South trade – which we have often referred to as New Trade Corridors – involving increased flow of goods, commodities, remittances, people, and portfolio and direct investment between emerging countries. This leads directly to the second big structural shift impacting the world economy now.

In 2010, we released a publication called 'The Super-Cycle Report'. The aim of this report was to highlight one of the major structural changes which we believed was already underway, namely the shift in the balance of economic and financial power from the West to the East. At a time when the world economy was facing great uncertainty and there was widespread caution about immediate prospects for the West, we felt it was important to stress some of the underlying changes.

Yet, it is important to highlight that this does not mean that emerging economies will keep growing and that the outlook is always rosy; far from it. As we have emphasised, the business cycle exists in China and India, as it does elsewhere. Also, the trend in emerging economies may be up, but one should expect set-backs along the way.

The reform process

That leads on to the third structural change, which is the focus of this report, namely reform. The good news is that reform is already happening. But, as this report highlights, there is an urgent need to accelerate the pace, whether be it in the West, in Japan, or across the emerging markets (EM). As the crisis was deepening, President Obama's Chief of Staff said, "You never let a serious crisis go to waste" (Rahm Emanuel, November 2008). But successful emerging countries should not be complacent either.
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In the West the crisis has highlighted many challenges, to some of which policy makers have responded well and others, less so. The London Summit of April 2009 was one of the successes, as world leaders combined to address problems, and prevent a depression. It was a classic example of how global policy forums can work, and indeed why such forums are necessary. But perhaps one of the many interesting aspects of the last few years has been how some companies, and countries, around the world have not wasted this crisis. Some have taken advantage of the environment to build market share, or to invest for growth. For some emerging economies, this has been an opportunity to move up the value curve.

The Asian pyramid

We have used the pyramid on the left before to help explain the structural shift underway across a number of Asian economies. The apex of the pyramid shows the country with the highest income per head, and those at the bottom the lowest.

Japan, despite the problems of the last two decades, is a high-income, low-growth economy. Japan faced both demand- and supply-side problems during its crisis, but tried to address only its demand-side problems, through various boosts. Supply-side reform was slow in coming. Nonetheless, Japan has a cutting-edge manufacturing industry based on high investment and innovation, although it seems it is in the process of losing its edge in some sectors to South Korea.

Next in the pyramid, Hong Kong and Singapore demonstrate the benefit of pursuing competitiveness and engaging in longer-term strategic planning. Both have continued to do well as international business and financial centres, with Hong Kong increasingly linked to the mainland.

Then there are South Korea and Taiwan. Both these economies have continued to invest and, in some respects, tried to replicate Japan’s success in building global brands. These two North East Asian economies are followed by Malaysia and Thailand, which have faced strong competitive threats from China and have focused on reform to climb up the value chain. At the bottom of the pyramid are the low-cost economies which have lately become the focus of investors and have generated much optimism. These include Vietnam, India, Indonesia and China. The message from Asia is that economies are all trying to move up the value curve.

Reforms needed

What needs to be done is the focus of this report. Infrastructure is a vital part of the reform story. When people talk about infrastructure, there is a tendency to focus on hard, physical assets, such as roads, railways, bridges or ports. These are all important. But they are only one part of the infrastructure story.

There are three parts to infrastructure: hard, soft and institutional. Hard infrastructure is often expensive and time-consuming. Currently there is a hard infrastructure boom going on around the world. In Asia alone, it is often said that the infrastructure bill over the next decade will be around USD 8tn. This considerable sum is affordable if Asia can channel its high domestic savings into this area, as well as attract and absorb inflows from overseas.
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Soft infrastructure implies skills and education. It is every bit as important as hard infrastructure to an economy’s future success. Countries need to compete on skills not only at the top levels, but at the medium levels too.

Institutional infrastructure is an important area, and yet it is often overlooked. Take China, for instance; this is one of the biggest challenges that country faces. The rule of law, importance of contracts and institutional independence are all things taken for granted in developed countries. In China, these issues have to be addressed. And, indeed, one of China’s biggest current challenges is that as the economy has boomed, it is still run in much the same way as when it was a much smaller economy. When the rule of law and the sanctity of contracts are above that of any individual or organisation, a country truly has reached a tipping point.

There are many other institutional issues that need reform. At the 2009 annual Asian Development Bank meeting in Indonesia, the focus was on what Asia needed to do to restructure its economies, away from export-led and towards domestic-driven growth. Three issues were highlighted. First, was the need for social safety nets in order to discourage people from saving excessively; second, the need for help to small and medium-sized firms as they are key to future job creation; and third, the need for deeper and broader bond markets. While the focus of the third point was on domestic bond markets, one could take it one step further and say the case is there for deeper and broader capital markets. These reforms are crucial for Asia to realise higher domestic demand. In the coming years, at a time when savings are likely to flow from the West to the East, such deeper and broader bond markets will help emerging economies absorb inflows without leading to the damaging consequences of rising asset price inflation. Yet, in the aftermath of problems in the West, this does not seem to be a priority for some policy makers.

In this report, we highlight country-specific issues that fit into this overall reform picture. We identify the need to prioritise hard infrastructure investment in, Brazil, India, Indonesia and Sri Lanka. Meanwhile, policies are necessary to accelerate labour-market reform, productivity and other soft infrastructure development in Japan, South Korea, Singapore, Taiwan, Thailand and the UAE. Then there is the need for institutional reform related to minimum wage and pension systems, sovereign debt, taxation and interest-rate policies, and the size and scope of the government bureaucracy, which we explore in the context of China, Hong Kong, India, Nigeria, and the US.

Reforms to the global system

Finally, there are other reforms that require multilateral action – and which are outside the remit of individual countries. In particular, there are issues related to global governance and reform of the international monetary system.

In the area of global governance, organisations need to be legitimate, accountable and effective. The Group of Seven (G7) evolved out of the economic crisis of the 1970s and, in time, moved from its original focus on economic issues to cover global geopolitical issues. The Group of 20 (G20) has grown out of the latest crisis but it has yet to prove itself, perhaps because it is too big and unwieldy. Indeed, it is more like a G28 than a G20 when one examines the countries and organisations that attend its meetings.
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Other groupings have emerged in recent years. For instance, the BRIC countries (Brazil, Russia, India, China) have held joint summits but, beyond that, they have not aligned among themselves. It may be that the G20 needs time to establish itself. There is a patronising view in the West that emerging economies do not play a proactive role at these meetings. If so, perhaps this will change as more emerging economies assume the presidency of the G20. South Korea did a good job in 2010 and, after France in 2011, the presidency has passed to Mexico this year. Russia, Australia and Turkey are due to take over the leadership in the next three years, respectively.

One aspect of this crisis is the growing role of the state. State capitalism and the growing influence of sovereign wealth funds is an issue we have written about before (Financial Times, 22 October, 2007). But the important lesson is that, when all sides came together, progress was made in constructing a common set of guiding principles, namely the Santiago Principles, governing future behaviour.

On the multilateral front, the United Nations appears to be the premier global body; but the membership of the powerful UN Security Council causes much debate and impairs regional legitimacy. The current permanent members of Security Council – the US, Russia, China, UK and France – were the global powers when the UN was created in the 1940s. If one were to recreate the institution today, would they be representative of the current global power balance? Critically, the Middle East and Latin America lack a permanent voice. Also, with China well on its way to being a new global super-power, it has the effect of crowding out other Asian voices. Reform of the Council is necessary, but it will be resisted. The IMF, too, is a premiere global institution which clearly is in a position of global leadership. However, the disproportionate delegation of voting rights to some European countries needs to be addressed to provide true global legitimacy, especially with the economic rise of emerging powers such as China, South Korea, India and Brazil.

Reform is required in several other international forums – such as the structure of the international monetary system, where the US dollar (USD) remains the international reserve currency. Here, China’s push to internationalise the use of its currency, the Chinese yuan (CNY), is a significant step towards counter-balancing the USD’s status. But this will take time, measured in years, not months.

Then there is the ongoing move to reform the global banking regulatory structure. This has gathered urgency following the financial crisis, with the introduction of the stricter Basel III standards, which determine minimum levels of capital adequacy and liquidity for banks. These are steps in the right direction, but they need to be combined with macro-prudential measures to impart the necessary stability to the international financial system. A number of macro-prudential measures are simple and easily implementable tools which have been used with some degree of success by Asian regulators – part of the reason why Asia has been able to avoid the pitfalls that led to the latest financial crisis.
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Conclusion: 1990s reforms show what can be achieved

In conclusion, our analysis in this report highlights the urgent need to accelerate the pace of reform across the globe – whether be it in the advanced economies of the US, Europe and Japan or across the emerging markets. While reforms have not completely stalled, they have clearly slowed over the past decade. And yet, recent success stories from Asia and other EM indicate the powerful effect of past reforms which were implemented following the financial crisis of the 1990s. Now, facing its own crisis, the euro area is reforming, although there is a great deal still to be done and, for some countries such as Greece, it may already be too late. But, even in the economies where reforms were successful, there can be no room for complacency.

Reform is essential if the global economy is to extract further dividends from the virtuous confluence of favourable demographics, technological progress and international trade and capital flows that have driven the current super-cycle over the past couple of decades. We remain optimistic that reform will pick up as people, policy makers and politicians – both in the West and the East – see its longer-term benefits. We hope this report will help show the way.
2. Executive summary

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- Reform can accelerate economic growth by boosting the supply side
- The pace of reform has slowed in many countries due to complacency, resignation or resistance
- There is broad consensus on needed reforms, though the role of the state is controversial
- Successful reform broadens markets and can increase investor returns
- We identify and analyse one crucial reform in each country

There is an urgent need for accelerated reform

Reform is the key to unlocking faster economic growth, in developed countries as much as EM. Without reform, economies become stuck in low growth trajectories. For emerging countries this means that they fail to exploit the potential for catch-up by harnessing capital, labour and efficiency gains to generate rapid growth. Developed countries can drop back from the frontier of living standards and may suffer from high unemployment, emigration and a sense of decline.

Growth matters

Growth is good. It is not just about being able to buy more things, though most people even in rich advanced countries seem to aspire to this. It is also about better health and longer life expectancy, a higher quality of life, greater educational opportunity, and more interesting jobs. The two strongest objections to the pursuit of economic growth come from the recently emerged “happiness economics” literature, according to which some economists believe they can prove that increased income does not bring greater happiness and from environmentalists who fear the environmental impact of industrialisation and growth, with climate change a particular concern.

However, the happiness literature makes it clear that for low-income countries there are unquestionable gains from growth while there are also strong arguments that these gains continue even for people in high-income countries. Meanwhile, “ordinary” pollution in the air and water is dealt with better in most rich countries than poor countries: high incomes lead to demand for an improved environment and there is money to pay for cleaner processes.

Is there a consensus on reform?

The so-called Washington Consensus, first coined in 1989, has been widely criticised both on technical grounds and from those who dislike the emphasis on free market reform, sometimes crudely paraphrased as “stabilise, privatise and liberalise”. Others have attempted to replace it with new models including the Beijing Consensus, the Mumbai Consensus, the Seoul Development Consensus and the idea of ‘inclusive development’. All of these offer insight, though they are much less concrete than the original Washington Consensus.

The most comprehensive attempt to define the latest thinking on development comes from the Growth Commission Report, which offers 14 general recommendations, many of them similar to the Washington Consensus, but also tackling some new ground (including capital account opening, embracing urbanisation, promoting equality of opportunity and safeguarding the environment). The Growth Commission also comes with a different tone, emphasising some of the uncertainties and disagreements among development professionals and policy makers.
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There is still plenty of debate around the sequencing of reform; its importance was increasingly recognised in the 1990s both in Latin America and Eastern Europe. Sequencing remains critical since getting it wrong can lead to development dead ends or macroeconomic instability. Moreover, even vigorous reformist governments cannot do everything at once. There are also different views on the role of the state and how big a role to give industrial policy and state-owned enterprises (SOEs). The strictly limited role of the state, recommended by free-market enthusiasts is widely questioned, not least in Asia, where proponents argue that the state can accelerate development.

We are inclined to side with the Growth Commission, which concludes that the state’s role should be limited in both scope and time. But the stunning growth success of many Asian countries, using variants of the state-led reform model, coupled with the recent debacle in the US, has changed the debate.

The pace of reform has slowed

The 1990s was a golden era of reform with major strides forward in China, Vietnam, India, Bangladesh, Egypt, Brazil and Peru and many other places. We find evidence from the Economic Freedom Index (published by Heritage Foundation) that the pace of reform has slowed over recent years, with a few exceptions such as Vietnam, Nigeria and countries in Central and Eastern Europe. We also find from analysis of the World Competitiveness Report (from the World Economic Forum) that recent reforms have tended to be in the ‘easier’ areas of infrastructure, health and education, together with improving the ease of doing business for firms. Further progress in ‘harder areas’ like labour and product-market efficiency and improving institutions, areas associated with boosting total factor productivity, is less common.

Most emerging countries have achieved macroeconomic stability over the last decade, a huge achievement after the traumas of earlier decades. This has laid the foundation for higher investment and stronger economic growth. But many countries need to follow through with microeconomic reforms if they are to push growth up to the 7-8% rate which the most successful countries achieve. For higher income countries such as Brazil, and especially for Korea and Taiwan, such high rates are probably out of reach now but, with the right policies, these countries could almost certainly grow faster.

We estimate that failure to reform is costing countries 1-3ppt in lost GDP growth. Successful reforms could boost GDP per capita in 2030 by an extra 20% in Korea and Taiwan, 40% in Brazil, China, Indonesia, Nigeria and Thailand and 50% in India.

A key factor in emerging country success in the last 15 years has been trade liberalisation inspired by the Uruguay Round which, together with computers, mobile phones and the web has helped drive globalisation. Unfortunately, further global trade liberalisation is stalled at present, though FTAs with the US and Europe as well as regional agreements can be constructive. The picture on infrastructure is mixed, with some countries making big strides while others struggle to get projects done.

The slower pace of reform is likely due to a combination of complacency, resignation, lack of a “good crisis”, disillusionment with market-oriented reforms, together with the usual political resistance. Predicting which countries will accelerate reform and when is hard. Sometimes the trigger can be a new government, a crisis, or a long-planned process which finally comes to fruition, as in trade opening, for example. When countries accelerate reform they will in time see the benefits and markets will react early.
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**Market implications**

A boost for investors
Reforms which improve macro-stability usually bring lower real and nominal interest rates with less volatility, and a less volatile exchange rate. Supply-side reforms tend to accelerate growth over time and are good for investors in several ways: lowering interest rates and volatility, boosting the exchange rate over time, and deepening and widening equity and credit markets, which enhances liquidity and transparency and brings in new investors. Investors tend to anticipate these effects, which is why markets often move on policy announcements, ahead of implementation. It may also be why economists sometimes struggle to find a relationship between economic growth and market performance; the markets move first.

The need for regulatory reform, too
Greater investment in infrastructure, frequently highlighted in this report, is likely to require an expansion of debt markets for funding. In many countries, efficient allocation of capital would benefit from reforms in financial regulation and corporate governance as well as the development of pension and life insurance markets. In the international credit markets, we urge issuers to choose greater transparency and disclosure which would often help to reduce risk premiums.

**Equities – Comparing Indonesia and the Philippines**
To highlight the role of economic reforms on equity markets we focus on comparing the cases of Indonesia and the Philippines. Indonesia implemented a series of important reforms after 1997 which now leave the MSCI Indonesia stock index 27% above its high in 1997 in USD terms. In contrast, the Philippines, which has only recently stepped up plans for reform, remains 37% below. Three areas of reform in particular – energy, infrastructure and mining – have the potential to deliver real change for the Philippine economy. If the Philippines can make good progress on reform, the potential equity-market upside is considerable if the example of Indonesia is any guide.

**Country studies**
We identify one key area of reform for each country
We asked our country economists on the ground to investigate in depth one area of reform which is particularly important for their countries. Infrastructure and labour-market reforms came up repeatedly, along with the role of the state. For countries further along the development path, the emphasis is more on creating a knowledge-based economy. We include the US, where macroeconomic stability is in question given the burgeoning public debt and inadequate policy response.

**Brazil – In need of infrastructure**
Brazil has re-established macroeconomic stability over the last decade, but trend economic growth is stuck at about 4.0-4.5% p.a. Its infrastructure compares poorly with other large countries and we argue that this should be a key focus. The government is working hard to boost government investment, with new spending on the Olympics and World Cup acting as a catalyst. But there is an enormous amount to be done and it will require a range of microeconomic changes to make the environment more attractive for private investment, which will be crucial to success. We expect infrastructure investment to gradually accelerate, though it will take other reforms as well to boost Brazil to the 5-6% trend growth of which it is capable.
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China – Pay households a decent return on their savings
To help rebalance the economy China needs further interest-rate reform, to raise the return on savings, thereby boosting incomes and providing better discipline for investment decisions. We spell out the key steps needed, including sorting out the external imbalances (which will require further appreciation of the CNY), squeezing out excess interbank liquidity so that rates can be moved up – starting with long-term deposit rates, and finally improving the liquidity in the bond market. The sequencing is complex and the government will likely follow its usual approach of testing the ground with experiments first.

Hong Kong – Public matters, private solutions
Hong Kong is already a rich economy and one of the freest and most competitive in the world, so we investigate the best way to retain these advantages while addressing growing social concerns. Some recent measures such as a minimum wage, a new home ownership scheme and an old-age pension, while understandable, may have a damaging effect on the economy because of the way they are structured. We argue that the government should be more of a facilitator than a provider and focus on how to structure the health and education sectors to increase private-sector involvement.

India – Overcoming the infrastructure deficit
We identify five factors behind the difficulties India faces in expanding infrastructure fast enough to keep up with the economy: regulatory hurdles – especially concerning the environment and land acquisition, lack of regulatory coordination, pricing inefficiencies with widespread price controls, teething problems with public-private partnerships (PPPs) and financing constraints, especially given India’s budget deficit. The proposed new land bill will be a major step forward. Important further steps will be creating a more holistic regulatory approach to infrastructure, introducing more rational pricing and facilitating funding.

Indonesia – Infrastructure and bureaucratic reform
We highlight the closely related problems of expanding infrastructure and reforming the bureaucracy. High payroll costs impede higher government capital spending while the bureaucracy is not as effective as it might be. The government is taking steps to tackle both problems, with the land acquisition bill particularly important on the infrastructure side and a raft of reforms on the bureaucracy side, including offering early retirement (there is a preponderance of older, less educated bureaucrats), a temporary ban on recruitment and boosting training.

Japan – Labour-market reform
With a declining population and high government debt, Japan needs to make better use of its human resources if it is to grow faster. We look at ways to boost female participation, improve the hiring environment for the elderly and provide better employment protection to non-regular workers. Female participation is relatively low, especially for prime-age women (25-54) while the unemployment rate is high for older workers. Non-regular workers earn much less than regular workers, enjoy insufficient social security coverage and tend not to receive good training.
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Nigeria – Escaping the oil curse
Nigeria has achieved a decade of sustained economic growth and has seen improvements in governance and fiscal management. But growth has relied heavily on buoyant oil revenues and Nigeria is finding it difficult to effectively use those revenues to promote sustainable development and to significantly reduce poverty. We outline 10 areas of focus that could help drive structural transformation, ranging from extending the time horizon of policy, boosting long-term savings and creating the fiscal space for infrastructure spending, to the need for technocratic reform teams.

Singapore – The search for total factor productivity
Singapore is almost certainly the most successful long-term example of state-led economic development, having shifted the structure of the economy several times as income grew. The government is now sensibly focussing on ways to enhance the efficiency of the work force by increasing research and development efforts, deepening skills, fostering a creative culture and encouraging entrepreneurship, (much of which economists measure as total factor productivity, or TFP). It is also beginning a shift away from relying so much on cheap foreign labour, which we believe will raise wages and force more capital investment in sectors such as construction and retail.

South Korea – Boosting the services sector
The slowdown in trend economic growth over the last decade is due mainly to weak TFP growth in the services sector. Manufacturing and especially IT are still very strong. We assess the government’s measures to enhance productivity in the health, education, tourism, culture and business services sectors. The approach is a mixture of liberalisation to promote competition and help for specific sectors where opportunities can be identified. Both are needed, especially for new sectors, but in our view it will be the liberalisation and emphasis on competition which brings long-term results, especially in promoting TFP.

Sri Lanka – Improving the climate for investment and trade
With the civil war over, Sri Lanka’s resources, good educational levels and past reforms, which put it ahead of regional competitors on many measures, leave it in a solid position to generate strong sustained growth rates. We emphasise the need for reform to reduce the dominance of state-owned enterprises and encourage private investment, both foreign and domestic. SOEs in Sri Lanka have been under-performing due to pricing policies often aimed at achieving social objectives. The government is active in shifting towards more investor-friendly policies, though policy uncertainty and bureaucratic red tape continue to weigh on investor sentiment.

Taiwan – Leveraging mainland China’s rapid growth
To reinvigorate growth we argue that Taiwan needs to speed up the process of normalising its economic ties with mainland China. It also requires local Taiwan producers to re-think their current growth strategy that primarily considers mainland China a low-cost overseas production base for exports, which until recently has allowed them to put off necessary upgrades and changes to stay competitive against its key Asian rivals. Taiwan producers also need to shift away from the low-cost contract manufacturing model and develop more own-brands.
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**Thailand – Boosting labour productivity**
Thailand has likely been caught in the middle-income trap since the 1997 Asia crisis. The low rate of growth is therefore both a cause and consequence of periodic political instability. We focus on the need to upgrade labour-market skills so that Thailand’s manufacturing sector can continue to move up the technology curve. There is a shortage of graduates in science, engineering and health sciences and a preponderance of social science graduates. We also suggest that the ASEAN Economic Community, modelled on the European Community, due to start in 2015 could play a big role in encouraging specialisation and growth within the region.

**UAE – Reversing the trend in labour productivity**
Despite very impressive growth and development, labour productivity in the UAE has declined over the long run, in absolute terms. The UAE’s labour-market model leaves nationals (11% of the total population) mostly in government jobs; and imported labour, facing strict labour regulations, in most private-sector jobs. We make three recommendations: Adjust the worker entry system to encourage more skilled labour, make labour laws more flexible as in the existing free zones which have higher productivity, and narrow the wage differential between nationals and non-nationals to encourage nationals to seek higher education and move into the private sector.

**US – The fiscal policy challenge**
We discuss the threat to economic growth from the rise in government debt and outline what is needed, both short-term from the danger of rapid tightening in 2013 and longer-term if nothing is done. The ideal strategy now would have several elements: a gradual reduction of the deficit over a multi-year period, weighted towards lower spending, but not ruling out higher tax revenues; tax reform stripping out loopholes, but reducing tax rates; a procedure for revising the plan as time passes, which credibly constrains the government from ramping up spending or cutting taxes unless it is ‘paid for’ within the plan; and progress on reducing long-term entitlements.
3. Growth matters

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- Growth increases living standards, health, life expectancy and probably ‘happiness’
- It is associated with democracy and peace and helps pay for improving the environment
- The recent increase in inequality within countries is a challenge

Why growth matters
Experience suggests that successful reform, though often painful, generates faster economic growth. Yet sometimes the benefits of growth are questioned, as people fret that money does not buy happiness or worry about the environmental impact. We argue in this chapter that economic growth matters because it improves people’s lives in many different ways. A growing economy provides more goods and services, which translate into greater prosperity, higher standards of living, a higher quality of life, longer life expectancy and more life satisfaction. It can also help to improve the environment and is associated with such benefits as democracy and freedom. Well-being becomes a source, not just an outcome, of growth, as a well-fed, healthy, better-educated, long-lived – and happier – work force becomes more productive.

Higher standards of living and well-being

Higher income per head
Standards of living can be measured in different ways. The most common definition is in terms of income per head, which is economic output adjusted for population growth, and crudely represents the purchasing power of an average citizen. There seems little doubt that most people value greater purchasing power in itself, but it is far from the only benefit of economic growth.

Longer life expectancy
Life expectancy is a good reflection of human health. Figure 1 shows that between 1000 and 1820, life expectancy at birth in the West increased by 12 years from 24 years to 36 years, while that of the rest of the world stagnated. The divergence in life expectancy between the West and the ‘rest’ was attributable to relatively faster development of the West, with improvements in agriculture, mining and shipping. The spread of universities and book printing in the Middle Ages encouraged intellectual progress, which later, during the Renaissance and Enlightenment movements in the 17th and 18th centuries, laid the foundations for the development of science. The rest of the world remained untouched by the technological progress, and life expectancy there remained stagnant.

Figure 1: West versus the rest
Life expectancy at birth (years)

Figure 2: Life expectancy: France versus Russia
Life expectancy at birth (years)
3. Growth matters

The divergence in growth between the West and the rest of the world sharply accelerated after 1820, following the Industrial Revolution. By 1900, life expectancy in the West had increased by a further 10 years, to 46, almost as much as during the previous 800 years. It then increased by another 20 years, to 66, by 1950, and it is 80 today, nearly double the level of just a century ago. Meanwhile, in the rest of the world, which did not start to benefit from the Industrial Revolution until much later, life expectancy remained in the mid-20s until the 1900s, before rising to 44 by 1950 and to just over 60 today, still some 20 years behind life expectancy in the developed world.

The impact of growth on life expectancy can also be observed by examining a relatively short and recent comparison of Russia and France (Figure 2). Rapid post-WWII growth in the Soviet Union led to a catch-up in life expectancy, so that by the early 1960s, in both countries, it was around 70. From that point, however, the Soviet growth model started to disappoint. Living standards gradually deteriorated until the system collapsed in 1990.

The painful transition from centrally planned to market economy through the 1990s further eroded standards of living (exacerbated by excessive vodka consumption, though this too may be partly a response to the dire economic situation). As a result, Russian life expectancy fell back, to 65 by 2000, and only started to pick up once Russian growth resumed in the last decade. Today, life expectancy in France is 82, while in Russia it is only 69 – the communist experiment and its aftermath robbed the average Russian of 13 years of life.

Life expectancy is only one measure of health. Other important barometers, such as malnutrition, maternal mortality, the incidence of serious diseases such as malaria, tuberculosis, HIV/AIDS and meningitis are also more prevalent in poorer countries. Easily treated problems such as cataracts and other relatively straightforward conditions are often not treated. People in poorer countries are much less likely to be able to afford sophisticated drugs taken for granted in richer countries, drugs such as antibiotics and vaccinations, or even simple medicines such as painkillers and skin balms. Many of these health problems are linked to lack of clean water, inadequate nutrition, poor education and overcrowding, as well as to the lack of access to health care.
3. Growth matters

More education

Education is another important aspect of human well-being, as a tool for personal development and a gateway to economic opportunities. Figure 3 shows the relationship between income per head and literacy rates, and a similar relationship holds for primary, secondary and especially tertiary enrolment rates. The richer the country, the better educated is its work force, and in turn, the better educated the work force, the stronger and more sustainable is growth. More education accelerates accumulation of human capital, which then facilitates absorption of technology and industrial capital.

Happiness

Economic growth may also lead to greater happiness, though this remains a controversial topic. On the one hand, Richard Easterlin described a “paradox” that, despite a tremendous increase in living standards after the World War II, happiness in the US and Europe and Japan has stagnated. Richard Layard 2 came to the same conclusion, and provided an explanation supported by the psychology literature that this is because people compare their income to that of others, and it is higher relative income not the absolute income that makes them happier. Absolute income only matters to happiness at low levels of development. However, once basic needs are met, at approximately USD 15,000 per head, countries reach a satiation point, where extra income does not necessarily buy more happiness.

Contrary to this view, more recent studies find a strong link between economic growth and happiness. Stevenson and Wolfers, 3 for example, poke holes in Easterlin’s and Layard’s analyses and assumptions, and find that income and happiness are highly correlated at all income levels, thus rejecting the satiation-point hypothesis. They also find that this relationship holds between countries and within countries. That richer people are happier than poorer people is also supported by the work of Angus Deaton 4 who, using the Gallup World Poll survey on “life satisfaction”, found that the richer a nation, the more satisfied with life its citizens are. People in western Europe, North America, Japan or Saudi Arabia are wealthiest and most satisfied, while people in Sub-Saharan Africa, poorer countries in Eastern Europe, Afghanistan, Haiti or Cambodia are least satisfied with their lives (although some of these countries, like Nigeria, are also most optimistic about the future, according to another Gallup poll). Moreover, the study found that an increase in GDP leads to a proportionate increase in life satisfaction, and that the relationship holds for both high-income and low-income countries. Figure 4 shows a linear relationship between growth and well-being. With the exception of Hong Kong and Singapore, where despite having high income per head, only 19% of people consider themselves to be ‘thriving’, pursuit of growth seems to be another way of pursuing happiness.

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3. Growth matters

More democracy
A higher standard of living also tends to be associated with societies that are more stable, tolerant, fair and committed to democracy. Indeed, various measures of prosperity, including higher per-capita income, longer life expectancy and a smaller gender gap are also found to predict democracy, perhaps because these variables allow for the formation of the middle class, which is the bedrock of democracy. Conversely, stagnating societies make little progress towards these goals, and more frequently regress, as we saw with the failure of democracy in Africa in the 1960s.

For most people democracy is something valuable in itself, particularly with its associated freedom of expression, judicial resolution of disputes and peaceful changes in leadership. Interestingly, democracy is statistically linked to faster growth. According to Paul Collier, growth in democracies outperforms that in autocracies by 2ppts (studies that find otherwise often do not control for natural resource endowment, and in many autocracies growth is resource-driven). This is likely because democracy provides checks and balances against a single individual or a group that may wish to control a country’s resources. Moreover, many autocracies tend to be centrally planned, which is not always efficient, and waste resources through patronage or subsidies designed to keep the regime in power.

Peace and security
Growth is also good for peace. Paul Collier found that 73% of ‘the bottom billion’, that is, billion people who live in the poorest countries of the world, have recently been through a civil war. While the causes of wars are complex, Collier’s research shows that if a country’s income doubles, the risk of civil war halves. He further finds that each percentage point of growth reduces the risk of war by a percentage point. Thus, low income and slow growth (plus commodity dependence) make countries prone to civil war. Interestingly, political repression or ethnic diversity are not statistically significant predictors of civil war. The risk of civil war, therefore, boils down to growth.

Civil wars are usually more destructive than inter-state wars because they tend to last longer and countries that suffer from civil war are more likely to relapse into conflict. However, economic growth also limits international conflict.

With the new wave of globalisation, after the World War II, the incidence of inter-state wars has decreased dramatically. An important driver of this change is economic interdependence, which makes countries more prone to engagement and compromise rather than conflict. Some say that ‘geo-politics’ has been replaced with ‘geo-economics’, and ‘mutually assured destruction’ (nuclear deterrence) with ‘mutually assured economic destruction.’ Furthermore, because democracies do not generally fight each other, the spread of democracy has also contributed to greater stability, and as noted earlier, democracy too is an outcome of prosperity.

However, globalisation, while contributing to increased security, has also introduced new risks. For example, the enemy is no longer other states, but instead transnational threats such as terrorism, climate change, and pandemics, among others, that are propagated by globalisation. But the consequences of these problems and, arguably their root causes can be better addressed with higher living standards.
3. Growth matters

**Growth in emerging economies**

The benefits of growth for emerging economies, where incomes per capita are much lower than those in the West, are naturally particularly large for all the reasons just discussed. Owing to a series of successful reforms over the last two decades, a large number of emerging economies, and importantly the two largest ones, China and India, have set their economies on a strong growth path and their standards of living have been catching up with those in the West. In East Asia, for example, the percentage of the population living in poverty, according to the World Bank definition of USD 1.25 a day at purchasing power parity (PPP), has fallen from 56% in 1990 to 14% in 2008, lifting 642mn people out of poverty even as population increased by 336mn. This is largely due to the economic transformation of China, which reduced the ratio of poor from 60% to 16% between 1990 and 2005, lifting 475mn people out of poverty.

Correspondingly, there has been a tremendous improvement across all other development indicators, even for happiness. While the relationship between income and happiness is controversial for the rich world, research has settled on the fact that at lower levels of income, increases in wealth lead to more happiness.

Growth is also particularly important in emerging countries to absorbing rapidly growing labour forces. Many EM, especially those in the Middle East, Africa and South Asia, continue to experience rapid population growth rates. Providing jobs and opportunities for their young populations will be important to their political stability. Even for those economies where the population growth is slowing, there remains a massive need to find jobs for people displaced from the countryside as agricultural productivity rises. Most EM have legions of under-employed people.

**Expanding the middle class**

A key issue for many developing countries is the creation of a large middle class, which tends to bring many valuable side effects. As already noted, a larger middle class tends to be associated with democracy, and democracy tends to be associated with peace. It is also likely to be associated with greater attention to improving the environment. Furthermore, the larger the middle class is relative to a country’s total population, the more stable its domestic demand and the more consensual its society, in turn cementing a more sustainable growth trend. The middle class is also often seen as the source of entrepreneurship and innovation, running the small businesses that generate jobs and wealth. The middle classes also consume different kinds of goods and services compared with the rural or urban poor, unlocking new sources of growth.

**Figure 5: Size of the middle class (mn)**

*Daily per-capita incomes of USD 10-100 in PPP terms*

**Figure 6: Impact of prudent management on growth**

*Real GDP per capita (1990 PPP dollars)*

Sources: OECD, Standard Chartered Research

Sources: Angus Maddison, IMF, Standard Chartered Research
3. Growth matters

The middle class can be defined in relation to income in each country, but as the world globalises, it is more relevant to consider it in absolute terms. The OECD, which defines the middle class as those with incomes of USD 10-100 daily per capita (in PPP terms), predicts that by 2030, the total number of people in this range will increase from about 1.8bn to 4.9bn. However, the numbers in Europe and America will remain about the same and all the increase will be in the emerging countries, with Asia’s share of the total rising from 28% to 66%. Meanwhile, the absolute numbers in other emerging regions will also rise, although their share will fall (Figure 5).

However, these predictions are dependent on emerging economies’ ability to maintain growth momentum, which depends on continued reform. Outcomes can be very different if they fail to do this. To illustrate the significant impact economic management can have on growth, look at the historical development of Canada and Argentina. In the 1930s, the two were very similar in terms of income per head, abundance of natural resources, productive agricultural sectors and European investment and immigration inflows. However, over time, they pursued a very different development path. Unlike that of Argentina, Canada’s growth was supported by stable politics and prudent economic policy. As a result, Canada’s income per head is still nearly double that of Argentina, despite Argentina’s recent spurt. (This growth spurt may prove unsustainable. We will note in Chapter 4 when we consider measures of progress on reform, such as the Economic Freedom Index, that Argentina stands out because it is going backwards on these measures.)

The West and Japan: Are the days of growth over?

Over the last century or more, sustained long-term growth has meant that people in the West and Japan could look forward to living a significantly better life than their parents. However, there are concerns that increasing prosperity may have hit a ceiling due to excessive debt, unfavourable demographics, globalisation and technological development.

### Figure 7: Median GDP growth at given debt to GDP level

<table>
<thead>
<tr>
<th>Debt Level</th>
<th>GDP Growth</th>
</tr>
</thead>
<tbody>
<tr>
<td>Below 30%</td>
<td>4.0%</td>
</tr>
<tr>
<td>30-60%</td>
<td>3.5%</td>
</tr>
<tr>
<td>60-90%</td>
<td>2.5%</td>
</tr>
<tr>
<td>90% and above</td>
<td>1.0%</td>
</tr>
</tbody>
</table>

Source: Reinhart and Rogoff (2009)

### Figure 8: Countries with debt/GDP of 90% or more

<table>
<thead>
<tr>
<th>Country</th>
<th>General government debt (% GDP)</th>
<th>Real GDP growth</th>
<th>General government balance (% GDP)</th>
<th>Current account balance (% GDP)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Japan</td>
<td>219</td>
<td>2.0</td>
<td>-6.9</td>
<td>-2.2</td>
</tr>
<tr>
<td>Greece</td>
<td>181</td>
<td>-3.0</td>
<td>-7.0</td>
<td>-6.3</td>
</tr>
<tr>
<td>Italy</td>
<td>128</td>
<td>-0.5</td>
<td>-1.6</td>
<td>-2.6</td>
</tr>
<tr>
<td>Iceland</td>
<td>127</td>
<td>2.4</td>
<td>-3.3</td>
<td>-3.4</td>
</tr>
<tr>
<td>Portugal</td>
<td>122</td>
<td>-3.2</td>
<td>-4.5</td>
<td>-3.8</td>
</tr>
<tr>
<td>Ireland</td>
<td>119</td>
<td>1.0</td>
<td>-8.7</td>
<td>1.7</td>
</tr>
<tr>
<td>US</td>
<td>104</td>
<td>2.0</td>
<td>-9.3</td>
<td>-2.9</td>
</tr>
<tr>
<td>France</td>
<td>102</td>
<td>0.3</td>
<td>-4.5</td>
<td>-2.2</td>
</tr>
<tr>
<td>Belgium</td>
<td>102</td>
<td>0.5</td>
<td>-3.2</td>
<td>-0.3</td>
</tr>
<tr>
<td>UK</td>
<td>97</td>
<td>0.5</td>
<td>-8.7</td>
<td>0.1</td>
</tr>
<tr>
<td>Canada</td>
<td>93</td>
<td>1.9</td>
<td>-4.1</td>
<td>-2.9</td>
</tr>
<tr>
<td>Hungary</td>
<td>91</td>
<td>-0.6</td>
<td>-3.4</td>
<td>1.4</td>
</tr>
<tr>
<td>Germany</td>
<td>87</td>
<td>0.6</td>
<td>-1.1</td>
<td>4.9</td>
</tr>
</tbody>
</table>

Sources: OECD, Fitch, Standard Chartered Research
3. Growth matters

The development frontier is still moving out

Rich economies already have high levels of human capital and labour participation, and high and productively employed capital stock, so the only way for them to grow is by leaps in productivity due to technological breakthroughs. Those are of course, by definition, unpredictable, and any new technology only impacts growth once it has been not only developed but also widely adopted. This is why almost all of the technologies that will drive economic growth in the next ten, even twenty years have already been invented. The work now is to adapt them for use and to see them spread through the population.

We see no reason to believe that the development frontier has stopped moving forward. The advances in information technology and networking are likely to continue to reverberate through the system for many years to come, driving growth. Of course, to benefit fully, the developed countries need to be able to change and adapt to the new realities and create and invest as required. Enter debt and demographics.

Excessive debt may hold back growth

A major threat to developed countries’ growth is that they are over-burdened with debt. Reinhardt and Rogoff found that, in rich economies, when the government debt-to-GDP ratio exceeds 90%, median growth rates are 1ppt lower than for countries with debt-to-GDP ratios of 60-90% (Figure 7), and average growth rates fall nearly 2ppts. Countries with debt-to-GDP ratios of approximately 90% and above in 2012 are listed in Figure 8.

Higher debt levels imply a higher probability of both default and inflation and thus push up the risk premia, and therefore the cost of funding in the economy. Moreover, higher government borrowing may crowd out private investment and push interest rates yet higher, though business caution on new investment as well as quantitative easing (QE) are offsetting this problem at present. Finally, high debt, especially if funded at higher interest rates, translates into greater debt service, hence presenting a further drag on fiscal balances and risking moving indebtedness to unsustainable heights. While funding costs are very low at present, the risk of a debt crisis at some point is rising, as debt mounts. We explore the government debt issues through the experience of the United States in the case studies later.

In many countries the problem is not confined to public-sector debt; it extends to high private-sector debt.

Historically, the largest debt reductions were achieved through growth.

While debt is a threat to growth, fast growth, if it can be achieved, can reduce debt. Historically, the largest reductions in debt were undoubtedly achieved through growth. Debt balances after the World War II in Europe were even higher than they are today, but they were successfully brought down thanks to the strong economic growth that ensued. Rapid growth, and the reduction in interest rates conferred by EMU membership, also helped Ireland reduce its public debt from 109% in 1987 to 25% in
3. Growth matters

2007. Thus, reform that helps find new sources of growth will be key to debt reduction, which in turn will unlock further growth, and reduce the heavy debt burdens.

Demographics slow work-force growth and add to dependency

Today’s surge in public borrowing is taking place just before the rich world needs to address the huge pension and health-care costs of ageing populations. By 2050, the number of people over 65 in the West will double (Figure 9). According to the IMF, this will cause an increase in annual government spending of as much as 8.8% of GDP in Spain, and 13.4% of GDP in Korea (Figure 10). Without mitigating policy measures, public debt in the rich world could increase by an additional 60ppts, just due to aging, by 2030, which will have significant implications for growth. Moreover, in some countries, notably the US and the UK, existing defined-benefit, private-sector pensions could become a significant burden on the corporate sector.

Ageing can also directly subtract from growth simply because the working population shrinks. Just as increasing labour participation from women entering the work force after the World War II boosted growth in the West, the rapidly ageing population, combined with low fertility rates, will shrink labour supply and consequently growth. This is not a bad thing in itself: Reduced labour supply should in theory raise real wages and boost the capital/labour ratio. However, in a globalised world, business may look elsewhere to invest.

Rewriting the social contract to eliminate spending that used to define the European welfare-state model, which will be no longer affordable, may be inevitable to mitigate the projected debt build-up. However, more constructively, countries can alleviate some of this worrisome trend by raising the retirement age to reflect longer lives; improving incentives to work for older workers, who are more experienced and thus arguably more productive than young workers; or by loosening immigration restrictions. Such reforms will maintain labour supply and reduce fiscal costs, thus supporting growth, which will in turn help bring down age-related costs.

Technology and globalisation

A key problem for many in the West today is that low- and medium-level jobs which used to be relatively high-paying are increasingly being replaced by static machines locally (computers and robots), together with lower-paid people in other countries. This...
3. Growth matters

is not a new phenomenon: Jobs have been replaced by machines at least since the spinning jenny machine replaced the traditional spinning wheel in the 18th century.

Jobs have also been lost to imports for decades or more, as lower wages elsewhere were ‘embedded’ in goods coming in. What may have changed is the pace, due to the rapid advance of computing and network technology, which makes it easier to tap lower wages elsewhere, combined with the rapid pace of globalisation as China and India open up.

To respond to these trends with protectionism would likely reduce growth and welfare over time. The answer has to be to move to enhance the skills and creativity of the work force as well as increasing the flexibility of the economy to encourage new investment and growth. If economic growth is sufficiently strong, there will be enough jobs. However, in some cases these jobs may be lower-paying than the jobs lost, affecting the distribution of income. This is the final threat to average living standards in the West.

Growth and inequality

Rapid growth in emerging economies has produced lower inequality between countries: however, inequality within countries has increased around the world. It is a particular problem in the West because slow economic growth combined with rising income inequality may mean that the average worker gets no better off over time, or even becomes worse off. Faster growth might at least mean that everyone is still on an improving track, even if at a different pace.

In the US, the top 1% took home 9% of national pre-tax income in 1974, and 24% in 2007 – nearly three times as much. The income gap between the poor and middle class has not widened; instead, inequality in the West has been driven by explosive gains in wealth at the very top level of income distribution. Because the West has a comparative advantage in high-value-added exports, returns accrue to high-skilled, at the expense of low-skilled labour, which is abundant in the emerging world. With technological progress, relative returns to those who are most skilled increase further.

In EM, rapid growth tends to reduce absolute poverty and make almost everyone better off. However, not everyone gets their fair share, and some people become much better off than others. As already noted, rapid growth in China lifted 475mn people out of poverty in the 15 years to 2005, but income inequality has risen. The Gini coefficient, the most common, albeit imperfect, measure of inequality, where zero represents perfect equality and 100 perfect inequality, rose from 35.7 to 46.9 between 1990 and 2005.

Although cross-country inequality comparisons (Figure 11) can be misleading due to differences in calculation, with the Gini coefficient at 36.8, it is probably safe to say, India is relatively less unequal than China. However, unlike China, India saw an increase in the number of poor by 20mn between 1990 and 2005.

Does inequality matter? Research shows that inequality, perhaps because it violates a deeply seated sense of fairness, produces social problems, including more crime and violence, less social mobility, and even drug abuse, obesity, shorter life, and teenage pregnancy. It can also become a political problem if the rich exert disproportionate political influence by being able to ‘buy’ laws and regulations favourable to them. However, many of these claims are difficult to empirically verify, and opinion surveys on how much people care about inequality are also mixed.
3. Growth matters

The Pew Global Attitudes Project (Figure 12) asked respondents whether or not they agreed that “most people are better off in a free-market economy, even though some people are rich and some are poor.” In China and India, 84% and 79% of respondents, respectively, agreed. However, only 68% agreed in the US, 60% in Russia – although the majority still prefers the free market – and only 43% in Japan. This could be a reflection of the “Easterlin paradox” where people in poorer countries are happy as long as they are growing, while people in richer countries are anxious about their neighbours getting richer than they are.

The problem is that it is difficult to have fast and equitable growth at the same time. Efficiency often comes at the expense of equality, and vice versa. While markets drive efficiency, government policy is necessary to maintain equality, and finding the perfect balance can be tricky.

How far policy makers should go to promote equality is difficult to know. The Soviet bloc countries were egalitarian with good social services, yet stagnant and with low standards of living.

Sometimes, policies designed to promote equality can also make things worse. Rajan, for example, claims that increasing inequality in the US prompted the government to loosen regulations to channel more credit to lower income (subprime) households, to encourage their home ownership and thus perceived wealth, at no direct cost to the government. However, these same households were the hardest hit during the financial crisis that ensued. China’s policy makers are also emphasising more “inclusive” growth, and partly as a result of this growth, official targets are being revised down.

We explore this issue further in the context of Hong Kong in the case study later in this publication. Hong Kong is arguably the most successful development story ever, enjoying rapid economic growth for decades from the 1950s onwards, rapidly becoming a developed high-income economy. This success was rooted in an almost entirely free-market approach: the main exceptions being land supply policy and the exchange rate. Yet Hong Kong now is right at the front line of the inequality challenge. Cheaper labour, also highly educated, is available just a short distance across the border, adding to the already considerable inequality of income.

Figure 11: Gini coefficient

0=perfect equality, 100=perfect inequality

Figure 12: Pew Global Attitudes Survey

% who agree that “most people are better off in a market economy, even though some are rich and some are poor”

Source: CIA World Factbook

Source: Pew Research Centre

3. Growth matters

Growth as a way to fix the environment

Finally, growth generates both negative consequences for the environment as well as solutions for combating climate change.

Rapid economic growth, accompanied with rapid population growth and urbanisation, has put pressures on the environment from overexploitation of resources and pollution. In addition, rising CO2 emissions are believed to be causing global warming and climate change, which is creating further challenges for food, energy and water supplies. The impact of climate change varies greatly across regions but it is disproportionately felt by the poor, who are most hit by the disease and destruction that follows the rising number of floods or droughts, and by rising food prices.

It is simply not plausible that fast-growing countries like China and India will give up much of their growth to reduce CO2 emissions at this point in their development, given the myriad other problems they face. Even in the West, the problems and risks from climate change are heavily discounted by many voters and consequently politicians, so progress is limited there too. Paradoxically, perhaps, the best hope for dealing with it lies with growth.

Responses to climate variability are broadly focused on mitigation and adaptation, and will come at a cost. Economic growth can help meet these challenges. First, it generates more financial resources to invest in green technologies. The falling trend of global energy intensity (or the energy required to produce USD 1,000 of real GDP) is a result of improvements in technology that allow the global economy to expand with less additional energy needed to produce an extra unit of output (Figure 14). These include the use of bio-fuel, de-carbonisation of the power sector, and the development and implementation of hybrid technology for cars. While falling energy intensity cannot restore the global environment completely, it may help to delay the speed of environmental degradation. Second, as richer populations get richer, they tend to care more about issues related to environment and climate change and put pressure on political leaders to put the issue on the political agenda.

Overall, then, we conclude that while growth brings problems, lack of growth is a greater threat to human living standards. In the next chapter we look at whether there is agreement on how to achieve growth. Is there a consensus on reform?
4. Is there a consensus on reform?

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- The original Washington Consensus has faced strong criticism
- New recipes for growth have emerged, inspired by Asian countries’ success
- The role of the state and how to sequence reforms remain controversial

From Washington to Seoul

Economists’ prescriptions of how to achieve economic growth evolve constantly, and are often shaped by crisis. The Washington Consensus, which advocates free market policies and reduced government intervention, was built upon the Latin American crisis in the 1980s. Many of the principles, such as fiscal policy discipline, maintaining a competitive exchange rate, trade liberalisation and the importance of property rights, remain valid and widely accepted, at least in principle.

Nonetheless, the Washington Consensus has come under challenge in the past two decades, partly driven by subsequent crises. After the Asian crisis in 1997, strict policy prescriptions implemented by the IMF in exchange for financial assistance, were seen to exacerbate economic hardship in the short term. Then during the 2008-09 crisis, developed economies deviated by intervening heavily, and abandoning both fiscal discipline and the admonition to keep interest rates positive.

Elements of the Washington Consensus have also been directly challenged by the success of some countries’ growth models, which have not fully conformed. For example, successful Asian countries have not always had interest rates dictated by market forces, not fully liberalised trade and FDI, and not privatised all state companies. Over the coming decade it will be interesting to see whether countries which continue to deviate will face bottlenecks or constraints as a result.

New models for reform

The Washington Consensus approach was always more nuanced than extreme free-market radicalism. Nevertheless, the global financial crisis devalued the free-market approach in the eyes of some, while the demonstrably superb growth performance of China and India has led to new approaches, including the so-called Beijing Consensus, the Mumbai Consensus, ‘inclusive growth’ and the Seoul Development Consensus. Their relatively loose specifications reflect both the difficulty of reaching agreement among policy makers facing different political and economic realities, as well as uncertainties among researchers about what works best.

These uncertainties are brought out very clearly by the Commission on Growth and Development, a World Bank-sponsored report published in 2010. In many ways the report still follows the Washington Consensus line, but with far more qualifications and doubts. It also reflects the greater modern focus on environmental sustainability and on poverty reduction and income distribution.

Still, many elements of the Washington Consensus stand. The two biggest challenges may be how fast and in what order to pursue some of the policies, (so-called sequencing), and the effectiveness of the state in leading growth.
4. Is there a consensus on reform?

**How reform creates growth**

Economic growth can be calculated as the sum of the growth of three factors – labour, capital and total-factor productivity (TFP). More labour input, either more workers or longer hours per worker, will produce more output. Better tools and equipment and improved infrastructure (physical capital) or better skills and training (human capital) will also increase production. Finally, improved processes or organisation can boost economic activity without adding more labour or capital (TFP). In practice, TFP is a residual item after labour and capital inputs are accounted for.

For reforms to create growth they need to boost one or more of these factors and it is tempting to assume that the answer is for the government to directly and actively intervene. Many governments do indeed see this as their role. However, the Washington Consensus emphasises the importance of minimising government involvement and interference in the economy, except to create a stable, attractive investment environment and to maximise competition. In its simplest form this is sometimes summarised as ‘stabilise, privatise and liberalise’.

**The Washington Consensus and its critics**

In 1989 John Williamson coined the term ‘Washington Consensus’ to summarise a standard set of specific policy prescriptions advocated by Washington-based institutions such as the IMF, the World Bank and the US Treasury. This set of prescriptions was primarily used then in Latin America, where the aftermath of the 1982 debt crisis left countries struggling with low growth and high inflation. It subsequently became the basis for policy prescription in Eastern Europe after the fall of the Berlin Wall as well as in Asia after the Asia crisis. It became the policy consensus in the US and UK from the 1980s onwards and, less enthusiastically, in continental Europe.

Some critics are suspicious of the free market

While many of these principles are still broadly shared by most policy makers and development economists, there has been a strong challenge from the left, which is suspicious of private institutions and free markets and believes the state has a central role to play in regulating markets, directing and leading development and protecting vulnerable groups. Critics from this viewpoint point to the successful growth path of East Asian countries, where the government has usually played a strong leadership role. They also note the tendency for the benefits of economic growth in recent years to be disproportionately enjoyed by higher income groups, which they ascribe, to some extent, to free-market and low tax policies.

**Figure 1: Washington Consensus**

| Fiscal policy discipline, avoiding sizeable budget deficit |
| Redistribution of public spending away from subsidies to broad-based pro-growth supply-side spending such as infrastructure, primary | |
| Broad tax base and moderate marginal tax rates |
| Market-determined interest rates, preferably moderately positive in real terms |
| Competitive exchange rates |
| Trade liberalisation, by tariff reduction and lowering of non-tariff barriers |
| Liberalisation of inward FDI |
| Privatisation of state-owned enterprises |
| Deregulation, especially in areas that restrict competition and prevent market entry, but provide prudential oversight on safety, environment |
| Enforcement of property rights |

Sources: John Williamson, Peterson Institute for International Economics, Standard Chartered Research
4. Is there a consensus on reform?

The 2008-09 financial crisis was a blow

Support for the ideas behind the Washington Consensus was severely jolted by the 2008-09 global financial crisis. One view of the causes of this crisis emphasises the role of free markets and light regulation. Moreover once the crisis struck, developed country governments responded by adopting policies that went against the Washington Consensus. Significant fiscal stimulus was injected into the economy to support growth. Financial institutions were bailed out, effectively nationalised, using public money instead of being allowed to fail, or forced to merge with other private financial institutions. In the US, government-owned institutions such as Freddie Mac, Fannie Mae and the Federal Housing Administration became almost the sole providers or guarantors of mortgages while large parts of the car industry were bailed out with government money.

Arguably, it is unfair to judge policy in a crisis against prescriptions for long-term healthy growth and the prescriptions themselves were not necessarily intended as a short-term crisis response. Nevertheless the experience has damaged the Washington Consensus both by raising questions about free-market prescriptions and undermining the credibility of the Western advisors who recommend them. Commentators in Asia were particularly enraged as the ‘doctors’ who prescribed the tough medicine for them in 1997 refused to take the tough medicine themselves.

Important technical disputes on exchange rates and trade liberalisation

There have been a number of technical disputes about how to apply the principles in the Washington Consensus. In part this is a debate about sequencing and coordination. For example, rapid trade liberalisation without other measures to ensure that companies are ready to compete or that new areas of economic activity are ready to emerge can push an economy into recession. Measures to deregulate financial activities can lead to a bubble and bust, unless appropriate interest- and exchange-rate policies are followed, together with sound financial supervision.

There have also been important disputes about some of the principles themselves. Ironically, it was the IMF itself which moved away from emphasising the imperative of maintaining competitive exchange rates, soon after the original term was coined. In the 1990s the IMF supported a number of country programmes which tried to use a fixed or quasi-fixed exchange rate to anchor inflation. These programmes probably could have worked, if all the necessary supporting policies had been fully in place, but they went spectacularly wrong in Russia in 1998 and in Argentina in 2001.

The importance of maintaining a competitive exchange rate is once again central, perhaps partly because it is has always been central in Asia, and Asian countries are now increasingly taking the lead in development policy. This issue has been at the core of the euro crisis in recent years.

The emphasis on trade liberalisation also remains controversial. Many successful Asian countries (and arguably the UK, Germany and the US in the 19th century) did not open up new industries to competition until they were well established, the so-called infant industry defence. Yet, trade protectionism, whether through tariffs or more commonly these days through other restrictions, prevents companies from being forced to fully compete. In some countries and industries, protectionism holds...
4. Is there a consensus on reform?

back economic growth. A strong case can be made that the success of both China and India over the last two decades owes an enormous amount to more open trade. The answer seems to be that there is a sequencing issue to some extent, but that vested interests almost always delay trade liberalisation for longer than desirable.

**Minimal state or state-led development**

Finally, as already noted, the issue of privatisation is controversial. Again, there seems little doubt that in many emerging countries government-owned businesses are a major impediment to growth. They tend to enjoy monopolistic positions and special privileges which make them wasteful, inefficient and slow to innovate. In some countries, dominant companies are owned by friends of the regime, so-called crony capitalism, which was derided in Asia after the Asian crisis, and was a major factor in the Arab Spring uprising.

However, not all state-owned or government-linked companies are poorly run. There are some good examples, either because of a particularly effective government or because they do face serious competition. What may be most important is not necessarily who owns companies, but whether they face genuine competitive pressures and whether they are properly separated from political interference and political favouritism. In practice, both these conditions are easier to achieve in a privatised environment, which is why, in our view, it is still to be preferred. But this whole area remains highly controversial and the eclipse of the Washington Consensus in recent years has given a stronger voice to those who argue for "creating national champions" or emphasising state-led growth.

**The Commission on Growth and Development**

The Commission on Growth and Development published the ‘Strategies for Sustained Growth and Inclusive Development’ in 2010. This was the result of a four-year effort “to gather the best understanding there was about the policies and strategies that underlie rapid and sustained economic growth and poverty reduction”. The focus was particularly on what worked for the countries that over the last few decades have grown at 7% p.a. or more over a sustained period (similar to our analysis in Special Report, 17 September 2010, ‘The 7% Club’).

Its conclusion is that there is no generic formula, and there are still important controversies and uncertainties. Nevertheless, the Commission outlines a broad framework for rapid development, in the form of 14 general recommendations (Figure 2). These contain a great deal of ‘motherhood and apple pie’, though, in fairness, our summary table is distilled from 35 pages of discussion and cannot do full justice to its rich detail and subtle nuances, which makes it well worth reading.

There are many similarities with the Washington Consensus, but the Growth Commission recommendations cover a broader range and, in some cases strike a different emphasis. In terms of extra range, for example, the Growth Commission provides important recommendations on the need to embrace urbanisation, promote equality of opportunity or “inclusive growth”, and safeguard the environment. It also tackles capital account opening, which was not directly addressed in the Washington Consensus and has been a major controversy. It puts less weight on keeping taxes down, on maintaining positive real interest rates and on privatisation.
4. Is there a consensus on reform?

There is also a marked difference in tone, with the Growth Commission noting controversies, technical uncertainties, worries over sequencing and difficulties with practical political realities. John Williamson’s Washington Consensus list was intended to summarise what the main Washington development institutions were asking in the way of reforms, in return for funding, not represent his personal recipe.

The Growth Commission also provides an interesting list of “bad ideas”, policies which will impede rapid growth (Figure 3). Many of these are familiar bugbears and they are all too common, usually because of short-term political considerations, linked to pressure from interest groups and, to some extent weak government. Probably every country in the world is making at least one of these mistakes currently and many slow-growing countries can probably be accused of several.

**Figure 2: Growth Commission – How to achieve 7% p.a. growth**

| Maintain a high rate of investment | At least 25% of GDP, including 7% in physical infrastructure  
Another 7-8% of GDP in education, training and health |
| Encourage rapid technology transfer | FDI usually an important channel;  
Foreign education, especially university education |
| Embrace, do not resist, competition and structural change | Encourage new entrants and do not protect existing firms,  
“Protect people not jobs” |
| Encourage labour mobility | From farm to factory, and between factories;  
special economic zones may help |
| Expect rapid export growth to be key | Role of government in promoting it is controversial;  
best if role is limited in both scope and time |

Maintain a competitive exchange rate, especially early in development

Open up to capital flows gradually

Maintain macroeconomic stability  
Keep inflation in single digits, not necessarily ultra-low;  
Keep budget deficit at sustainable levels, not necessarily ultra-low;  
Government investment spending is very important

Promote a high domestic saving rate, since relying on foreign inflows is risky

Develop the financial sector  
Needs good regulation  
FDI in this sector is very useful

Embrace urbanisation, but spend on housing, sanitation, etc.

Promote both equality of opportunity and equity  
Rural vs. urban, regional and gender inequalities should be addressed;  
Some redistribution of income is good to reduce poverty and promote cohesion

Take care of the environment

Effective government is very important

4. Is there a consensus on reform?

Beijing Consensus – Pouncing tiger, flying dragon

The rapid economic development of India and China over the past two decades has prompted a closer look at their economic growth models. Their development ideology in many ways has deviated significantly from the Washington Consensus. For example, state-owned enterprises in China are dominant, both in terms of output as well as in investment and overseas expansion. Many industry leaders, even if privately owned, have some affiliation with the central and/or local governments.

In India, government subsidies, especially on fuel, food and fertiliser, remain sizeable. While India has thrived in the globalisation of its services, export manufacturing is still a laggard relative to its East Asian neighbours due to weak infrastructure. Both countries continue to suffer from corruption issues. Despite their non-conformance with the Washington Consensus, both economies have managed to expand rapidly and experienced a rapid reduction in poverty. In response, commentators have coined the terms ‘Beijing Consensus’ and ‘Mumbai Consensus’. The Beijing Consensus is a phrase used by Joshua Cooper Ramo to characterise China’s model of economic development. In his words:

- China’s new development approach is driven by a desire to have equitable, peaceful high-quality growth; critically speaking, it turns traditional ideas like privatisation and free trade on their heads. It is flexible enough to be barely classifiable as a doctrine. It does not believe in uniform solutions for every situation, and is defined by a ruthless willingness to innovate and experiment. It holds tightly to Deng Xiaoping’s pragmatic idea that the best path for modernisation is one of “groping for stones to cross the river” instead of trying to make one big, shock-therapy leap.7

Joseph Ramo emphasises two other points. First, he argues that innovation is important and developing countries do not need to follow the historical path of other countries. Instead, new technologies may enable them to leapfrog whole industries. Second, he emphasises the importance of sustainability and equality, but links these to chaos management, which he sees as a reality in a country as complex as China.

Figure 3: The Growth Commission’s ‘Bad ideas’

<table>
<thead>
<tr>
<th>Subsidising energy</th>
</tr>
</thead>
<tbody>
<tr>
<td>Relying on the civil service as ‘employer of last resort’</td>
</tr>
<tr>
<td>Reducing fiscal deficits by cutting infrastructure spending</td>
</tr>
<tr>
<td>Providing open-ended protection of sectors, industries, firms or jobs</td>
</tr>
<tr>
<td>Imposing price controls to stem inflation</td>
</tr>
<tr>
<td>Banning exports to keep domestic prices lower</td>
</tr>
<tr>
<td>Resisting urbanisation and under-investing in urban infrastructure</td>
</tr>
<tr>
<td>Treating environmental protection as an ‘unaffordable luxury’</td>
</tr>
<tr>
<td>Measuring education improvement solely by the number of schools or enrolment</td>
</tr>
<tr>
<td>Underpaying civil servants</td>
</tr>
<tr>
<td>Poor regulation of the banking system and interfering too much</td>
</tr>
<tr>
<td>Allowing the FX rate to rise too much before the economy matures</td>
</tr>
</tbody>
</table>


4. Is there a consensus on reform?

This approach is very different from the rule-based, one-size-fits-all Washington Consensus or the Growth Commission’s detailed set of recommendations. The emphasis is much more on flexibility and experimentation. Such a philosophy is reflected in China’s experiment with Special Economic Zones as a testing ground for private-sector participation, which has proven to be a success and spread to the rest of the country. The current liberalisation of the Chinese yuan (CNY) in the offshore market (CNH), starting with Hong Kong, is another example, using Hong Kong’s unique political and financial advantages as a step towards CNY internationalisation.

While China has experienced remarkable success in economic development and reducing poverty, its development model is far from flaw-free. There are serious worries that growth could slow sharply in coming years without major changes to the model, many of which are likely to be in the direction of the Washington Consensus or the Growth Commission, though doubtless with Chinese characteristics.

Mumbai Consensus and ‘inclusive growth’

In October 2010, Larry Summers, President Obama’s economic advisor, suggested the term Mumbai Consensus. In his view, this Mumbai Consensus is:

- Not based on ideas of laissez-faire capitalism that have proven obsolete or ideas of authoritarian capitalism that ultimately will prove not to be enduringly successful. Instead, a Mumbai Consensus is based on the idea of a democratic developmental state, driven not by a mercantilist emphasis on exports, but a people-centred emphasis on growing levels of consumption and an increasing middle class.8

Like the Beijing Consensus, this is far from a detailed prescription, and more an attempt to focus on some of the unique features of Indian growth, particularly the absence of export-led growth as a key driver and the important role of its vibrant democratic system and intense public debates (affectionately known as Delhi Discord). The quotation implies that India seeks a route different both to the Washington Consensus and China’s more autocratic system. However, whether India can succeed without following the usual path of export-led industrialisation is open to debate.

The Mumbai Consensus is not much discussed in India these days, but the idea of ‘inclusive growth’ is very popular. As the name suggests, this means economic growth which is broad-based across sectors and is inclusive of as much as possible of the country’s labour force. The Growth Commission puts considerable emphasis on this concept, advocating policies which balance rural versus urban sectors, support different regions and help women to fulfil their full educational and economic potential. The concept is also linked closely to the importance of poverty reduction.

While it might be argued that too much emphasis on inclusiveness could slow the rate of economic growth and hurt the poor in the long run, supporters argue that highly unequal growth may prove unsustainable if it provokes a severe political reaction. In Asia and in developed countries, inequality has increased over the last 20 years (based on Gini coefficients), though in Latin America inequality appears to have decreased, if from extremes.

8 http://www.whitehouse.gov/administration/eop/nec/speeches/india-global-economy
4. Is there a consensus on reform?

A matter of conditions, not choice

China’s and India’s approaches were not pre-packaged choices, but derived by default in response to prevailing conditions. China and India have two very different political systems, which facilitated their growth model. In China, the prevailing economic system allows rapid decision-making and implementation, especially in areas such as infrastructure. Competition among provincial and local governments to attract FDI and achieve strong growth is intense, since a strong economic performance advances the careers of local officials.

For India, the democratic process makes it difficult to put in place critical elements for an export-oriented economy, particularly infrastructure. India naturally focuses on the domestic economy instead of expanding its merchandise export base. It has been successful at outsourcing business processes and software engineering because of an ample and educated work force (although this section is still low as a proportion of total population), and these industries require little hard infrastructure.

In any case, as we have highlighted, the Beijing Consensus, the Mumbai Consensus and inclusive growth are at best partial frameworks. They provide little concrete reform guidance. Currently, neither China nor India is satisfied with its growth model. China 12th Five-Year plan has placed great emphasis on boosting consumption and diversifying away from exports. India is also looking to attract more FDI, although the current political backdrop makes this challenging.

Figure 4: Seoul Development Consensus – Six core principles

<table>
<thead>
<tr>
<th>Focus on economic growth</th>
<th>The G20 suggests that economic growth is closely linked with low-income countries’ (LICs’) ability to achieve the Millennium Development Goals. They state that measures to promote inclusive, sustainable and resilient growth should take precedence over business as usual.</th>
</tr>
</thead>
<tbody>
<tr>
<td>Global development partnership</td>
<td>LICs should be treated as equal partners, with national ownership of their own development. Partnership should be transparent and accountable.</td>
</tr>
<tr>
<td>Global or regional systemic issues</td>
<td>The G20 should prioritise regional or systemic issues where their collective action is best placed to deliver beneficial changes</td>
</tr>
<tr>
<td>Private-sector participation</td>
<td>The G20 recognises the importance of private actors in contributing to growth and suggests that policies should be business friendly</td>
</tr>
<tr>
<td>Complementarity</td>
<td>The G20 will try to avoid duplicating the efforts of other global actors, focusing its efforts on areas in which it has a comparative advantage.</td>
</tr>
<tr>
<td>Outcome orientation</td>
<td>The G20 will focus on tangible practical measures to address significant problems.</td>
</tr>
</tbody>
</table>

Sources: G20 Seoul Summit, Annex I,(see http://www.g20.utoronto.ca/2010/g20seoul-consensus.pdf), Standard Chartered Research
4. Is there a consensus on reform?

Seoul Development Consensus – Goals by flexible means
Following the global financial crisis, global leaders felt they needed a refreshed set of principles for how to approach international economic relations and development. With the expansion of the G7 to G20, this set of new principles was established in the 2010 G20 Seoul Summit. Again, rather than coming up with a rigid set of rules, the Seoul Development Consensus (SDC) focuses more on objectives, including poverty reduction and growth sustainability, and how to approach them (Figure 4).

The SDC is very much a consensus, hammered out by the G20 countries and reflecting political realities rather than simply technical advice. Stripped of the diplomatic jargon, we could paraphrase it as follows (slightly tongue in cheek): Growth is good and it should be inclusive, sustainable and resilient. Poorer countries should be treated with respect (presumably that means not simply ordered to comply with the Washington Consensus or similar structures). The G20 should focus on regional or systemic issues where it can make a difference, and stay out of the way of the IMF, the World Bank and regional development banks. The private sector is important because it contributes to growth. The G20 hopes to do something useful.

The point about the private sector is noteworthy because it runs counter to the free-market view that growth is created by the private sector once the government gets out of the way. The free-market view reached its high point sometime between the identification of the Washington Consensus and the 2008 crisis, and the emphasis has now shifted.

The Asian model versus the free-market model
Asia's economic rise in the past few decades was achieved by embracing many of the principles set out by the Washington Consensus. Asian countries also followed many of the recommendations of the Growth Commission, not surprisingly since the latter was based largely on analysing 13 success stories, the majority in Asia. Maintaining a competitive exchange rate has been a critical focus for Asian countries, exports have been a key driver, and saving and investment rates have been high. Government budgets have usually been managed well and tax rates kept low.

However, in three key areas there are significant differences in the way countries have grown and there remains controversy over whether the free-market approach is enough. Some leaders and researchers believe that it is necessary to depart from the 'purist' free-market approaches, especially in the early stages of development. Others believe it is not necessary and that maintaining heavy state involvement for too long could hold development back. This is one interpretation of the so-called middle-income trap, when countries grow rapidly for a while, then seem to run out of steam. This may be caused by the lack of new reforms, including the failure to unwind some of the interventionist things that worked at the beginning.

The first area of difference is the role of supportive industry policy versus privatisation. Many successful Asian corporations did receive state support in their infancy. Often whole industries or sectors were identified as potential leaders and then prioritised for government support. They were increasingly exposed to competition as they needed to compete internationally, but were often sheltered at home. South Korea is a good example of having both a successful policy to support its heavy industries,
4. Is there a consensus on reform?

such as automobiles, ship-building, steel and chemicals, as well as the consumer electronics sector, which was exposed to global competition from the start, and now is a global leader.

A second conundrum of economic development in Asia is the role of FDI. Korea, Japan and Taiwan have not been significant recipients of FDI, but they managed to set up their industrial base, which later translated into more mature R&D centres and high-value-added manufacturing. In contrast, China, Thailand, Vietnam and Indonesia have relied more on FDI to support their industrialisation. The capital brought in via FDI is only one benefit of such flows. The technological content and other soft skills (business organisation, management style, training etc) are also important for facilitating economic development. Geopolitically, the flow of people and international connections put Japan, Korea and Taiwan in a more advantageous position to absorb such technological progress than China or South East Asia. One answer to this debate is that later developers need foreign investment more than earlier developers.

The third main area of difference is the role of state-owned or state-led companies in development, as discussed above. It is clear that neither the Washington Consensus nor the Growth Commission is keen on the state trying to do too much. Yet many Asian countries, from Singapore to China, have grown rapidly, with state companies in the lead. Opponents argue that other countries with large state sectors have not grown rapidly, so there is no proof that this route was essential. But it remains controversial, and as free market ideas wane, proponents of state capitalism have become more confident. This is likely another manifestation of the shift in power from West to East.

Conclusion – A consensus nuanced by political realities

In our view, the Washington Consensus approach has stood the test of time, especially as developed, nuanced and broadened by the Growth Commission. An active state may be able to accelerate development, but it will be successful in the long run only if it is highly effective at managing the intervention and also, very importantly, withdraws at some point, usually better sooner than later. Most of the time, most countries have clear examples where the state needs to step back.

However, the other approaches discussed here also contain important nuggets of wisdom, especially in recognising the differing economic and political realities faced by different countries. In practice, all countries, but especially developing countries, face a whole range of areas where reform is needed, but implementation is nearly always difficult politically. Moreover, it is impossible to do everything at once, so prioritising and sequencing are vital. In this publication we identify one key reform area for each country that we believe is worth prioritising. But first, we look at the current progress of reform and ask whether it has slowed in recent years.
5. Reform has slowed

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- Both anecdotal evidence and scrutiny of international data suggest reform has slowed
- The reasons include resistance, complacency, resignation and disillusionment
- Top reformers since 1995 include Bangladesh, Vietnam, Botswana, India and Nigeria

A golden age of reform in the 1990s

Reform seems to have slowed after impressive changes in the 1990s. The 1990s was a crucial decade of reform, with China overhauling its state-owned companies and joining the WTO, India dismantling its ‘licence-raj’ system, Latin America defeating inflation and Central and Eastern Europe transforming their economies as they emerged from communism. These reforms helped to generate a particularly rapid rate of growth for the world economy in the early 2000s, but recently reform seems to have slowed.

The Economic Freedom Index, one of the best measures of progress in reforms, illustrates this well. Taking the average score of emerging countries since 1996, there was a significant improvement in the years to 2003, but the index has tracked sideways since then (Figure 1). Central and Eastern Europe is the only region which has improved throughout the period. The Middle East/North Africa (MENA) region also shows an upward trend, though most of the gains came early. Latin America and Africa also improved early on, but then scores fell back after about 2000, particularly in Latin America. Asia has tracked sideways (Figure 2).

In the West, countries enjoyed a spate of reforms in the 1980s and early 1990s including privatisation, liberalisation of labour and product markets, and granting full independence to central banks. The Economic Freedom index suggests that the West continued to improve slowly in the years from 1996 to 2008 (mainly due to gains in Australia and Canada), but has since deteriorated due to the economic crisis. The hard-earned macroeconomic stability in the West in the 1980s is now in question as government debts threaten to spiral out of control, government spending surges as a proportion of GDP and infrastructure spending declines. In Europe reform is being forced on some countries by the crisis there, though mostly on the countries in southern Europe that lagged in the 1980s and 1990s.

Figure 1: Economic freedom has stagnated since 2003
Average scores on the Economic Freedom Index

Figure 2: Central/Eastern Europe the only region still rising
Average scores on the Economic Freedom Index

Sources: The Heritage Foundation, Standard Chartered Research
5. Reform has slowed

**The Economic Freedom Index**

The Economic Freedom Index (EFI), from the Heritage Foundation is a measure of how far an economy has gone in the direction of free markets and small government (www.heritage.org/index). The approach is broadly in line with the Washington Consensus view of optimal economic policy, but it is probably fair to say that it pushes further in a neo-liberal direction. The analysis uses a wide range of available indicators as well as surveys and covers property rights, freedom from corruption, fiscal freedom, government spending, business freedom, trade freedom, fiscal freedom, monetary freedom, investment freedom, financial freedom and labour freedom.

Hong Kong and Singapore are the top two economies overall, with Australia, New Zealand and Switzerland following a little behind. Richer countries score higher on the EFI than poorer ones, but, on its own, this is evidence of correlation rather than causation. However, there is also good evidence that a significant improvement in the index score leads to faster economic growth. This is well borne out anecdotally, with evidence that countries which implement rapid reforms see a surge of growth in the years thereafter. The opening up of China, India and Vietnam are good examples.

### Strong overall trend to reform from 1995-2012

Looking first at the period from 1995-2012, eighteen countries improved their scores by five points or more, while only five saw a loss of more than five points (Figure 5, shows selected countries). This suggests that during last 15 years, reform in the direction of more liberal policy has been considerable. The stellar performers include many of the more obvious countries such as Bangladesh, Botswana, Peru, Vietnam, India and Nigeria. The weak performers are Argentina, whose score dropped by a stunning twenty points, but also Malaysia, Thailand and Korea, perhaps reflecting the continuing negative impact of the Asian crisis (with the comparison from 1995, just before the crisis). China, Indonesia and Russia were little changed over the period.

### Weaker trend in recent years

When we divide the period into two sub-periods, the picture since 2003 is less encouraging. The biggest gainers are Turkey, Nigeria, Malaysia and Vietnam. But

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**Figure 3: BRICs (Brazil, Russia, India and China)
Score on the Economic Freedom Index**

![Chart showing the Economic Freedom Index scores for Brazil, Russia, India and China from 1996 to 2011.]

**Figure 4: Improvers (Bangladesh, India, Nigeria, Vietnam)
Score on the Economic Freedom Index**

![Chart showing the Economic Freedom Index scores for Bangladesh, India, Nigeria and Vietnam from 1996 to 2011.]

Sources: The Heritage of Foundation, Standard Chartered Research
5. Reform has slowed

two of these countries – Turkey and Malaysia – saw declines from 1995-2003, so at least partly, they were just recovering. Several of the stellar performers for the whole period turn out to have delivered most of the gains in the first sub-period, with reform slowing markedly during 2003-12. This group includes Bangladesh, Botswana, Egypt, Peru, India and Brazil. Only Nigeria and Vietnam seem to be making strong recent progress.

World Economic Forum's Global Competitiveness Report

The Global Competitiveness Report (GCR) scores and ranks countries across twelve categories or pillars. These pillars include several common in the economics literature, including macro-stability, institutions, infrastructure, and goods and labour-market flexibility. The report also includes pillars which are derived more from a business-school view of the world, including technological readiness, business sophistication and capacity to innovate. The twelve pillars are weighted differently according to countries' stage of development and the approach recognises three stages.

Figure 5: Economic Freedom Index movers 1995-2012

<table>
<thead>
<tr>
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<tbody>
<tr>
<td><strong>Selected gainers 1995-2012</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Bangladesh</td>
<td>10.6</td>
<td>3.9</td>
<td>53.2</td>
</tr>
<tr>
<td>Botswana</td>
<td>11.8</td>
<td>1.0</td>
<td>69.6</td>
</tr>
<tr>
<td>Egypt</td>
<td>9.6</td>
<td>2.6</td>
<td>57.9</td>
</tr>
<tr>
<td>Peru</td>
<td>7.7</td>
<td>4.1</td>
<td>68.7</td>
</tr>
<tr>
<td>Vietnam</td>
<td>4.5</td>
<td>5.1</td>
<td>51.3</td>
</tr>
<tr>
<td>India</td>
<td>6.1</td>
<td>3.4</td>
<td>54.6</td>
</tr>
<tr>
<td>Nigeria</td>
<td>2.2</td>
<td>6.8</td>
<td>56.3</td>
</tr>
<tr>
<td>Jordan</td>
<td>2.6</td>
<td>4.6</td>
<td>69.9</td>
</tr>
<tr>
<td>Chile</td>
<td>4.8</td>
<td>2.3</td>
<td>78.2</td>
</tr>
<tr>
<td>Brazil</td>
<td>12.0</td>
<td>-5.5</td>
<td>57.9</td>
</tr>
<tr>
<td>Turkey</td>
<td>-6.5</td>
<td>10.6</td>
<td>62.5</td>
</tr>
<tr>
<td>Ghana</td>
<td>2.6</td>
<td>2.5</td>
<td>60.7</td>
</tr>
<tr>
<td><strong>Selected losers 1995-2012</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Argentina</td>
<td>-11.7</td>
<td>-8.3</td>
<td>48</td>
</tr>
<tr>
<td>Thailand</td>
<td>-5.5</td>
<td>-0.9</td>
<td>64.9</td>
</tr>
<tr>
<td>Malaysia</td>
<td>-10.8</td>
<td>5.3</td>
<td>66.4</td>
</tr>
<tr>
<td>Korea</td>
<td>-3.7</td>
<td>1.6</td>
<td>69.9</td>
</tr>
<tr>
<td><strong>Reference</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>US</td>
<td>1.5</td>
<td>-1.9</td>
<td>76.3</td>
</tr>
<tr>
<td>China</td>
<td>0.6</td>
<td>-1.4</td>
<td>51.2</td>
</tr>
<tr>
<td>Indonesia</td>
<td>0.9</td>
<td>0.4</td>
<td>56.4</td>
</tr>
<tr>
<td>Russia</td>
<td>-0.3</td>
<td>-0.3</td>
<td>50.5</td>
</tr>
</tbody>
</table>

Sources: Economic Freedom Index, Standard Chartered Research


10 The GCI also suggests reform was patchy in recent years, with gains mainly in the areas of infrastructure, education and health.
5. Reform has slowed

The GCR includes an assessment of over 100 variables and is based more heavily on surveys, though it also uses hard data for some indicators. It has changed and developed over the years, so we have looked only at the recent changes in the scores, comparing the 2012-13 report just published, with four years ago, the 2008-09 report. We find the following results:

1) Of 15 major developing countries, nine have improved their score, notably Saudi Arabia, Sri Lanka, China, Brazil and Indonesia, while six have worsened, notably Nigeria, Russia and Korea. The scores average out to a slight improvement.

2) The areas of greatest improvement are in infrastructure, health and primary education, macroeconomic stability and higher education.

3) The areas of deterioration are in goods-market efficiency, financial sophistication, labour-market efficiency and institutions.

**Figure 6: WEF Competitiveness indicators**

<table>
<thead>
<tr>
<th>Country</th>
<th>Change Last 4 yrs</th>
<th>Components better or worse</th>
</tr>
</thead>
<tbody>
<tr>
<td>Saudi Arabia</td>
<td>0.47</td>
<td>Better: Infrastructure, institutions, macro environment, higher education, technological readiness</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Worse: nothing</td>
</tr>
<tr>
<td>Brazil</td>
<td>0.27</td>
<td>Better: Infrastructure, tech readiness, macro environment, higher education.</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Worse: Goods-market efficiency</td>
</tr>
<tr>
<td>Sri Lanka</td>
<td>0.17</td>
<td>Better: Infrastructure, institutions, health/primary education</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Worse: Tech readiness, goods-market efficiency</td>
</tr>
<tr>
<td>Indonesia</td>
<td>0.15</td>
<td>Better: Infrastructure, macro stability, health/primary education</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Worse: Labour-market efficiency, goods market efficiency, financial sophistication</td>
</tr>
<tr>
<td>Singapore</td>
<td>0.14</td>
<td>Better: Macro, health/primary education, technological readiness</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Worse: Goods-market efficiency</td>
</tr>
<tr>
<td>China</td>
<td>0.13</td>
<td>Financial-market sophistication, health/primary education, infrastructure</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Worse: Goods-market efficiency</td>
</tr>
<tr>
<td>Taiwan</td>
<td>0.06</td>
<td>Health/primary education, institutions, higher education</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Worse: Financial sophistication, tech readiness, macro</td>
</tr>
<tr>
<td>HK</td>
<td>0.05</td>
<td>Better: Health/primary education, infrastructure, higher education</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Worse: Financial-market sophistication, goods-market efficiency, institutions</td>
</tr>
<tr>
<td>Malaysia</td>
<td>0.02</td>
<td>Better: Higher education, goods market efficiency</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Worse: nothing significant</td>
</tr>
<tr>
<td>India</td>
<td>-0.01</td>
<td>Better: Health/primary education, infrastructure</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Worse: Institutions, goods-market efficiency</td>
</tr>
<tr>
<td>South Africa</td>
<td>-0.04</td>
<td>Better: Financial sophistication, health/primary education</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Worse: Macro environment, Institutions, goods and labour-market efficiency</td>
</tr>
<tr>
<td>Thailand</td>
<td>-0.08</td>
<td>Better: Macro environment</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Worse: Institutions, financial-market sophistication, labour-market efficiency</td>
</tr>
<tr>
<td>Russia</td>
<td>-0.11</td>
<td>Better: Macro environment, Infrastructure</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Worse: Financial sophistication, labour-market efficiency</td>
</tr>
<tr>
<td>Nigeria</td>
<td>-0.14</td>
<td>Better: Macro environment, Tech readiness</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Worse: Financial sophistication, health/primary education</td>
</tr>
<tr>
<td>Korea</td>
<td>-0.16</td>
<td>Better: Infrastructure, health/primary education, macro</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Worse: Institutions, goods-market efficiency</td>
</tr>
<tr>
<td>Average</td>
<td>0.06</td>
<td>Better: Infrastructure, health/primary education, higher education.</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Worse: Goods-market efficiency, labour-market efficiency, institutions</td>
</tr>
</tbody>
</table>

Sources: World Economic Forum, Global Competitiveness Report 2012-13, Standard Chartered calculations
5. Reform has slowed

These results also suggest that reform, while proceeding, is patchy and less impressive than in the past. The biggest gains in competitiveness appear to be in infrastructure spending and health and education spending.

Where the GCR gives particular cause for concern is that in some of the key areas of reform such as goods market efficiency there were very few countries showing significant improvement and many showing worsening. Also, 5 of the 16 emerging countries showed deterioration in institutions versus three improving. Overall then, while the direction is still positive, the GCR suggests that reform is fairly slow, with some countries in some categories going in the wrong direction.

Ease of Doing Business survey

The World Bank’s Ease of Doing Business survey (www.DoingBusiness.org, henceforth DB), looks at key factors for companies in doing business, ranging from ease of starting a business, through getting credit, to enforcing contracts. The report publishes detailed data on these various components, together with an overall ranking of countries. A welcome innovation is a new ‘distance to frontier’ measure, which shows the distance countries would have to travel to be the best in all of the categories, but this information is only available since 2006.

Figure 7: Distance to frontier 2006-12

<table>
<thead>
<tr>
<th>Country</th>
<th>ppt moved</th>
<th>Distance remaining</th>
</tr>
</thead>
<tbody>
<tr>
<td>Egypt</td>
<td>16</td>
<td>45</td>
</tr>
<tr>
<td>Colombia</td>
<td>16</td>
<td>30</td>
</tr>
<tr>
<td>Saudi Arabia</td>
<td>16</td>
<td>26</td>
</tr>
<tr>
<td>China</td>
<td>14</td>
<td>42</td>
</tr>
<tr>
<td>Sierra Leone</td>
<td>14</td>
<td>49</td>
</tr>
<tr>
<td>Angola</td>
<td>11</td>
<td>57</td>
</tr>
<tr>
<td>India</td>
<td>11</td>
<td>50</td>
</tr>
<tr>
<td>Russia</td>
<td>10</td>
<td>44</td>
</tr>
<tr>
<td>Morocco</td>
<td>10</td>
<td>39</td>
</tr>
<tr>
<td>Ghana</td>
<td>10</td>
<td>35</td>
</tr>
<tr>
<td>Mexico</td>
<td>9</td>
<td>30</td>
</tr>
<tr>
<td>Nigeria</td>
<td>9</td>
<td>48</td>
</tr>
<tr>
<td>Indonesia</td>
<td>8</td>
<td>46</td>
</tr>
<tr>
<td>Thailand</td>
<td>7</td>
<td>41</td>
</tr>
<tr>
<td>Tunisia</td>
<td>7</td>
<td>41</td>
</tr>
<tr>
<td>Korea</td>
<td>7</td>
<td>20</td>
</tr>
<tr>
<td>Zambia</td>
<td>7</td>
<td>40</td>
</tr>
<tr>
<td>UAE</td>
<td>7</td>
<td>35</td>
</tr>
<tr>
<td>Malaysia</td>
<td>7</td>
<td>22</td>
</tr>
<tr>
<td>HK</td>
<td>6</td>
<td>10</td>
</tr>
<tr>
<td>Vietnam</td>
<td>6</td>
<td>41</td>
</tr>
<tr>
<td>Taiwan</td>
<td>5</td>
<td>28</td>
</tr>
<tr>
<td>Bangladesh</td>
<td>5</td>
<td>45</td>
</tr>
<tr>
<td>Disappointing countries</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Venezuela</td>
<td>-7</td>
<td>68</td>
</tr>
<tr>
<td>Zimbabwe</td>
<td>-4</td>
<td>62</td>
</tr>
<tr>
<td>Italy</td>
<td>0</td>
<td>39</td>
</tr>
<tr>
<td>Brazil</td>
<td>0</td>
<td>55</td>
</tr>
<tr>
<td>Philippines</td>
<td>1</td>
<td>51</td>
</tr>
<tr>
<td>Pakistan</td>
<td>2</td>
<td>42</td>
</tr>
</tbody>
</table>

Source: www.DoingBusiness.org
5. Reform has slowed

The DB survey suggests there has been major progress in recent years. Of 174 countries in the database, 163 have moved closer to the frontier overall and only 11 have moved away. In practice, a large number of countries have moved only slightly, but if we take movement of 5ppt as significant, then 87 countries have improved significantly and only one has deteriorated by more than 5ppt (Venezuela).

The two categories with the most improvement (averaging across all countries) are the ease of starting a business and the ease of getting credit. While the former is primarily about simplifying bureaucratic processes and the World Bank has been helping countries improve here for some time, the improvement in the ease of getting credit suggests significant development in the financial sector. We will come back to this below.

Many of the countries that score well on the Economic Freedom Index (EFI) have also made improvements on this measure, which is not too surprising since some of the components here are included in the EFI. But it is also notable that several of the countries which looked to be doing poorly on reform overall on the EFI show significant improvements here including Saudi Arabia, China, Russia, Thailand and Malaysia. This is valuable, though it is only one element of economic reform.

Six countries are very disappointing on this measure. Venezuela and Zimbabwe show outright deterioration, perhaps unsurprisingly. Four other countries – Italy, Brazil, Philippines and Pakistan – all show little or no improvement, despite being quite far from the frontier. Greece improved by 4ppts (below our cut-off of 5ppt), but ranks an extraordinarily low 100, just behind Yemen and Vietnam.

**Economic growth performance**

An alternative way to measure whether reform is happening is to look at economic growth performance, on the grounds that if economies are growing fast, they must be doing something right. Our analysis of fast-growing countries (Special Report, 17 September 2010, “The 7% Club”), found 16 countries that were growing at 7% or more in 2007 (just before the crisis) and had been for 5 years or more. Encouragingly this was the largest number seen in the last 30 years. However a closer analysis of the countries involved is not so encouraging. The majority of the fast-growing 16 countries were commodity producers, with only a few – Cambodia, China, India and Vietnam – not reliant on commodities.

**The Asian crisis promoted certain reforms, not others**

Crises are often thought to be catalysts of reform and the 1997-2008 Asia crisis was severe, much worse than the 2008-09 downturn for the countries concerned. At the time, there was much criticism of the structure of Asian economies from the West, in line with the free-market view of the world then prevalent. Interestingly, the Economic Freedom Index suggests that none of the Asian economies most directly impacted by the crisis (Thailand, Indonesia, Korea and Malaysia) have improved their scores since 1996. While they score reasonably well on the index, they are well behind Hong Kong and Singapore. So it seems these economies did not respond to the crisis by reforming in the direction of economic freedom.
5. Reform has slowed

Nevertheless, these four countries did change, not only by restoring macroeconomic stability, but also by taking measures to make a recurrence of the crisis less likely. Exchange rates were allowed to become more flexible (except initially in Malaysia, which re-fixed with exchange controls at a lower level until 2005) and emphasis was put on avoiding a current account deficit and building up stronger foreign-exchange reserves. Private foreign borrowing was more closely managed, the financial sector was re-organised and regulation and supervision were tightened.

These advances meant that all four were in a relatively strong position when the 2008-09 crisis hit. But all four have also seen economic growth remain on a significantly slower trend than in the decade prior to the crisis. A key reason for this is that their investment-to-GDP ratios have remained much lower than pre-1997. Overall, this suggests that while the 1997 crisis did lead to important reforms, countries could have done more to create the conditions for fast growth.

A survey of six main areas of reform

1. Macro stability – Good news

In contrast to the 1980s in Latin America and the 1990s in East Asia, most emerging countries have achieved both improved stability and stronger defences. Broadly speaking, budget deficits, government debt ratios, private-sector debt ratios, inflation and current account deficits are low or manageable, while FX reserves are strong and financial regulation has been improved. For those who recall the repeated Latin American crises in the past, the disappointments in Africa, and the Asian crisis, this is hugely welcome. Moreover, most emerging countries showed impressive resilience to the shock of the Great Recession in 2008-09. Many underwent a recession or sharp economic slowdown, but nearly all bounced back with their sound fundamentals intact.

For a number of countries, the transformation in macro-stability has been a key source of economic success in recent years, perhaps most notably in Brazil, the Philippines, South Africa and Egypt (at least until the latest political changes). These countries now need other kinds of reform, to achieve really fast growth. However, there are still a few countries with significant macroeconomic weaknesses; e.g., Turkey’s large current account deficit, India’s budget deficit and Vietnam’s inflation.

One concern is that many emerging countries are now heavily dependent on high commodity prices. Among oil-producers for example, the ever-increasing break-even oil price for government budgets could cause problems even with a pull-back to USD 70-80/barrel. In our view, commodity prices will generally remain buoyant for quite a few more years, but this is not guaranteed and the cycle will turn eventually. The critical issue is whether countries can use the boom to push economic development and living standards forward, while strengthening their economies to withstand the inevitable downturn when it comes.

The source of recent US instability, a housing bubble and bust, could also hurt certain emerging countries, such as China, though governments are not shy of using strong macro-prudential policies to limit the dangers. Overall, the number of emerging countries in good macroeconomic shape is far larger than in previous decades. This is a key base for further reform, though it also requires vigilance to maintain.
5. Reform has slowed

2. Trade and FDI are opening up, though the Doha Round seems dead

This is another area that showed considerable success over the last decade or so. The Uruguay Round was signed in 1994 and came gradually into force from 1995-2000. A number of countries, including China, Saudi Arabia and Vietnam joined after the initial set-up in 1995, with the latest, Russia in September 2012 (Figure 8). Tariffs on industrial products were brought down significantly. China’s entry was a crucial element in leveraging a range of other reforms then, as well as cementing China in the global production chain. The expiration of the Multi Fibre Arrangement in 2005 was also a significant step forward for lower-income countries in freeing up the production chain. Countries with a comparative advantage in this area, notably Bangladesh, Cambodia, India, Vietnam and China, gained, though others in Africa and parts of Latin America lost out.

The Uruguay Round was the last of eight rounds of trade liberalisation since WWII, but it is nearly 20 years old now and progress in global talks has stalled. The Doha Round, which aimed to tackle services and agricultural trade is considered dead-in-the-water; instead, there has been movement on a series of bilateral and regional agreements. While these are often important drivers of new trade corridors and activity, they can sometimes divert trade in inefficient ways. Global trade agreements are better because they ensure that countries specialise in areas in which they have comparative advantages and enjoy the benefits of the lowest international costs.

Still, new progress on a multilateral basis looks impossible and back-tracking is a major concern. Fortunately, when emerging countries negotiate deals with the US or EU, the effect is usually to significantly open up some of their sectors as well as improve their access to developed-country markets, which can be very helpful.

3. Competition among producers is a mixed story

In Chapter 3 we noted that while it is probably optimal to have the economy comprised mainly of private-sector companies at arms’ length from government, what really matters is the level of competition. Yet in many countries, important areas of the economy are often dominated by monopolies or oligopolies. Frequently these firms are either state-owned or closely linked to the government, which makes it harder to force competition on them. The recent crisis held back privatisation in some countries due to weak stock markets and limited investor interest. But some governments believe that state-owned companies or state-backed ‘national champions’ are the best way to go. This may indeed help with competing internationally, but if it leads to monopoly or oligopoly at home it is not helpful.

Figure 8: WTO membership time-line

<table>
<thead>
<tr>
<th>100+ founder members</th>
<th>1995</th>
</tr>
</thead>
<tbody>
<tr>
<td>Oman</td>
<td>2000</td>
</tr>
<tr>
<td>Jordan</td>
<td>2000</td>
</tr>
<tr>
<td>China</td>
<td>2001</td>
</tr>
<tr>
<td>Taiwan</td>
<td>2002</td>
</tr>
<tr>
<td>Cambodia</td>
<td>2004</td>
</tr>
<tr>
<td>Saudi Arabia</td>
<td>2005</td>
</tr>
<tr>
<td>Vietnam</td>
<td>2007</td>
</tr>
<tr>
<td>Russia</td>
<td>2012</td>
</tr>
</tbody>
</table>

Source: WTO
5. Reform has slowed

In many countries of all types, lack of competition for the provision of key business inputs such as energy, financial services, land and telecoms has contributed to inefficiencies and weak national competitiveness. Some oil-producing countries maintain a monopolistic national oil company and this has been a significant drag both on increasing output, as well as improving efficiency.

Measures are limited, but the Global Competitiveness Report surveys noted above suggest that product-market efficiency, one component of this issue, has not been progressing well in recent years. To the extent that more and more goods and services are internationally traded, this lack of domestic competition may be offset by international competition, but this takes us back to the limited progress on reducing trade barriers, especially in services, noted above.

4. Reforms to improve labour-market flexibility are slow

The GCR indicators suggest that progress on reforming labour markets is also slow. Lack of labour-market flexibility is a major problem in some countries, both developed and developing. This can discourage investment in manufacturing, especially now that manufacturing has become a globalised activity. If one country has an unattractive labour market, companies will go to another. Reform in this area is notoriously difficult. In Europe, for example it has taken the euro crisis and immense pressure from the combined weight of the EU and the IMF to push Greece, Spain and Italy to reform their labour laws.

5. Infrastructure varies markedly

Some countries are doing an impressive job building physical infrastructure. Ample finance from the commodity boom in commodity producing countries or high saving rates, notably in the case of China, are a big help here. But other countries are struggling to make projects happen, usually because of difficulties obtaining land or governance limitations. India and Indonesia are good examples.

Public-Private Partnership (PPP), a relatively new innovation, is helping in some countries. While sometimes criticised for costing more than if they were financed wholly by the state, PPP can also catalyse more money into infrastructure as well as increase market disciplines in procurement and operating. PPP can also harness foreign investor money looking for long-term stable returns.

The fiscal response to the crisis stimulated a burst of infrastructure projects, particularly in emerging countries and most notably in China. In developed markets draconian budget cuts tend to hit infrastructure spending hard. Ideally, many Western governments would use the opportunity of ample spare resources (especially in the construction sector) and low long-term borrowing costs to fund important infrastructure renewal and growth. In practice this is not happening, one of the key “mistakes” identified by the Growth Commission (see Chapter 4).

6. Institutional weaknesses are a barrier to progress in some countries

As already noted, the original Washington Consensus formulation probably underplayed the importance of good institutions, though legal security for property rights was one of the 10 policy recommendations and good institutions were perhaps implicit. Still, along with other analysts, we are inclined to give this area of reform a strong emphasis, especially since it covers a wide area.
5. Reform has slowed

Countries may fall down institutionally in a number of ways. Political institutions may be unable to formulate good policies because of some kind of gridlock or stand-off (examples might include the US, Thailand, India). Sometimes this can be resolved quickly with an election which changes the balance of parties, but other times the problem seems more embedded. Implementation of policies may be weak because of inefficiency or corruption. Particular institutions such as the central bank or regulatory agencies may be weak, corrupt or inefficient, or too subject to political interference. The GCR found a significant deterioration in institutions in five countries with an improvement in three, suggesting that institutional reform is not necessarily going in the right direction.

Huge potential for faster growth

As we argued in our 7% Club analysis, average long-term GDP growth rates of 7% or more are within the reach of all emerging countries if they make the right reforms. This is also the theme of the Growth Commission’s report discussed in the last chapter. At 7% p.a., an economy’s GDP doubles roughly every 10 years and quadruples every 20.

Historically, the most successful emerging countries have achieved growth rates even higher than this, frequently averaging 8% or more over long periods. Nor were these rates achieved only in the very early stages of development. Japan’s growth still averaged 8.5% p.a. in the 10 years to 1973 when its per capita GDP hit USD 25,000 (in 2011 USD), Hong Kong grew at 8.3% in the 10 years to 1988, reaching USD 22,000 and Singapore maintained growth at over 7% until 1997, when its per-capita income reached about USD 28,000. South Korea, also hugely successful during the early stages of development, saw growth slow somewhat earlier in its development, in 1997 when its per-capita income was USD 13,000.

These examples suggest that most emerging countries whose per capita GDP is still well below these levels have the potential for rapid growth for many years, even decades, if they can get policy right. For some countries today we might need to subtract 1-2ppt for slower population growth than in these historical examples. But this does not apply to India or Nigeria, for example, which still have relatively strong population growth.

Figure 9: Potential growth rates assuming reform

<table>
<thead>
<tr>
<th>GDP per capita USD</th>
<th>GDP growth 1997-2007</th>
<th>GDP growth 2011-12F</th>
<th>Current trend growth our estimate</th>
<th>With reform, growth potential</th>
</tr>
</thead>
<tbody>
<tr>
<td>Brazil</td>
<td>12,789</td>
<td>2.8</td>
<td>2.2</td>
<td>3.5</td>
</tr>
<tr>
<td>China</td>
<td>5,414</td>
<td>9.9</td>
<td>8.5</td>
<td>6.5</td>
</tr>
<tr>
<td>India</td>
<td>1,389</td>
<td>7.2</td>
<td>5.9</td>
<td>6.5</td>
</tr>
<tr>
<td>Indonesia</td>
<td>3,509</td>
<td>2.8</td>
<td>6.4</td>
<td>6</td>
</tr>
<tr>
<td>Nigeria</td>
<td>1,490</td>
<td>5.2</td>
<td>7</td>
<td>7</td>
</tr>
<tr>
<td>South Korea</td>
<td>22,778</td>
<td>4.4</td>
<td>3</td>
<td>4</td>
</tr>
<tr>
<td>Sri Lanka</td>
<td>2,877</td>
<td>5</td>
<td>7.7</td>
<td>7</td>
</tr>
<tr>
<td>Taiwan</td>
<td>20,101</td>
<td>4.7</td>
<td>3</td>
<td>4</td>
</tr>
<tr>
<td>Thailand</td>
<td>5,394</td>
<td>3.4</td>
<td>2.3</td>
<td>5</td>
</tr>
</tbody>
</table>

Sources: World Bank, Standard Chartered Research
5. Reform has slowed

For higher income countries such as Brazil, and especially for Korea and Taiwan, such high rates are probably out of reach now but, with the right policies, these countries could almost certainly grow faster. Also, the analysis here suggests that, for many countries, failure to implement necessary reform could see growth slow from the current trend path in coming years. Reform is an ongoing process and countries often require different structures at different stages of development. Overall then, emerging countries which fail to pursue reform may be giving up the potential to grow at anything from 1-3ppt faster.

**Outlook for the three largest Asian countries**

India has recently stepped up the reform effort, after growth slowed to the 5-6% range, far slower than the 9% rate seen as achievable only a year or two ago. We expect that the recently announced reforms, together with improvements expected in power supply, will enable growth to pick up to 6.5% over the next few years, or about 5% p.a. in per capita terms. But India has the potential for much higher growth. With extensive further reform, India could maintain a GDP growth rate of 9% p.a., implying per capita gains of 7.5% p.a. Then it would achieve a 50% higher per-capita income by 2030 than if growth continued at an average 6.5% rate.

Indonesia has performed well in recent years, as we highlight in the next chapter, but it has the potential to grow even faster, given its still-early stage of development. With GDP growth of 8% p.a., implying per capita gains of 7% p.a., Indonesia would be 40% better off in per capita terms by 2030, than otherwise, and approach Brazil’s average standard of living. Indonesia grew at rapid rates for many years prior to the 1997 crisis and still has the potential to regain this trajectory.

Finally China, which has been the star of development in the last couple of decades, has achieved 10% p.a. growth on average. Somewhat slower growth seems inevitable over the next decade as labour-force growth slows and the pool of rural labour dwindles. Population growth has fallen to only about 0.5% p.a. now and will fall further in coming years, making per-capita income growth little different from total income growth. However we believe that 8.5% per capita growth is possible for many more years if China succeeds in implementing all the necessary reforms. The difference between achieving an average 8.5% per capita growth rate rather than 6.5% is that average living standards will be 40% higher in 2030.

**Figure 10: GDP per capita in 2030 depends on reform efforts**

<table>
<thead>
<tr>
<th></th>
<th>GDP per capita 2011 USD</th>
<th>At 3%</th>
<th>At 5%</th>
<th>At 7%</th>
<th>At 8%</th>
</tr>
</thead>
<tbody>
<tr>
<td>Brazil</td>
<td>12,789</td>
<td>21,772</td>
<td>30,778</td>
<td>Not likely</td>
<td>Not likely</td>
</tr>
<tr>
<td>China</td>
<td>5,414</td>
<td>9,217</td>
<td>13,029</td>
<td>18,299</td>
<td>21,634</td>
</tr>
<tr>
<td>India</td>
<td>1,389</td>
<td>2,365</td>
<td>3,343</td>
<td>4,695</td>
<td>5,550</td>
</tr>
<tr>
<td>Indonesia</td>
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<td>Not likely</td>
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<td>12,981</td>
<td>18,231</td>
<td>21,555</td>
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</table>

Sources: World Bank, Standard Chartered Research
5. Reform has slowed

Why has reform slowed?
We have argued that, while reform has certainly not stopped, the pace has slowed in recent years and a number of important emerging countries are progressing more slowly than they ideally would. The question then is, why? It is hard to generalise, and the answer is likely different in different countries, but we suggest the following reasons:

1) Complacency: Countries already growing fast, due to commodity riches or to successful past reform may rest on their laurels, rather than stepping up to the next level. Growth may falter after a while if the benefits of high commodity prices or past reform dwindle.

2) Resignation to slow growth: Some countries seem to be resigned to slow growth and adapting to it, rather than seeking to break out of it. The so-called middle-income trap is controversial, but may apply to some formerly fast-growing countries such as Thailand. Now, the developed countries may be in a ‘deleveraging trap’. The example of Japan shows that even a disappointing performance over a long period may not trigger reform, if things are not too bad.

3) Lack of a ‘good crisis’: Tellingly, some countries in crisis in recent years are reforming fast – Iceland, Estonia, Greece, Spain and Italy. However, as we noted in East Asia, reform following a crisis does not always go far enough.

4) Political resistance: Weak governments, strong lobbying by vested interests as well as resistance from voters may be preventing progress in some countries.

5) Disillusionment with market-oriented reforms: The free-market model is severely tarnished by the US crisis, which has given the green light to alternative approaches. Some of these approaches may still work, given the right conditions (such as relatively efficient, non-corrupt governments), but others likely will not.

6) Rising population: This is making congestion an increasing problem, raising land values and making infrastructure projects harder.

Conclusion and implications
Reform has certainly not stopped, but the pace has slowed. Progress is still being made in most countries, to varying degrees. But the need for reforms is still huge in emerging countries as they seek to catch up with the developed countries as fast as they can, while the West and Japan now face the serious challenge of how to generate economic growth in a much more difficult environment than pre-2008.

Some Asian countries face the risk of falling into the ‘middle-income trap’ of slow growth, unless they step up the pace of reform. Hopes for very high sustainable rates of growth have faded somewhat and China may be heading for a slower pace too, unless the new economic leadership can step up and embrace faster reform.

Africa has become a growth story over the last 10 years, boosted by reforms, commodity-price strength and increased aid and debt forgiveness. Most countries have achieved a degree of macroeconomic stability which was elusive for a long time after independence. The key to sustaining strong growth will be using these gains to cement a stronger economic structure. The Middle East is in transition. Political changes in some countries could open the door to a renewed economic reform push, but it is too early to tell and, initially, economies are struggling. The Gulf oil producers need to use the oil bonanza to diversify their economies.
5. Reform has slowed

In Latin America, broad macroeconomic stability has been achieved in most countries and the commodity boom is helping. Again, reforms are needed to help follow the example of Chile, with its sustained strong development. Central and Eastern Europe has the best reform record of the last 15 years, helped by the magnet of joining the European Union.

For the developed countries, the 2008-09 crisis created problems in itself, but also brought forward the looming crisis of ageing. The widening distribution of income is also a challenge for developed economies, including Hong Kong and Singapore.

We have argued that the world entered a new super-cycle around the beginning of this millennium, a period of historically high growth lasting a generation or more (see The Super-Cycle Report, 14 October 2010). We still believe that the super-cycle is on track for the medium term, because we are optimistic that, over time, governments and countries will rise to the occasion and implement the necessary reforms. Predicting which countries will accelerate reform and when is very hard. Sometimes the trigger can be a new government, a crisis, or a long-planned process that finally comes to fruition – as in trade opening. However, we are sure that when countries accelerate reform they will in time see the benefits and, moreover, markets will usually react early.

The country section of this report presents a series of articles on some of the main countries in Standard Chartered’s footprint, where we have economists on the ground. Each article focuses on one key reform, or area of reform, which would make a major difference to growth prospects. First we look at how markets react to reform.
6. Market implications

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- Reforms boosting macro-stability enhance returns and lower volatility
- Reforms that accelerate supply-side growth usually do the same
- Markets also gain from increased liquidity and transparency, which bring in new investors

Summary – Deepening and strengthening markets

Macro-stability reform is critical for rates and FX markets

When countries achieve macro-stability they usually see lower real and nominal interest rates, with less volatility. The exchange rate also typically shows less volatility whether managed or floating. Fixed exchange rates are less prone to periodic major moves. A disciplined budget position is one key requirement of macro stability, helping to curb inflation and encouraging markets to fund the deficit; a failure to do either can cause a crisis. How to avoid private-sector booms and bubbles – another cause of crises both in Asia in the 1990s and the developed countries recently – is controversial, but the answers likely include sound fiscal and monetary policy, macro-prudential regulations and good banking supervision.

Supply-side reforms accelerate growth and are good for investors

Supply-side reforms which boost growth have a different effect on markets than faster growth arising from increasing demand; for example, due to cuts in official interest rates or higher fiscal spending. Improved supply-side growth will usually lead to a lower level of interest rates and reduced rate volatility. This is because a stronger supply side lowers inflationary risks both directly by pushing prices down and indirectly by making it easier for governments to balance budgets. Similarly, fast-growing economies will often tend to have appreciating exchange rates, partly because rapid productivity growth improves competitiveness and partly because economic success brings capital inflows.

Faster growth works to deepen and widen equity and credit markets, which can enhance liquidity and transparency and therefore bring in new investors. To the extent that it reinforces macro-economic stability, (less risk of ‘boom and bust’) it will reduce volatility and lower the risk that investors face a major downdraft at some point. For investors in credit, progress on accelerating economic growth should help to lower spreads within rating categories, but also lead to more rating upgrades. All these factors can boost returns.

It is hard to find a strong, direct relationship between the rate of economic growth in a country and the performance of its stock market. There are good reasons for this, including that economic growth in EM is often driven by exporting companies while stock markets are dominated by banks, real estate and utilities. However, there are plenty of good examples of countries which make big strides forward in reforms seeing very strong stock market returns in ensuing years, alongside faster growth, including China, India, Brazil, Egypt, Indonesia and others. Here we look at the experience of Indonesia and argue that the Philippines could also see significant market gains if it can make progress in reform in the key areas of energy, infrastructure and mining.
6a. Market implications – FX

The exchange-rate reaction to the reform process is simple in theory, but more nuanced in practice
EM reforms to boost infrastructure should boost growth expectations and the local currency
US tax reform, if passed, would be a major multi-year positive for the USD

On the face of it, the response of FX markets to an accelerated reform process is obvious. If reform results in more liberalised markets and faster economic growth, this will lead to changes in both the current and capital accounts within the balance of payments, boosting capital inflows and as a result the local currency.

In practice, the response from FX markets is likely to be more nuanced. Much depends on what part of the economy reform targets. If reform is focused on boosting infrastructure, it should support expectations for accelerated domestic demand. This will lead to deterioration in the external balance, but should be offset by higher capital inflows, resulting in local currency appreciation. However, if reform targets liberalising capital markets, it may lead to net capital inflows or outflows depending on the nature of the capital account.

Much of the reform process is in EM rather than developed (DM) economies. Within this, the focus for reforms in Brazil, India and Indonesia is very much on infrastructure. Inadequate infrastructure is restraining the potential growth rates of these countries. As such, this should lead to expectations for higher growth and higher capital inflows from international investors. However, some countries – notably Brazil – have taken measures to counteract the impact of existing capital inflows on their domestic markets, including the exchange rate. As such, EM countries that pursue domestically focused reforms such as infrastructure development should ideally combine this with reform measures to liberalise capital outflows to balance out the overall effect on the economy and competitiveness.

EM countries began their economic reform process through external trade liberalisation. The next stage is likely to be more domestic – labour, infrastructure and further domestic capital market liberalisation. China’s gradualist approach to economic and market reform is likely to extend with interest-rate reform. When China’s capital account is fully opened, interest-rate reform over time should allow for higher interest rates. Uncovered interest-rate parity suggests that higher interest rates should, over the medium- to long-term, lead to exchange-rate depreciation. However, practically, in the short term at least, higher interest rates should lead to higher capital inflows and therefore exchange-rate appreciation.

In the G4, the reform process is happening at a time of elevated budget deficits and as such may be focused on ways of boosting state revenues and reducing external dependency. In the US, tax reforms – aimed at boosting tax revenues via the Laffer Curve – would be a net positive for the budget (if passed) and for the US dollar (USD). While the Mundell-Fleming approach to exchange rates states that in a world of free capital mobility the policy combination of easy monetary policy and tighter fiscal policy should lead to exchange-rate depreciation, in practice the multi-year trends for the USD TWI and the US budget deficit show clearly that fiscal consolidation is a medium-term positive for the USD.
6b. Market implications – Rates and credit

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- Growth unleashed by reform will be positive for the development of international debt markets
- Deepening of financial markets needs more than just improved physical infrastructure
- Better corporate governance will bring in more investors and lower the credit risk premium

The reform process will clearly have a positive impact on economic growth – and will allow these countries to achieve higher and more sustainable economic growth. Our analysis (for details please see Special Report, ‘The Super-Cycle Report’, 14 November 2010) suggests that higher per-capita income growth has a positive impact on the size of the international debt markets (Figure 1).

More importantly, however, the combination of rising per-capita income levels, macroeconomic stability and investment requirements – especially for those countries outlined in this report requiring significant infrastructure capacity – is likely to drive development of domestic capital markets. ‘Original sin’ – the term coined by Eichengreen and Hausmann in 1999 to characterise the inability of many sovereigns to fund in domestic currency – led to significant currency mismatches in EM economies, and was a contributing factor in the Asian financial crisis. By developing macroeconomic stability and greater currency predictability, the reforms we describe in this report can also lead to a virtuous circle in capital market development and a reduction in ‘original sin’ (Figure 2).

Higher economic growth will also likely improve the potential for corporate earnings, which in turn should help improve the outlook for ratings and lower the probability of default. All things being equal, this should have a beneficial impact on the country risk premium – and should help lower credit spreads for the issuers from the countries in question.

Figure 1: AXJ international bonds show stellar growth

Figure 2: Domestic-currency debt as a percentage of total has increased, reducing ‘original sin’
6b. Market implications – Rates and credit

Infrastructure offers opportunities

As highlighted in this study, infrastructure remains a huge growth bottleneck for countries ranging from India and Indonesia to Brazil. In our view, addressing the infrastructure bottleneck will result in more widespread economic growth – helping bring new players into the economic sphere. This will likely result in players others than banks (in India) and commodity companies (in Indonesia) tapping the international capital markets. We also suspect that a large number of these infrastructure projects are likely to be debt-funded (both in international and local currency debt) via public-private partnerships.

That said, while per-capita income growth is an important consideration, growth of these markets will likely depend on a number of different things. Development of soft infrastructure, including local-market regulatory, pension-sector and financial-sector reforms will be critical in helping develop these markets further. Larger pools of savings are strongly associated with higher per-capita income, as savings vehicles such as life insurance and a private pension are luxury goods when compared with the basics of food and housing. Nevertheless, the relationship between per capita GDP and non-bank financial assets is impressively robust (Figure 3).

With appropriate regulatory reform to encourage both the development of these investor categories and their role in domestic debt market development – such as second and third pillar pension reform, risk-based capital frameworks for life insurance, and a robust regulatory regime for mutual funds – infrastructure needs can be financed in domestic currency through domestic savings pools. More stable, long-term allocations from international investors are also likely, with many emerging economies already seeing significant allocations either directly or indirectly from global pension funds, insurance companies and central banks, albeit still significantly below the proportion of foreign holdings in developed economies. The interest-rate liberalisation that we discuss for China plays an even more direct role in such developments.

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Figure 3: Domestic institutional investor size increases with income growth (2010)

NBFI assets (log scale) vs. PPP GDP (per capita, USD)

Figure 4: 144a issuance is lower in Asia in 2012

EM 144a/non-144a issuance YTD by region (USD bn)

Sources: Bloomberg, Standard Chartered Research

Sources: Bond Radar, Standard Chartered Research
6b. Market implications – Rates and credit

Such reforms ensure that savings earn a fairer rate of return, thereby reducing the risk of misallocation of investment and capital. As highlighted in the chapter on reform in China, this is a very important reform consideration in China. In the absence of an appropriate return on savings, savers continue to focus on real assets, and to a lesser extent, equity markets. This has been an important factor behind the rise in speculative activity in the real-estate sector. This in turn has made housing unaffordable for first-time buyers in a number of cities – something the authorities have been trying to fix since early 2011.

International investors continue to highlight corporate governance (or lack thereof) as an important factor holding back investment into the EM credit space. This can also be seen in EM spreads, which reflect a higher risk premium versus peers in DM. Asian issuers have been less willing to allow detailed disclosure (via 144a registrations) – and have generally chosen Reg-S registrations for their bond issuance programme (Figure 4). Timing and abundance of cash within the region (meaning ability to solicit enough demand for their transactions without tapping the US market) have been primary drivers behind this. In our view, this is short-sightedness on the part of issuers from the region – and results in poorer investor reception and demand for the credit in the long run. We hope issuers embrace greater transparency and improved corporate governance over time. This, combined with an increased pace of reform – including around the softer issues highlighted above – will help develop and deepen the credit markets from EM and bring increased fund flows into these markets.
Equity-market performance is more closely linked to reform than to GDP growth

Indonesia’s market outperformance compared to the Philippines is linked to reforms

Philippines may now be following, with reforms planned

The connection between economic growth and equity-market performance in EM has always been tenuous. This is primarily due to a divergence between the drivers of EM economies (manufactured exports) and those of individual equity markets (banks, real estate and utilities). Nevertheless, there is a clearer link between the impact of economic reform or the competitiveness of individual economies, and equity-market performance.

We have narrowed our focus to two markets in Asia to illustrate the impact of economic reform on equity markets: Indonesia and the Philippines. Indonesia is a model of reform, following turmoil in the currency and equity markets after the Asian economic crisis in 1997. The Philippines has been used as an example of a country that has squandered its most valuable resource – an educated work force – and suffered under a series of corrupt governments.

A simple performance statistic illustrates the difference between investors' evaluation of the potential of the two economies over the past two decades. Following a 93% decline in the market between 1997 and 1998, MSCI Indonesia is now 27% above the highs recorded in 1997 in USD terms. MSCI Philippines fell an equally dramatic 89% from its peak in 1997; however, the market remains 37% below those highs.

The analysis presented here is not a review of what has gone wrong in the Philippines; rather, we focus on the reforms currently proposed, with a view to answering the question of whether the economy is in the same position Indonesia was five years ago. Indonesia has been rewarded for the reforms it has implemented since 1997 by a 74% appreciation in its currency, an equity market which has risen by a multiple of 18, a structural decline in risk-free rates and its recently achieved status as an investment-grade credit.

Reforms implemented in Indonesia

There are four key reforms in Indonesia that we have identified as having transformed the economy and in turn the equity market:

1) The Indonesian Bank Restructuring Agency (IBRA): 1998
2) The bankruptcy protection law: 1998
4) The bank deposit protection law: 2004

Each of these has had a significant impact on the economy, but two in particular stand out: the IBRA and the AMUC. Following IBRA’s establishment, it seized control of 54 private banks, which enabled it to shut, merge and sell off banks to foreign investors in an effort to deal with the insolvent nature of the sector.

In the case of the AMUC, when protectionism was at its highest during the eighties, an estimated 35% of imports was controlled by quota or import licences – which were
controlled by local monopolies; e.g., sugar. Since the establishment of the AMUC, practically all import licences have been removed and quotas are used to protect small producers as opposed to protecting the margins of large companies.

The impact of these reforms on the equity market is best illustrated by the increased weight of the banking and consumer sector in the equity market. In 1997, financials had a 10% share of the equity market; this fell to 4% in 1999. By 2012 the sector had a weight of 30%. The consumer discretionary sector has also been a big beneficiary of the reforms implemented in Indonesia. The sector’s weight in the market has doubled from 7% in 1997 to 14% in 2012.

Reforms proposed in the Philippines
The Philippine government has proposed a number of key reforms since President Benigno Aquino was elected in May 2010. He has launched the Philippine development plan 2011-2016 as well as reinvigorating the Public Private Partnership (PPP) programme. We focus on three areas of reforms that can deliver real change for the economy – energy, infrastructure and mining.

For investors who have analysed the Philippines in the past, the list may appear familiar. Electricity supply has been an ongoing issue since the early nineties with frequent difficulties in delivery. Failures in infrastructure development are clear to any visitor to Manila and mining has been a sector beset by delays for project approvals and concerns about loose environmental regulations.

We are not taking a view on the potential success or failure of these reforms. Rather our purpose is to highlight these reforms as having the potential to boost growth in the Philippine economy, which has significant mineral resources, an insufficient supply of electricity and underdeveloped transport infrastructure.

Impact of reforms on competitiveness
The Economist Global Competitiveness index highlights a dramatic improvement in the competitiveness of the Indonesian economy since 2000, rising from outside the top 50 to 37th in 2011. Reforms implemented over the past 20 years have undoubtedly contributed to its higher rank in the index. Using the World Economic Forum Global Competitiveness report, which focuses on >130 different metrics

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**Figure 1:** Indonesian sector market share, 1998
Sector weight breakdown – as at end-1998

**Figure 2:** Indonesian sector market share, 2012
Sector weight breakdown – as of end-H1-2012

Sources: MSCI, Standard Chartered Research
ranging from literacy and health to labour-market flexibility highlights Indonesia’s position increasing from 55 in 2008-09 to 50 in 2012-13.

The impact of improved competitiveness on equity-market performance is not linear, but there is a clear link. Over the past 20 years the Indonesian equity market has witnessed annual growth of 7%; this compares with 12% for the S&P 500, with the US economy typically in the top 5 in surveys of global competitiveness and historically ranked 1st in The Economist’s competitiveness league, although it did lose its top spot to Hong Kong in 2011.

If we contrast these performance trends in economies that have reformed and liberalised the supply of goods and services to the Philippines, which is only at the stage of proposing reforms, the difference in equity-market performance is marked. The rank of the Philippines in the Economist competitiveness index fell from 32 in 2000 to 41 in 2011 and the WEF index shows a similar deterioration – from 71 in 2008-09 to 75 in 2011-12. Focusing on equity-market performance, the Philippine index has returned a mere 3% annually over the past 20 years.

On a positive note, the Philippines jumped 10 places in the 2012-13 WEF survey, just published, compared to the last survey. The range of competitiveness indicators that the economy scored positively on in the WEF survey rose from 18% to 40% between 2008-09 and 2011-12. While it is far too short a period to measure the impact, we note that the equity market has risen 41% since 2008 in USD terms, outperforming the S&P500 and keeping up with the 50% gain in the Indonesian index.

**Link between reforms and sector weights**

As with equity-market performance, there is no linear link between the size of individual sectors in a market and reforms implemented. Nevertheless, there is a body of investment literature that highlights greater efficiency and higher profitability resulting from reforms in the banking sector.  

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11 See for example, George Abonyi’s “Policy reform in Indonesia and the ADB’s financial sector governance reforms program loan”, ADB ERD working paper No. 76, December 2005
6c. Market implications – Equities

The impact of these reforms on the equity market can be judged in terms of share price performance as well as the size of the sector in the equity market. The size can be influenced by many factors, including lacklustre growth in other sectors, which can result in the financials capturing a larger share of the market. Nevertheless, for banks to expand and succeed, they typically need the broader economy to grow and prosper; hence growth in the financial sector reflects solid economic growth. The increased size of the sector reflects its success in capturing a significant share of this growth.

Figure 5: Indonesian sector weight breakdown

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<td>8.3</td>
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Sources: MSCI, Standard Chartered Research

With this in mind we note that the weight of the financial sector in the Indonesian market has expanded from 10% of the total to 30% since 1998. This could not have happened without the successful implementation of the reforms listed above, including the IBRA, bankruptcy protection and deposit insurance. Reflecting the broader success of the Indonesian economy, in which per-capita income has risen to USD 2,500 as well as the positive effect of the implementation of the AMUC, the consumer discretionary sector has witnessed its share of the equity market expand from 7% to 13% over the same period.

Link between reforms and portfolio flows

There has been a noticeable increase in the pace of portfolio flows into the Indonesian market over the past 10 years. When measuring flows it is important to make a distinction between the price effect – increased USD value of flows due to a rising equity market; and the volume effect – individual market share of total flows. We focus on the volume effect in estimating the relative attractiveness of a market. Once again, it is impossible to make a linear connection between reforms and the share of flows accruing to an individual market; nevertheless, it is unlikely that a market will witness an increase in its share of flows if reforms are being reversed or not fully implemented.

As can be seen in Figure 6, Indonesia has steadily increased its share of portfolio flows into Asia over the past 12 years. Its total share of flows over that period was almost 2%; however there is a clear distinction between flows if we divide this period into two. In the first six years, Indonesia's share of flows was almost 1%; in the second six years, its share increased to 3%.
6c. Market implications – Equities

Lessons of reforms for the Philippines

The new Philippine government has been rewarded for the progress it has made so far in fiscal reforms, targeting lowering the fiscal deficit to 2% by 2016, with an upgrade in its credit rating by Standard and Poor’s to BB+, one notch below investment grade. Expectations are for the government to achieve investment grade by 2015. For equity investors, concrete progress on the three key reform areas – energy, infrastructure and mining – will be reflected primarily in an increase in portfolio fund flows to the market as well as an increase in its share of EM flows from the current 1.5%. Improved equity-market performance is already underway, with the market positing an annual average return of 11% over the past five years.

Nevertheless, equity markets can be fickle; we would recommend monitoring the WEF and Economist global competitiveness rankings for confirmation that reforms are being implemented. This would help to sustain the gains in the equity market as well as confirm the re-rating for valuations that has been witnessed over the past few years. The biggest confirmation of this will be a return to investment-grade credit status for the Philippines.

Conclusion

The conclusion we draw from this short analysis of the impact of reforms implemented in Indonesia since 1997 is that there is a real impact on equity-market performance. While solid economic growth has been a contributing factor to the 74% appreciation of the Indonesian rupiah (IDR) and an increase in the equity market by 18x, our analysis indicates that four key reforms: bank restructuring, the bankruptcy protection law, the anti-monopoly law and the bank deposit protection law are responsible for the more stable economic environment which has supported economic growth and in turn led to a structural re-rating of the equity market.

It is also our view that a similar trend may be underway in the Philippines. Three proposed reforms – in the areas of energy, infrastructure and mining – if successfully implemented, have the potential to create a solid economic foundation from which trend GDP growth can increase. These have the potential to ensure that the current re-rating of the equity market is a structural as opposed to cyclical phenomenon.

Figure 6: Indonesia is capturing a bigger share of inflows to EM

Flows to Indonesia and Philippines as a % of EM total

Sources: EPFR, Standard Chartered Research
7. Brazil – In need of infrastructure

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- With macroeconomic stability in place, micro reforms are needed now
- The government is rightly prioritising infrastructure
- Promoting infrastructure also requires policy support

A stable economy, but disappointing growth

According to the most recent Global Competitiveness Report, Brazil stood at 48 in the rankings, after an impressive upward trend over the last couple of years (up 26 positions from 2007). Its ranking has climbed as Brazil has secured macroeconomic stability, liberalised and opened up broad sectors of the economy, and reduced income inequality over the past two decades. Brazil’s economic freedom score is 57.9, according to the latest measure, making its economy the 99th freest. Its score has improved significantly since the 1990s and is 1.6 points better than the previous year, with improvements in 4 of the 10 economic freedoms, including financial. Brazil is ranked 20 out of 29 countries in the South and Central America/Caribbean region, and its overall score is below the regional and world averages. Brazil will have to improve these figures if it is to accelerate growth above the recent trend path of about 4.0-4.5% p.a.

Stability is necessary, but not enough

Over the past two decades, policy led to a sounder macroeconomic environment, supported by greater investment, better predictability of the economy and more efficiency, paving the way for improved growth performance. The 1990s and 2000s were the decades of macroeconomic stabilisation in Brazil; the next challenges are concentrated on the microeconomic front as worries about debt sustainability and external financing fade. Brazil still has a long way to go in expanding the credit market for both consumers and firms, and ensuring the formation of adequate macro and microeconomic underpinnings for production and consumption. Important fiscal reforms are necessary to bring down real interest rates in Brazil, which could unleash substantial investment and consumption in the years ahead. But the poor quality of infrastructure compared with other large countries suggests this should be a focus.

Figure 1: Brazil ranks poorly on infrastructure quality

<table>
<thead>
<tr>
<th>Infrastructure ranking</th>
<th>Brazil</th>
<th>Chile</th>
<th>China</th>
<th>India</th>
<th>Indonesia</th>
<th>Mexico</th>
<th>Russia</th>
</tr>
</thead>
<tbody>
<tr>
<td>Quality of overall infrastructure</td>
<td>107</td>
<td>31</td>
<td>69</td>
<td>87</td>
<td>92</td>
<td>65</td>
<td>101</td>
</tr>
<tr>
<td>Quality of roads</td>
<td>123</td>
<td>23</td>
<td>54</td>
<td>86</td>
<td>90</td>
<td>50</td>
<td>136</td>
</tr>
<tr>
<td>Quality of railroad infrastructure</td>
<td>100</td>
<td>64</td>
<td>22</td>
<td>27</td>
<td>51</td>
<td>60</td>
<td>30</td>
</tr>
<tr>
<td>Quality of port infrastructure</td>
<td>135</td>
<td>34</td>
<td>59</td>
<td>80</td>
<td>143</td>
<td>64</td>
<td>93</td>
</tr>
<tr>
<td>Quality of air transport infrastructure</td>
<td>134</td>
<td>39</td>
<td>70</td>
<td>68</td>
<td>89</td>
<td>64</td>
<td>104</td>
</tr>
<tr>
<td>Available airline seat km/week, millions</td>
<td>7</td>
<td>37</td>
<td>2</td>
<td>13</td>
<td>20</td>
<td>21</td>
<td>12</td>
</tr>
<tr>
<td>Quality of electricity supply</td>
<td>68</td>
<td>53</td>
<td>59</td>
<td>110</td>
<td>93</td>
<td>79</td>
<td>84</td>
</tr>
<tr>
<td>Fixed telephone lines/100 pop</td>
<td>55</td>
<td>68</td>
<td>58</td>
<td>118</td>
<td>78</td>
<td>73</td>
<td>41</td>
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<tr>
<td>Mobile telephone subscriptions/100 pop</td>
<td>41</td>
<td>30</td>
<td>114</td>
<td>116</td>
<td>90</td>
<td>107</td>
<td>5</td>
</tr>
<tr>
<td>GDP per capita in nominal USD</td>
<td>12789</td>
<td>14278</td>
<td>5414</td>
<td>1389</td>
<td>3,509</td>
<td>10,153</td>
<td>12,993</td>
</tr>
<tr>
<td>GDP (PPP) as share (%) of world total</td>
<td>2.91</td>
<td>0.38</td>
<td>14.32</td>
<td>5.65</td>
<td>1.43</td>
<td>2.11</td>
<td>3.02</td>
</tr>
</tbody>
</table>

Sources: The Global Competitiveness Report 2012-13, Standard Chartered Research
7. Brazil – In need of infrastructure

Brazil scores poorly on infrastructure

We believe that infrastructure investment is the best way to foster per capita growth over the next three to five years. Brazil scores relatively weakly on the quality of its infrastructure compared with other large countries, reflecting inadequate investment, but also the lack of a supportive structure. The deregulation and, more importantly, privatisation that occurred back in the late 1990s was a response not only to the need for increased economic competitiveness, but also to help foster new investment in infrastructure. The government recognises that more needs to be done.

The growth programme, Programa de Aceleração de Crescimento (PAC), instituted by the government is a start, but thus far has been relatively disappointing in fostering infrastructure development. A continued stream of capital investment in infrastructure will continue to depend on a few important pillars, with most of them still changing.

We highlight the following issues as preconditions for this type of fast private and public-private investment:

- A greater level of global integration is crucial, along with continued positive trends in FDI flows and technological advancement.
- Tax reform will be important for sustained growth, as Brazil’s tax burden is among the world’s highest and most complex.

Even though Brazilian exports have grown significantly over the past decade in absolute terms, the degree of economic openness (measured by exports/GDP—see Figure 2) remains well below the level in Latin American peers such as Mexico, Peru and Chile. The boom in commodity prices has been important for investment in the mining and agricultural sectors. Nevertheless, more openness would improve competitiveness in other sectors of the economy, increase specialisation and attract more investment (both domestic and foreign) in infrastructure and vice-versa. Unfortunately, the prior (Lula) administration was and the current government is opposed to major initiatives to advance an agenda of free-trade agreements.

Figure 2: Brazil remains a closed economy by any standard

Total exports over GDP; Brazil versus Mexico

Sources: MDIC, Banxico Standard Chartered Research
7. Brazil – In need of infrastructure

Foreign investment needs further encouragement

FDI has reached record levels, with a run rate of around USD 70bn over the last twelve months. Brazil has attracted substantial foreign capital as the economy expands, and benefits from favourable terms of trade, while multinationals look to target a growing middle class of consumers. The economy has benefited significantly from stronger flows, but a more competitive and open economy would likely boost further investment from abroad. The degree of openness is closely related not only to the import tax system, but also to the overall tax code in Brazil. Merchandise and investment from abroad are over-taxed, and the complexity of the domestic tax code generates an inefficient allocation of resources, in many cases inhibiting the establishment of foreign partnerships or trade.

Brazil has introduced capital controls to discourage portfolio investment, which has led to appreciation pressure on the Brazilian real (BRL). By repeatedly introducing different types of tax schemes for foreign currency flows, the government has increased uncertainty about the safety of foreign investment, clearly a step back. IOF taxes have been lifted on firms that raise external debt, for maturities up to 5Y. Additionally, the government has hiked import tariffs on certain sectors such as autos, which have been particularly impacted by BRL appreciation.

The political framework and strong popularity of the current government (also seen in most other countries in the region) reduces incentives for reform. The government has recently highlighted its intent to move ahead with its growth acceleration program (PAC), focusing more intensely on public-private partnerships in infrastructure projects. The FIFA World Cup (2014) and Olympics (2016) will demand important investment, likely to materialise over the next two to three years. A more permanent and sustained stream of investment in infrastructure will nonetheless depend on the country’s ability to foster private initiatives based on real economic incentives.

Figure 3: Brazil’s real interest rates remain very high
Real interest rates using actual and expected inflation

Figure 4: Investment is up, but still too low for fast growth
Total fixed investment/GDP

Sources: Bloomberg, Standard Chartered Research
Sources: IBGE, Standard Chartered Research
Recent infrastructure developments

The administration of President Dilma Rousseff has targeted an increase in public investment focused on infrastructure. On 15 August, the President announced a stimulus package, Programa de Investimentos em Logística: Rodovias e Ferrovias, which translates to: “investment programme in logistics: highways and railroads”.

To briefly summarise, the administration announced a package which will focus on railroads and highways, areas in which Brazil is sorely lacking. The program targets BRL 133bn in investment, with BRL 91bn to highways and the rest to roadways. This budgeted amount does not include another BRL 50bn that the administration is targeting for the bullet train project connecting Rio and São Paulo (This is a highly controversial project as many believe that the funds would be more efficiently used for other infrastructure projects given the high costs). Of the BRL 133bn, BRL 79.5bn will be concentrated in the next five years, with the balance to be allocated in the following 20 years. The auctions for these concessions are due to take place in April 2013, with contracts supposed to be signed in May-June 2013.

Brazil’s experience with the PAC, which was initiated by Lula in 2007, was mixed; only time will tell how efficient and successful this scheme will be. The model will be focused on public-private partnerships (PPPs), which have a mixed track record. BNDES financing will be involved for concessionaires, at TJLP (currently 5.5%) + 1.5%.

It will be interesting to see if Brazil can reverse a relatively poor track record in improving infrastructure. Certainly the plan is ambitious – but also necessary in the sense that Brazil’s growth record in recent years has disappointed due in part to the subpar state of its roads, highways, bridges, ports and airports. With the World Cup and Olympics occurring in the next four years, the urgency is even greater. The announcement may provide some short-term confidence to private capital, in general, but we don’t think the announcement changes much for the private sector until this plan brings results.

Meanwhile a recent example of the huge pent-up demand for infrastructure expansion in key sectors was the auctioning of the rights to operate the São Paulo international airport, Brazil’s main passenger and cargo hub. The rights were sold for more than BRL 16.2bn, almost four times the minimum offer. A total of BRL 24.5bn (USD 14bn) was paid for three of the country’s busiest airports. A consortium backed by the pension funds of two large public companies won the license to operate Guarulhos (São Paulo) for 20 years.

Another São Paulo-based construction company led a group that won the Viracopos airport license in Campinas (80km outside São Paulo) with a BRL 3.8bn bid, and a consortium led by another São Paulo-based builder took that for the airport in the capital, Brasilia, for BRL 4.5bn. In total, the government raised more than four times the BRL 5.5bn it had estimated from the licensing of the three airports. The three airports together accounted for about a third of Brazil’s 179mn passengers last year and 57% of its air cargo.

The project in Guarulhos includes building a terminal capable of handling 7mn passengers a year, while in Viracopos and Brasilia new terminals and improved runways are planned. Although some may argue that the groups overpaid for the rights, the potential is tremendous given how far behind the current infrastructure is.
7. Brazil – In need of infrastructure

Substantial new investment is on the way

Some private estimates on the likely size of the total fixed investment surrounding the two upcoming sports events are close to USD 100bn, including stadiums, subway and train lines, and highways. While the investment is directly focused on improving the logistics of the two events, the outcome is bound to be a much better overall infrastructure, which could foster other investment, including housing and transportation.

If we assume a successful execution of the second PAC phase, we are likely to see more than USD 500bn (20% of GDP) of investment in housing, energy infrastructure, sewage, transportation and urbanisation projects over the coming three to four years. Private investment in energy, communications, highways and railways, ports and airports could add up to another USD 200bn (8% of GDP) over the next three to four years. Industrial sectors such as oil and gas, mining, electronics, chemicals and autos could add up to USD 370bn (15% of GDP) over this same period.

Despite the size of Brazilian markets and the potential growth of the consuming classes, the ongoing demographic changes will likely make this significant investment in infrastructure just enough to keep potential growth from falling below the current 4.0-4.5% range.

Conclusion – Investment is rising, but has a long way to go

Brazil has a relatively low rate of investment (19.4% for 2011), with that for infrastructure estimated at little more than 2% of GDP. The Growth Commission argues that an emerging country needs an investment/GDP ratio of 25% or higher, together with infrastructure of 5-7% of GDP to break through into GDP growth of 7% or higher. That said, thanks in part to PAC, public investment has increased from 16%/GDP in 2006, even during a period of numerous financial crises globally.

The PAC managed to invest only 0.7% of GDP in 2011, the most since its implementation in 2007. Therefore, the upcoming investment is likely to significantly improve growth prospects. We are sceptical about the execution of such ambitious investment by the public sector. The government has an extremely rigid structure of fixed costs, with personnel and pension costs together accounting for over 11% of GDP, which leaves little room for significant cuts. Revenues come from an extremely inefficient tax system, with very high rates and little room for significant income increases.

More permanent rises in productivity and therefore potential growth are related to longer-term reforms. Among them we highlight: (1) Taxation, as Brazil’s tax code is labyrinthine and the marginal tax rate is among the highest in the hemisphere; (2) labour, as the cost of hiring and firing remains excessively high; and (3) pensions, as thorough reform is needed to improve the sustainability of the system. Addressing these issues would help reduce the so-called ‘custo Brasil,’ or ‘Brazil cost’, which implies that the discount rate for investment in the country remains very high due to the numerous obstacles entrepreneurs face.

Furthermore, educational underperformance, even relative to other peers in the region, is evident. For Brazil’s potential growth to reach 5-6%, as we believe is possible, will require massive progress on the reform front, which appears unlikely in the near future. While the government has set out on the right path, we believe progress will come only slowly.
8. China – Pay households a decent return on their savings

The next twenty years should be about nurturing the next wave of new consumers
- Interest-rate reform – and raising the return on savings – is key to boosting household income
- It would also discipline investment decisions, and help improve the quality of growth

If its stunning growth is to continue, China needs to become a consumption-driven economy. At this stage in its growth, we believe that plenty of investment is still a good thing. Cities, factories and infrastructure to connect it all together need to be built – with the urbanisation rate just having crossed 50%, we believe that urban China will keep on growing for many years to come (See On the Ground, 4 January 2011, 'China – Masterclass: China 2011, England 1890'). For sure, in 2012-13 we are dealing with some fixed-asset indigestion, and the funding model certainly needs rethinking, but our call is that China’s investment boom has not yet ended.

Indeed, China’s growth is still getting more investment-heavy, if official numbers are to be believed. In 2011, fixed investment accounted for some 49% of official value-added activity, up from 42% in 2005. Private consumption fell to 35% from 39%. We show these ratios in Figure 1.

Now, it is likely that these numbers underestimate the importance of consumption to the economy. We believe that the National Bureau of Statistics (NBS) does not have as good a grasp on the services sector (on the production side) as it has on the industrial sector. Moreover, on the income side of the balance sheet, we believe that its household survey misses a lot of (informal) income. Work by Professor Wang Xiaolu at the National Economic Research Institute suggests that GDP was underestimated by some 10% in 2008 because large sums of grey income are not being reported, and much of the spending was on services and luxury goods, often bought overseas.

Figure 1: How GDP breaks down, officially

GDP by expenditure, ppt

Sources: CEIC, Standard Chartered Research
8. China – Pay households a decent return on their savings

To illustrate the likely underestimation of consumption in China, we present Figure 2. This shows the value of car sales as a proportion of GDP, against consumption as a proportion of GDP in various G7 and BRIC countries. China is – weirdly – on the far left, which suggests to us that China probably underestimates the consumption ratio.

Car data is useful since it shows that absolute growth in household consumption in China is nothing to be ashamed of. Figure 3 shows the value of car sales in the large emerging markets, as well as in the United States over 2006-10. China’s market was worth USD 178bn in 2010. Growth slowed in 2011 to only 4% y/y, but at some point soon China’s car market will be worth more than that in the US. (And before you wonder if all those cars are going to government departments, our channel checks suggest that only 10-15% of car sales in China go to the government or firms.)

So, China’s economy is already partly being driven by private consumption – but as the infrastructure and housing sectors begin to mature, more will be needed. Vice Premier Li Keqiang made the same point in an article in Seeking Truth (求实) magazine; domestic consumption has to become the growth driver, he argued (See On the Ground, 7 June 2010, China – The next premier of China speaks). And two things will drive household spending – higher household incomes and lower household saving rates.

**Figure 2: Consumption share is probably higher**
*Car sales and consumption, % of GDP*

**Figure 3: Car sales to overtake those in the US soon**
*Value, USD bn*

**Figure 4: Key metrics for understanding household income and saving trends, (% of GDP)**

**Figure 5: Share of taxpayers’ money going back into social spending, (% of GDP)**

Sources: CEIC, Standard Chartered Research
Sources: Lardy, Xinhua, NBS, Standard Chartered Research
8. China – Pay households a decent return on their savings

China’s household saving rate (around 35% of income, as a simple average) is pretty normal for a developing Asian economy; levels of around 0-10% are normal for advanced western economies. Some of China’s high savings rate is explained by the saving culture of the older generation, but much is driven by the need of the new middle-classes to self-finance health care, old-age and education for children. Young people save to buy a house. The authorities have begun to rebuild the social welfare systems and to finance them in the last decade. But it is a slow process. Total social spending rose from 5% of GDP in 2003 to 6.6% in 2010, according to official figures (as Figure 5 shows). Some would focus on dragging this saving rate down.

But we believe that the key for China over the next decade or two is boosting household incomes. Once incomes are up, saving rates will naturally decline. Strong wage growth in recent years has helped. Inflation has eaten away at some of this growth, but not all of it, as our annual wage survey shows (see On the Ground, 5 March 2012, ‘China – More than 200 clients talk wages’). As labour-force growth continues to slow, and after 2013-15 likely reverses, China’s comparative advantage will shift. We hope that labour-productivity growth – thanks to education, better equipment etc. – will continue to mean labour can be paid more of the returns to growth. This will be a fundamental driver of household income growth.

At the same time, though, households have built a large savings pool and they are not being paid for the savings they provide to investors. For this reason, the key reform we call for in China today is interest-rate reform. In mid-2012, this began again after a long hiatus, as the People’s Bank of China (PBoC) expanded the bands within which banks can set deposit and loan rates. This was an important first step, but there is more now to do.

**Interest rates**

From 2004-10, according to calculations by Nicholas Lardy, the average one-year bank deposit rate was -0.3% in real terms, compared to +3% from 1997-2003 (On the Ground, 31 January 2012, ‘Masterclass: Nick Lardy and the consumption thing’). Although low real rates provide a stimulus to growth, the disadvantages are also serious. Low real deposit rates have squeezed household incomes and led to over-investment in real estate and some other sectors of the economy. When monetary policy needs to be tightened, a combination of concerns about hot-money inflows and leverage in the state sector means that quantitative credit controls, not interest rates, are used. This results in ‘asymmetric tightening’: the private sector’s credit costs get bid up hugely, killing the economy’s long-term engine, while the state sector saps still-cheap credit from banks.

To illustrate the damage low deposit rates are doing to household incomes, we show in Figure 6 a crude estimate of the resulting loss of income to households. We have approximated what households would have earned from their savings if they had been paid 3% real returns, and what they did get paid. (Our estimate is based on households depositing their ‘extra’ returns each year.) Over 2004-11, households lost an average of 2.4% of GDP worth of income every year, we estimate. This is substantial when wage income in 2008 was estimated to be 57% of GDP. Now, of course, this is a crude estimate since higher interest rates would affect other parts of the economy – corporate borrowing costs, for instance – which would in turn have affected overall growth. But at least the calculation hints at the scale of the problem.
8. China – Pay households a decent return on their savings

Rate liberalisation has been on the agenda of China’s central government for many years now – and progress has been made. Much of this progress has followed best global practices, helping China to avoid the banking crises that have happened elsewhere (see The Renminbi Insider, 20 September 2011, ‘Fitter, stronger, leaner’):

- Interbank and bond interest rates are set according to market demand for liquidity, and are therefore indirectly influenced by the central bank’s open-market operations.
- From 2006 to H1-2012, bank loans could be priced freely above the PBoC’s base rate, and could be set up to 10% below.
- Deposit rates were free to fall below the PBoC-set base rate, though in practice this does not happen.
- Draft discounting rates for domestic trade are determined by bank liquidity, and can therefore be much higher than standard deposit rates.
- Wealth management products (WMPs) give middle-class households access to deposit rates that are higher than benchmark (see On the Ground, 22 February 2012, ‘China – Spreading the wealth’).
- Entrustment loans, in which corporates lend indirectly to other corporates, allow banks to be completely dis-intermediated and give corporates better borrowing and deposit rates.
- Tens of thousands of small loan companies, regulated by the PBoC, are now active and lend at rates well above benchmark.

Figure 6: Low interest rates cut household income
Extra income if deposits earned a 3ppt real return, CNY bn and % of GDP

Sources: CEIC, Standard Chartered Research
8. China – Pay households a decent return on their savings

The 2012 steps

There have been additional steps. In two moves in June-July, the PBoC cut rates, but also expanded the bands. Now, banks can lend at up to 30% below the benchmark rate – and can take deposits up to 10% above benchmark (Figure 7).

Concerns about the hit to bank profitability have been put to one side. We estimate that the bank sector net interest margin (NIM) will be compressed from 260bps in 2011 to 216bps by 2014 (of which 26bps will result from these moves, in addition to another 20bps from further reforms, possibly increasing the upside on deposits to 20% on top of the benchmark). By 2020, we expect NIMs to average 200bp, which we believe, based on a comparison with the rest of Asia, to be a reasonable equilibrium level.

The fact that the Chinese yuan (CNY) exchange rate is, at least for the moment, near equilibrium and FX inflows have stopped (and have reversed to a small extent) has also helped create a little more space for reform. One of the big impacts is that it allows the PBoC a great deal more independence in setting interbank rates.

Figure 7: Interest rate liberalisation has begun quietly

1Y lending rate/saving rate, floor and ceiling on 1Y saving rate, 7-day repo rate, %

What reform comes next?

First, the banks needs some time to get accustomed to the reforms thus far. Up to July 2012 we had not seen many cases of banks actually pricing credit at 20% or 30% below benchmark – and it is likely that banks will attempt to go slow on pricing to the downside to prevent a quick hit to margins. Many banks have implemented the 10% upside on deposit rates. There is a wave of non-performing loans coming – this happens in every downturn, and in China’s case, will be exacerbated by problems in the infrastructure and real estate spaces. In such circumstances, care must be taken not to undermine NIM (and the banking sector’s ability to at least partially recapitalise itself) too quickly.

Second, bank rates and interbank interest rates need to be linked up. At present, repo rates, the most liquid instruments in the interbank market, bear little relationship to the rates at which banks borrow and lend. Ultimately, the PBoC would probably like to link up the two rate universes. This could be done by basing benchmark rates
8. China – Pay households a decent return on their savings

off the 7-day repo or SHIBOR rates. The banks again could be given bands around which to work. The 7-day repo has been trading, more or less, between the benchmarks (Figure 7).

However, the big challenge is the excessive volatility of the interbank market (Figure 7). We need the interbank market to settle down a lot more before benchmark rates can be set off the repo or SHIBOR curves. This in turn requires banks to improve their own asset and liability management, and for the central bank to improve its ability to predict and deliver liquidity to the market.

**Real interest rates**

Real deposit rates have increased nicely in H1-2012 as inflation has fallen (Figure 8). This means households are being paid more on their deposits.

However, positive real saving rates need to be permanent, not just cyclical. The next time inflation rises, benchmark and interbank rates need to rise too, instead of quantitative tightening. This would ensure that households continue to get paid a real return while the economy is performing well. Now is the time to prepare for the next stage in the cycle.

**Figure 8: Real saving rate returns to positive territory**

*Real 1Y deposit and lending rate, %*

![Graph showing real saving rate returns to positive territory](image_url)

Sources: CEIC, Standard Chartered Research

**Get the domestic bond market working**

Finally, we need to consider how to get the bond market working properly. China’s bond market is big, but it is still not particularly liquid beyond the 1Y tenor. Banks and other financial institutions tend to buy and hold bonds in investment accounts, and as a result of the limited trading, there is no liquid risk-free curve. Banks and other asset managers need to become more active traders in the market, which requires a change in culture at banks. Things appear to be changing, though with trading turnover rising somewhat since 2009.

If the government chose to put more of its debt on its balance sheet rather than running quasi-fiscal infrastructure spending through the banks, this would provide a huge boost to onshore Ministry of Finance issuance and do much to support the development of the bond market. (For our proposals on how local government debt...
8. China – Pay households a decent return on their savings

could be partly resolved with a big central government debt issue, see Special Report, 18 July 2011, ‘China – Solving the local government debt problem’.

Finally, there are alternative ideas for boosting consumption floating around Beijing.

**Add dividend payments by state-owned enterprises (SOEs) into the budget.** This reform is, in our eyes, a no-brainer. Currently, state firms basically retain all their profits, which discourages discipline in investment decisions. A trial plan to ask the central SOEs to pay out some dividends has failed, since the funds are channelled back into firm subsidies. What is needed is a chunk of the profits remitted to the Ministry of Finance and from there into the general budget. A recent World Bank report estimated that remittance of 50% of profits by the central SOEs would raise 3% of GDP in revenues.

**Boost consumer finance.** Banks have expanded their loan books to finance mortgages in the last decade, and believe this is a healthy trend. However, the experiences of consumer credit in other Asian and developed markets suggest that caution is required. We like the idea of limiting households to only 60-80% mortgage financing, as China does, and would prefer that policy makers focused on boosting current incomes.
9. Hong Kong – Public matters, private solutions

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- Social challenges could limit Hong Kong’s longer-term growth potential
- The need for fiscal prudence and a simple tax regime call for wise use of public resources
- Public-private cooperation is the best way to go for health-care and education reform

Social challenges top reform agenda

One could easily argue that Hong Kong – the model for a small yet highly open, international and competitive economy – faces no urgency to reform to generate growth. It ranked, among other measures, first out of 179 in the Heritage Foundation’s 2012 Index of Economic Freedom; second out of 183 in the World Bank’s 2011 Ease of Doing Business Index; and third out of 77 in the Global Financial Centre Index (GFCI 11), just behind London and New York.

One could also argue that Hong Kong, having long lived under the influence of (or the threat of marginalisation by) a rising mainland China, is constantly in reform mode. Over two decades ago, it was rapid deindustrialisation and the extension of entrepreneurship into the neighbouring Pearl River Delta (PRD) region. And then there was the return of sovereignty in 1997, and the humbling experience of witnessing China’s spectacular growth from close range since then, including burgeoning wealth, the infrastructure boom and the rise of Shanghai. No longer are mainlanders the poor cousins. Yet one need look no further than the tourist-filled local shopping malls and the blossoming offshore CNY (CNH) market to know that Hong Kong has done well so far in carving out a niche for itself, and in staying competitive.

Wide distribution of income

The continued success in generating growth through fostering cross-border economic and financial integration, however, masks Hong Kong’s growing social challenges. For example, the widening distribution of income, coupled with rising pressure to return fiscal surpluses to the people, has made short-term populist measures more appealing than a fiscal overhaul.

Mishandling of social issues could undermine (or at least limit) Hong Kong’s growth potential in the coming years, in our view. What Hong Kong needs is a change in its fiscal mindset – from being a provider to a facilitator. The idea is to let the private sector share more of the social burdens, against a laissez-faire backdrop which has long been the bedrock of Hong Kong’s success.

Here we look at (1) some of the policy turns the government has recently taken; (2) the challenge of juggling upholding fiscal prudence and the need to expand social support; and (3) some reform proposals, focusing on public-private cooperation and more targeted and efficient use of public resources.
9. Hong Kong – Public matters, private solutions

Examples of recent policy prescriptions

Minimum wage

In May 2011 Hong Kong introduced a statutory minimum wage (at HKD 28, or USD 3.6, per hour, equating to roughly 42% of the median wage, comparable to those in OECD countries). This move surprised many people, who found it difficult to comprehend why a free market like Hong Kong would want to introduce such an impediment to its well-known flexible labour market.

It is indisputable that social pressure has been on the rise. An appreciating Chinese yuan (CNY) has eroded the Hong Kong dollar’s (HKD’s) purchasing power and fuelled imported inflation; cross-border capital inflows have driven local property prices higher, putting them out of reach for many lower-income households; a narrow industry base (the four main economic pillars being finance, tourism, logistics, and professional and business services; together they account for around 60% of GDP and half of the total workforce) has limited the number of households that are able to fully enjoy the windfall of strong economic performance over the past decade; and the influx of mainland Chinese migrants and tourists has reshaped Hong Kong’s retail landscape and induced greater competition for Hong Kong’s public services and resources.

While it is important to acknowledge the social issues at hand; setting policies to tackle them requires a long-term view.

Minimum wage proponents claimed that worries over a loss of labour-market flexibility were overdone, citing sustained low unemployment rates since its introduction (Figure 1). Some even made a case for having an even higher minimum wage level already, to say HKD 33 to 35, fuelling wage inflation expectations. Taking it one step further, the government is currently studying the introduction of standard working hours – the likely increase in overtime pay, in addition to any improvement in workers’ quality of life, is certainly one key motivation behind this proposition. Competition law is another area that is gaining traction. The loss in supply-side flexibility, however, may only be felt over time, especially when the Hong Kong economy next suffers a steep economic downturn.

Figure 1: Imposition of minimum wage risks undoing prior improvements

Trajectory of Hong Kong unemployment rate in recent economic downturns

Sources: Bloomberg, Standard Chartered Research

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According to OECD statistics, countries like US, UK, Canada, Japan and Korea had minimum-to-median wage ratios of 0.39, 0.46, 0.44, 0.37 and 0.41, respectively in 2010.
9. Hong Kong – Public matters, private solutions

**New Home Ownership Scheme**

The introduction of a new Home Ownership Scheme (HOS, or public housing for sale at a subsidised price) is, arguably, another example where social policy objectives are confused. The new scheme still has the flaws of its predecessor (which was suspended in 2002 after the post-Asian financial crisis collapse in the housing market), namely being awkwardly positioned between the ever-essential public rental housing (PRH) scheme and the vibrant private property market.

The government’s obsession with encouraging home ownership has always been at the centre of debate: the new HOS tops this by treating the subsidised portion of a unit’s purchasing price as a loan to the owner, effectively allowing homeowners to enjoy future capital appreciation if the flat is sold on the open market after repaying the loan part. While good in facilitating ‘upward mobility’, this appears to go way beyond the intention of traditional public-housing policies, which is simply to provide shelter for the needy.

The government’s more recent decision – as an interim measure before the new HOS flats come on board – to exempt 5,000 eligible applicants from paying land premium (i.e., excuse them from repaying the government subsidy) in purchasing existing HOS flats from the secondary market has been seen by some as creating another destabilising force in the property market, putting HOS flats out of PRH tenants’ reach while favouring private-sector buyers.

**Universal pension**

Our final example is the Old Age Allowance. Its non-discriminatory design (for those at the age of 70 or above) makes it a fair way to return wealth back to all senior Hong Kong residents, as a way to reward them for their past contributions to the economy. But the same design makes it an inefficient way to help the poor – not all Hong Kong residents aged 65 or above require government assistance.

Granting an extra month of allowance payment, as part of the government’s economic relief package on the back of the hefty fiscal surplus, has been a standard fixture in recent years’ budgets. One ought to question whether other more targeted measures could be used to make the money better spent in offering immediate relief and in redistributing wealth. Of course, any type of means-testing reduces incentives so there are always pitfalls.

**Making the best out of a simple tax regime**

For Hong Kong, meeting social challenges is inherently a tricky subject, no less because it (rightly) does not aspire to become a welfare state. We value the government’s commitment to fiscal prudence (which in turn underpins investors’ confidence in the currency peg), and its adherence to the principles of ‘market leads, government facilitates’ and ‘big market, small government.’ However, this also imposes a natural constraint on how much the Hong Kong government can do in expanding its social spending on a recurring basis.
9. Hong Kong – Public matters, private solutions

Figure 2, using public expenditure on health care as an example, shows how Hong Kong is comparable to other developed economies when it comes to devoting a material proportion of total public spending to health care. Its much smaller revenue base and insistence on (and success in) maintaining fiscal balance, however, translate into much smaller public health-care spending as a percentage of GDP.

Over the past decade, the Hong Kong government has committed to keeping total public expenditure within 20% of GDP. This is not set in stone, but is more like a self-imposed guideline for fiscal prudence’s sake. In fact, public expenditure did exceed 20% of GDP in 4 out of the past 10 years; it is also the case for the estimated expenditure for FY13 (ending March 2013). Yet for the government to permanently go above 20%, the consensus is that new sources of public revenue would need to be explored. Talk of introducing some form of value-added tax (VAT) in Hong Kong has been around for some time, but has never really gained traction.

Leaving aside the long-standing debate on whether the impact of VAT is regressive or progressive, any move to raise taxes or expand its base could risk impeding one of Hong Kong’s core competencies – a low and simple tax regime. Hence, we will not delve into the possibilities of expanding taxes, but rather ways to make the best use of existing public resources.

We see room for greater participation of the private sector in providing some social services (fitting the government’s core principles); the government should not just be a provider, but also a facilitator. A higher standard of living should come from creating and preserving jobs through improving occupational mobility and wage flexibility, not providing wage guarantees. And beyond the scope of providing public rental flats to meet the most basic shelter needs, it should be through the right land policy that market forces determine the right level of supply for affordable residential flats, instead of having them built and sold by the government itself. Health care and education are also key candidates for reforms.

Figure 2: Hong Kong committed to health care, and to low and simple taxes

* FY08, based on recurring total and health-care public expenditure;
Sources: WHO, HK Food and Health Bureau, CEIC, Standard Chartered Research
9. Hong Kong – Public matters, private solutions

Health care – An unhealthy public-private relationship

In many ways, Hong Kong’s public health care system has been a victim of its own success – high-quality service and low fees have stretched its resources. This has resulted in long working hours for medical professionals at public hospitals (exacerbated by a talent drain to the private sector owing to better pay and lifestyle), while long waiting times are common for both out-patients (queuing time in hours) and those that require specialised treatments (measured in years in some cases).

As a result, in the eyes of a patient, the decision between using public and private health care boils down to: pay or wait. And admittedly, there is no easy way out of this – reducing public hospitals’ quality is out of the question; but maintaining high quality while meeting ever-rising demand is too big a fiscal commitment over the longer run, especially in view of Hong Kong’s aging population.

One could also argue that this is one of the biggest challenges among most if not all developed economies, and is being felt more in Hong Kong now as the call for democratic accountability rises. The rise in usage of public health care by mainlanders in recent years, with controversy escalating about overcrowded maternity wards, further complicates (or even politicises) the problem.

A wholesale makeover is required to shake up the existing unbalanced public-private relationship, so as to better spread the burden. To encourage more people to use private health care requires both incentives and deterrents. For incentives, the HKD 50bn earmarked by the government to subsidise the uptake of voluntary private health-care insurance is a good start. But how targeted the scheme is in helping the less well-off remains questionable. Additional incentives, say tax deductions for those participating in private health-care insurance programmes, would also help keep people in the private sector; that said, the dead-weight cost of subsidising people who already have insurance makes it financially inefficient.

For deterrents, we see room for public health-care charges to go up – gradually and not to an extent that would make it inaccessible to the poor, but enough to deter over-usage and to make the system more financially sustainable long-term. More effective use of discriminatory pricing could also be considered for non-targeted patient groups. For example, in an effort to control public maternity ward usage by parents from the mainland, when neither parent is a local resident (a child born in Hong Kong would be eligible for residency), a minimum charge of HKD 38,000 (USD 4,900) is imposed on those who pre-booked under a quota system (for locals, maternity service is effectively free of charge, the main cost being HKD 100 per night for beds).

In contrast to all this, private practitioners generally charge between HKD 150-400 per consultation, and more for specialists. Medicine and tests are often billed separately. In-patients at private hospitals get charged around HKD 400-1,000 a day depending on the quality of the ward, not to mention separate billings for all add-on services (e.g., daily attendance fees of doctors).
9. Hong Kong – Public matters, private solutions

More deterrents are needed, mainly by gradually adjusting public charges

To discourage ‘gate-crashing’ for child delivery at public hospitals’ emergency wards, the minimum charge has been raised to HKD 48,000. Unfortunately, compared to the all-in final billing for child delivery at private hospitals, which could easily exceed HKD 100,000, the minimum charges are still not punitive enough to keep the public hospitals from being abused. Pressure is certainly for the government to bring them more in line with private-sector charges over time. In fact, the overflow of such ‘cross-border’ demand into the private sector – which is said to have crowded out local mothers – also prompted Chief Executive CY Leung to declare, starting next year, a ‘zero quota’ on private hospitals for taking in pregnant mainland women whose husbands are non-residents. This is down from a quota of 31,000 this year. But such forms of quantity control, effective as they may be in the short-term, are no substitute for more holistic and longer-term solutions to relieve social pressures.

Medical service is one of the six new industries that the Hong Kong government wants to develop (the other five being education, which we will touch on in the next section, testing and certification, environmental industry, cultural and creative industry, and innovation and technology). For this to succeed, tapping into mainland demand is a must. And yet, the recent maternity-ward controversy highlights the immediate challenges in segregating, channelling and ultimately meeting such exogenous demand under the existing system. Ideally, with the government facilitating the development of more private hospitals to handle the majority of the future non-resident medical needs, more public resources could be dedicated to meeting local needs.

Education – The beauty of ‘less is more’

At the core of education policy is the current 12-year free and universal programme (six years of primary education and six years of junior/senior secondary education) through public schools (including government schools and government-funded schools). The programme was expanded from nine years from the 2008-09 school year, and there are rising calls in the public for it to expand to 15 years (to cover pre-primary education). At this rate, the risk is to have Hong Kong’s education policy turning into another big social relief programme (the existing Pre-primary Education Voucher Scheme, in our view, already has this covered).

Figure 3: Large class sizes compared to regional and OECD counterparts

Average class size by level of education, all institutions, persons (2009)

* for school year 2009-10; lower secondary education refers to S1-S5;
Sources: OECD, Hong Kong Education Bureau, Standard Chartered Research
9. Hong Kong – Public matters, private solutions

For a knowledge-based economy like Hong Kong, with the accessibility of basic education no longer an issue, the government should not remain fixated on quantity, but should focus on quality. Otherwise, Hong Kong will have to increasingly resort to importing foreign talent (which could limit the upward mobility of local graduates), while more and more local parents send their children to study abroad.

As a first step, we believe the government should reduce the size of classes at public schools. This provides the flexibility for a more targeted curriculum to meet ever-changing economic needs. It will also allow more efficient use of public resources, while avoiding further public repercussion from the need to cut back on teachers, classes and to close down underutilised public schools – an increasingly acute issue in the face of the low birth rate and an aging population.

Enhancing educational quality is also about liberalising primary and secondary education to the private market, as opposed to crowding them out via an ever-expanding public programme. Hong Kong’s success in incubating world-class universities is a good example here. Moreover, much like health care, Hong Kong has the potential to build itself a new growth pillar; in view of China’s growing number of wealthy parents seeking to send their kids overseas for education, Hong Kong is geographically and socially (e.g., cultural proximity) well-positioned to be their preferred destination.

In 2010-11, over 70% of full-time research postgraduate programme students were non-locals; this compares very favourably to popular education destinations like the UK, where the ratio was 48%. For full-time undergraduates, the non-local percentage in Hong Kong was just under 10%, compared to 14% for full-time first degree international students in the UK. What Hong Kong can offer should not be limited to tertiary education.

Conclusion

While Hong Kong’s continued integration with mainland China is set to generate even more excitement as well as growth down the road, any mishandling of looming social issues could undermine the city’s inherent competitiveness. Economic success need not come at the expense of social welfare or with massive fiscal costs. Realigning government priorities and incentivising the private sector could be a way to resolve public-sector problems.
10. India – Overcoming the infrastructure deficit

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- Regulation, pricing and funding for infrastructure require comprehensive reforms
- The proposed land bill is an important step forward, but only part of the puzzle
- Effective structuring of private-sector participation is important

Infrastructure has fallen further behind

Urban Development Minister Kamal Nath noted recently, “We are not building for the future. We are still building for the past”. The infrastructure deficit is India’s Achilles’ heel, and has been a persistent characteristic of the economy. The Global Competitiveness Report (GCR) in 1999 ranked India 55th out of 59 countries in terms of the “adequacy of overall infrastructure”. The story remains unchanged 12 years later. The Indian business community still cited infrastructure as the single biggest hindrance to doing business in the 2012-13 GCR.

The infrastructure sector grew on average only about 6.3% p.a. during the FY03-08 period, versus average GDP growth of 8.7%, failing to meet spiralling demand from increasing industrial activity, expanding per-capita income and rising aspirations for big-ticket items like passenger cars. Infrastructure growth probably slowed further to average 5% during FY09-12, helping to drag GDP growth down to an average of 7.5% y/y. The slow pace of infrastructure development led to massive slippage in most of the physical infrastructure targets set under the Eleventh Five Year Plan (FYP, ended March 2012). In the power sector, additional generation capacity is estimated to be about 35% lower than targeted, while the goal for additional major port capacity was missed by as much as 75%. The achievement of building the golden quadrilateral – the highways linking India’s four largest cities – is a rare exception. Slippage in construction of other highways (two-lane and four-lane) has been high, at times by as a much as 90% (Figure 2).

India in general is estimated to lose about 2ppt of GDP every year because of inadequate infrastructure. With the increased infrastructure deficit in the past two years, the loss has probably increased further. Indeed, slower investment has already reduced non-inflationary growth potential in the near term to c.7.0% from 8.0-8.5% in the pre-crisis period, according to the Reserve Bank of India (RBI). Although we still believe in India’s long-term growth story, infrastructure needs urgent attention.

Figure 1: Infrastructure is the biggest business constraint
Percent of response for the most problematic factors

<table>
<thead>
<tr>
<th>Factor</th>
<th>Percent</th>
</tr>
</thead>
<tbody>
<tr>
<td>Govt. instability/coups</td>
<td>25</td>
</tr>
<tr>
<td>Lack innovation capacity</td>
<td>20</td>
</tr>
<tr>
<td>Inadequate education</td>
<td>15</td>
</tr>
<tr>
<td>Restrictive labour regs</td>
<td>10</td>
</tr>
<tr>
<td>Tax rates</td>
<td>10</td>
</tr>
<tr>
<td>Access to finance</td>
<td>10</td>
</tr>
<tr>
<td>Inflation</td>
<td>10</td>
</tr>
<tr>
<td>Political instability</td>
<td>10</td>
</tr>
<tr>
<td>Bureaucracy</td>
<td>5</td>
</tr>
<tr>
<td>Corruption</td>
<td>5</td>
</tr>
<tr>
<td>Infrastructure</td>
<td>0</td>
</tr>
</tbody>
</table>

Sources: GCR 2012-13, Standard Chartered Research

Figure 2: Targets and slippage
Progress on infra Eleventh Five Year Plan targets

<table>
<thead>
<tr>
<th>Header</th>
<th>Target</th>
<th>Progress</th>
</tr>
</thead>
<tbody>
<tr>
<td>Power</td>
<td>Power generation capacity of 78,000 mw</td>
<td>&lt; 50,000 MW</td>
</tr>
</tbody>
</table>

National highways

| Six-lane golden quadrilateral | 6,500 km                                 | 99.4% completed |
| 4-lane                        | 20,000km                                  | 5,447           |
| 2-lane                        | 20,000km                                  | 1,968km         |

Rural roads                    | 165,244                                    | Not met         |

Ports                          | Capacity addition of 485MT                 | 115MT           |

Sources: Issues in infrastructure development in India, FICCI
10. India – Overcoming the infrastructure deficit

Power and highways are a particular problem

India urgently needs more investment in all areas of infrastructure, including electricity, roads and bridges, telecommunications, railways, irrigation, water supply and sanitation, ports, airports, storage and oil-gas pipelines. We focus here on power (coal and electricity) and roads for two reasons.

First, for various Indian firms, power and roads ranked as the most important among various infrastructure requirements. This is evident from a survey of companies conducted in 2006, where electricity was identified as the most binding constraint by both urban and rural firms, ranking well above issues like corruption and regulations. A recent study of small enterprises found power to be the most crucial issue. This is not surprising, as almost 49% of firms use generators to mitigate the effects of the uncertain power supply. In some states, the power deficit is so severe during the summer that a one- or two-day per week power cut for selected manufacturing industries is mandatory. Second, since mid-2010, much of the policy inertia and other issues has been associated with these two segments.

Five issues plaguing infrastructure

Regulatory hurdles: Infrastructure development has suffered from lack of clarity on certain regulations. Land acquisition is one of the most commonly cited issues in this context. For instance, in the road sector, land acquisition issues have led to large-scale project delays and cost overruns. This is because, according to global best practices, land acquisition should be completed before a project is tendered. In India, however, a project is awarded at times with only 30% of the required land; acquiring the remainder is left to the developers. Against a backdrop of a poorly defined framework for pricing and land usage, developers are left with numerous rehabilitation and resettlement (R&R) issues.

The mining sector has suffered lately from increased environmental and R&R concerns. The country’s mineral-rich states have relatively higher forest cover, and are home to a large proportion of India’s tribal population. Sudden declaration of mining areas as ‘no go’ because of a lack of ministerial consensus has hit coal

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Figure 3: Power and roads cited as most important
10 = very important, 5 = important, 0 = unimportant

<table>
<thead>
<tr>
<th></th>
<th>Power</th>
<th>Communication facilities</th>
<th>Transportation</th>
<th>Water supply</th>
<th>Industrial estate facilities</th>
<th>Port</th>
</tr>
</thead>
</table>
| Sources: | Issues in infrastructure development in India, FICCI

Figure 4: Unsatisfactory regulatory landscape in India

<table>
<thead>
<tr>
<th>Regulator</th>
<th>Power</th>
<th>Roads</th>
<th>Railways</th>
<th>Ports</th>
<th>Coal</th>
<th>Civil aviation</th>
</tr>
</thead>
<tbody>
<tr>
<td>Source</td>
<td>Central Electricity Regulatory Commission (CERC) at the central level and SERCs at the state level</td>
<td>NHAI acts as both operator and regulator</td>
<td>Indian railways as both regulator and operator</td>
<td>Tariff Authority for Major Ports(TAMP)</td>
<td>No regulator, but still heavily regulated by the ministry</td>
<td>Airport Economic Regulatory Authority (AERA), Airport Authority of India (AAI)</td>
</tr>
</tbody>
</table>
| Sources:  | Issues in infrastructure development in India, FICCI

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1 Federation of India Chambers of Commerce, FICCI paper; ‘Issues in Infrastructure Development in India’, February 2012.
10. India – Overcoming the infrastructure deficit

production, which contracted by an average of 0.9% during the last 24 months, after robust growth of 7% during FY06-FY10. Similarly, in the telecom sector recently, a lack of clarity on certain aspects of the new telecom policy has created an uncertain environment for investors in this sector.

Lack of a coordinated regulatory approach: Construction projects require active cooperation from several government departments, at times spanning two to three states. Laxity in one of the departments or suggestions for changes in projects by different departments have delayed or derailed projects.

The lack of a holistic approach to the various infrastructure sectors makes implementation of projects difficult and leads to lower returns. There is no independent regulator for any of the sectors. The National Highway Authority of India (NHAI) acts both as an operator and regulator of roads. Indian railways own, operate, regulate and run the sector with an independent budget. Hence, project developments in one sector can often be left without support from other segments. For instance, several ports lack cost competitiveness, as they are not well connected by an efficient network of railways or roadways.

Pricing and associated inefficiency: Since most of the infrastructure facilities are dominated by the public sector, under-pricing is common at various stages. For instance, pricing of water – 80% of water is used by the agricultural sector – remains a sensitive issue. It is virtually free or hugely underpriced for major sections of the population. This has led to over-exploitation of ground water across the country and is an issue of grave concern, as water is a relatively scarce resource. India is home to 16% of world’s population, but has only 4% of usable fresh water.

Similarly, under-pricing in the power sector runs from the determination of coal prices through power generation, transmission and distribution. Coal prices, though theoretically unregulated, are adjusted only in consultation with the Ministry and have been changed as per the WPI index only five times since April 2004. Even after accounting for differences in calorific value, coal prices in India are currently about 30-50% lower than for imported coal. This has two implications: First, it acts as a disincentive to increase/invest in local coal production. Second, it leaves power producers with little incentive to meet coal requirements by increasing imports, as it puts them at a disadvantage compared with producers using domestic coal, especially as electricity tariffs are controlled by state regulators.
10. India – Overcoming the infrastructure deficit

Most of these regulators have shown a tendency to hold back tariff adjustments, typically under political pressure. The supply of free or virtually free power to the farm sector leads to inefficient use of scarce resources, with the distribution mechanism very leaky. According to a high-level government panel report submitted in December 2011, the accumulated losses of power distribution utilities in the last five years have been close to INR 2.5trn. More than 70% of these losses are financed by public-sector banks, which stopped additional lending to the power sector in Q3-FY12.

**Public-private partnership (PPP) model is yet to bloom:** Since the early 2000s, the share of private-sector participation in infrastructure investment has increased, from 20% then to 30% during 2007-2012. While private companies have bid aggressively to be a part of the huge opportunity which India’s infrastructure sector offers, the factors mentioned above have acted as dampeners. Also, some issues specific to the PPP agreements require revisiting. For instance, as most of the PPP projects are long-duration awards, lack of an option to renegotiate such contracts later leaves investors hesitant, especially in an uncertain macroeconomic environment. In South Africa, Australia and the UK, renegotiation of contracts is a standard practice. Similarly, poor assessment of the demand at the project preparation stage leads to less accurate estimation on the viability of such projects. The lack of information about projects available for bidding on by the private sector is another area of concern. Non-transparency in the bidding/awarding of such projects and a clear framework for dispute resolution are other roadblocks to the success of PPP.

**Financing constraints:** In a developing economy like India, an active role by both the public and private sector is crucial for infrastructure development. This is because states with lower per-capita income are able to attract private interest in infrastructure projects only if the projects are located close to a big city or are well connected. An active role for the public sector in infrastructure development is important. However, as the public sector has limited resources to support such huge investment requirements (the government intends to increase infrastructure investment to USD 1trn during 2012-17 from USD 500bn during 2007-11, with 50% private participation), the role of the private sector cannot be dismissed.

However, both sectors face significant funding constraints. India persistently runs a fiscal deficit because of the lack of expenditure reforms. High subsidy and interest-rate costs, along with other recurrent expenditures, leave the government with limited resources to boost infrastructure spending. Over the past five years, while 13% of GDP was spent to meet recurrent expenditures including the subsidy burden, only 1.3% was directed towards boosting the production capacity of the Indian economy. The lack of strong political will and high vulnerability to election cycles has left expenditure reforms largely unaddressed.

The private sector, in contrast, has to rely on the domestic banking system or foreign capital to meet financing requirements, as the corporate debt market is yet to develop fully. This is apparent from the financing pattern during the Eleventh Five Year Plan, which was as follows: 48:52 debt-equity ratio; 43% financed by banks, 23% via non-banks and 12% via foreign sources, with a 16% funding gap likely to be financed via foreign sources. Since the financial crisis, funding from foreign sources has been neither easy nor cheap. Over-reliance on the domestic banking system has led to an asset-liability mismatch, as infrastructure projects funding needs are huge and have long gestation periods. In addition, policy uncertainty has made lenders less willing to extend credit to this sector.
10. India – Overcoming the infrastructure deficit

The way ahead
Challenges in infrastructure provision are not unique to India. All governments have faced issues like scarcity of available funds for investment, uncertainty, and competing priorities in infrastructure planning and delivery. However, with a strong political will to make the necessary reforms, India – like other countries – can overcome these challenges. Below, we discuss the urgent measures that are required.

Reforms in the input market: As discussed, land acquisition and related environmental concerns are sore points in India’s infrastructure development. Recent talks suggest that the new proposed land bill is likely to be considered by the Parliament soon. In our view, combining rehabilitation and resettlement and land acquisition in a single bill is a sensible move, striking a balance between the rights of land owners/users and the need for industrialisation and urbanisation. If implemented, it would be a big step forward, especially for the mining sector. Though acquisition of land will come at a higher cost – our equity team estimates that land costs may increase by 20-200% once the new bill is implemented – the easier process of land acquisition could provide a much-needed boost to the mining sector.

However, it is difficult to accommodate all the needs of land owners/users and the needs for industrialisation and urbanisation in a single act, especially since it is being amended after 118 years. The act will likely need to be fine-tuned. For instance, the proposed act still lacks a comprehensive land-usage policy and modernisation of land records to address long-term demands for land, a necessity for kick-starting infrastructure investment. Similarly, environmental impact studies (necessary for mining activity) have not been made mandatory before land acquisition. These issues need to be addressed quickly once the first hurdle has been overcome.

Holistic approach to infrastructure development: As suggested by the Planning Commission, a common policy approach should replace the multi-regulatory framework running through states and centres. India could learn from the UK utility model (the Utilities Act 2000), which unified a scattered regulatory structure. In the UK, regulatory functions and the objectives of various regulators were brought under a single statute. Such an approach should be backed by uniform enforcement and a dispute-resolution process. Also, the autonomy of the regulators needs to be a cardinal rule of regulation. Recently the government has proposed to set up a National Investment Board (NIB) to...

Figure 7: Private sector has taken a prominent role
Private-sector infrastructure spending, USD bn

![Figure 7: Private sector has taken a prominent role](image)

Figure 8: Spending plans ahead
Infrastructure spending as a % of GDP

![Figure 8: Spending plans ahead](image)
10. India – Overcoming the infrastructure deficit

be headed by the Prime minister to fast track the approval process of big investment projects. The NIB is expected to act as a one-stop shop for investment approvals which otherwise need to be cleared at different ministries.

Rational pricing and rational usage: Rational pricing is necessary for both effective demand management and an adequate supply response for a sustainable long-term growth story. Hence under-pricing of various infrastructure facilities should be gradually eliminated. Also, such policies need to be accompanied by a rational usage policy. For example, as pricing of water is a sensitive issue, ‘lifeline’ water supplies for drinking and cooking could be provided at very low prices, while charging appropriately for additional water use by domestic consumers or industry. However, the monitoring policy needs to be tightened significantly.

Facilitating funding: The immediate focus of the government is a further doubling of infrastructure spending to USD 1trn under the 12th FYP (FY13-FY17), with the aim of increasing the ratio of infrastructure spending to GDP to more than 10% by the plan’s final year. Also, as the burden is expected to be shared equally by the public and private sectors, India needs to adopt a two-pronged approach: boost the pool of available funds and allocate such funds efficiently, to ensure that funds flow to the appropriate sectors.

Hence, the government should lay out and adhere to a fiscal consolidation plan. More importantly, such fiscal consolidation should be achieved by carrying out the much-needed expenditure reforms, reducing the subsidy burden to free resources for infrastructure development.

As the private sector is expected to provide 50% of financing requirements, several measures will be required to ease raising such funds. For instance, if a similar financing pattern (48:52 debt-to-equity ratio is used), the private sector will need to raise USD 240bn via the debt route. Specialised infrastructure financing companies and funds need to be set up to refinance some of the loans to reduce the burden on the banking sector. Pension and insurance companies need to be encouraged to finance infrastructure needs, as they would not suffer from the maturity mismatch that the banks face.

Further development of the corporate debt market is crucial for banks, but they would also benefit from efficient credit-risk transfer mechanisms, including credit derivatives and credit insurance. The government also needs to provide a supportive environment by formulating investor-friendly policies and instituting mechanisms to facilitate faster approvals.
11. Indonesia – Infrastructure and bureaucratic reform

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• Infrastructure development and bureaucratic reform are key priorities
• There is good progress on the legal framework for accelerating infrastructure development
• Bureaucratic reform is moving forward slowly

Concern that reform is too slow

In the 15 years since the Asian crisis hit Indonesia in 1997, considerable progress has been made in both economic and political reform. The first steps were to establish democracy and stabilise the economy, achieved under the IMF programme from 1998-2004. Reform continued over the last decade, particularly in strengthening macroeconomic management and in regulatory reform and decentralisation. Economic growth has accelerated and Indonesia weathered the world downturn well, but there are fears that the pace of reform has slowed.

In our Super-Cycle Report, we project Indonesia to become the sixth largest economy in the world by 2030, in nominal GDP terms. The projection was made by assuming real GDP will grow by around 7% annually, on average, from 2014-30, which compares with only 5.2% on average in the last ten years. However, this GDP growth target will be difficult to achieve if the problems of infrastructure bottlenecks and bureaucratic inefficiencies and corruption are not resolved quickly. In this chapter, we will focus on two areas: (1) accelerated infrastructure development and (2) bureaucratic reform.

Accelerated infrastructure development

Indonesia still lags far behind Singapore, Malaysia and Thailand in terms of the quality of its infrastructure, and is significantly ahead of India only in electricity supply (Figure 1). Infrastructure development has been slow in the past decade and has relied heavily on government spending. Fiscal consolidation made a high level of spending difficult. The government estimates that USD 1,429trn is needed for infrastructure development to achieve annual GDP growth of 5-7% during 2010-14, but can only provide about 35% of this funding. The remaining 65% is expected to come from the private sector, although so far funding is flowing more slowly than hoped.

Unless infrastructure conditions improve, it will be hard for Indonesia to enjoy higher than 7% economic growth

<table>
<thead>
<tr>
<th>Country</th>
<th>Singapore</th>
<th>Malaysia</th>
<th>Thailand</th>
<th>China</th>
<th>India</th>
<th>Indonesia</th>
<th>Philippines</th>
</tr>
</thead>
<tbody>
<tr>
<td>Roads</td>
<td>6.5</td>
<td>5.4</td>
<td>5.0</td>
<td>4.4</td>
<td>3.5</td>
<td>3.4</td>
<td>3.4</td>
</tr>
<tr>
<td>Railroads</td>
<td>5.7</td>
<td>4.9</td>
<td>2.6</td>
<td>4.6</td>
<td>4.4</td>
<td>3.2</td>
<td>1.9</td>
</tr>
<tr>
<td>Seaports</td>
<td>6.8</td>
<td>5.5</td>
<td>4.6</td>
<td>4.4</td>
<td>4.0</td>
<td>3.6</td>
<td>3.3</td>
</tr>
<tr>
<td>Air transport</td>
<td>6.8</td>
<td>5.9</td>
<td>5.7</td>
<td>4.5</td>
<td>4.7</td>
<td>4.2</td>
<td>3.6</td>
</tr>
<tr>
<td>Electricity</td>
<td>6.7</td>
<td>5.9</td>
<td>5.5</td>
<td>5.2</td>
<td>3.2</td>
<td>3.9</td>
<td>3.7</td>
</tr>
<tr>
<td>Score (out of 7)*</td>
<td>6.5</td>
<td>5.4</td>
<td>4.9</td>
<td>4.3</td>
<td>3.8</td>
<td>3.7</td>
<td>3.6</td>
</tr>
</tbody>
</table>

* 1 = lowest, 7 = highest; Sources: Global Competitiveness Report 2012-13 from World Economic Forum, Standard Chartered Research
11. Indonesia – Infrastructure and bureaucratic reform

In our report on Indonesia’s infrastructure (see Special Report, 14 February 2011, ‘Indonesia – Infrastructure bottlenecks’), we discussed problems related to four types of infrastructure: (1) land infrastructure including roads, toll roads, railroads and bridges; (2) seaports; (3) airports; and (4) electricity.

Land infrastructure is still concentrated in the western part of the country, in particular Sumatra and Java. The government is now focusing on developing a trans-Java toll-road system, but land clearance remains an issue. Meanwhile, compared to those in other ASEAN-5 countries, Indonesia’s main airports and seaports are outdated and, in some cases, overcrowded (Figures 2 and 3). New power plants are also badly needed to boost electricity supply and meet surging domestic electricity demand.

Financing, however, is not the sole problem pertaining to slow infrastructure development since the fall of the Suharto Administration. There are also other problems, such as land clearance, lack of skilled project managers, legal uncertainties (including contradictory central and local government regulations), red tape and extortion by bureaucrats, and unwillingness of government officials to become project managers or auctioneers of infrastructure projects because of the anti-corruption campaign by the anti-corruption commission (KPK).

To deal with the land-clearance problem, the parliament has approved the land-acquisition law for public interest (see On the Ground, 19 December 2011, ‘Indonesia – Land acquisition bill approved’); although the effectiveness of the law will be largely determined by lower-level implementation regulations.

In our Special Report on Infrastructure bottlenecks, we ran scenarios to assess the impact of infrastructure development in the transport and electricity sectors on Indonesia’s GDP growth. Under the best of our most plausible scenarios, Indonesia’s economy will grow 7.1-7.6% per year during 2011-14 if the private-sector participation rate reaches 50% of what is required and the government increases spending on transport infrastructure by 20% per year (ceteris paribus). Under an alternative (also positive) scenario, if capital expenditure by the state electricity sector is increased by 20% and private-sector participation reaches 50% of what is needed, growth can reach 6.9-7.5% (ceteris paribus). However, without these improvements, growth could be mired in the 5-6% range, well under Indonesia’s real potential.
11. Indonesia – Infrastructure and bureaucratic reform

Bureaucratic reform

Indonesia currently has 4.6mn civil servants, mostly working for local government. As Figure 4 shows, around 73% of Indonesia’s civil servants in 2010 worked at the municipal and regency level, 7% at the provincial level, and 20% at the central government level. The large size of Indonesia’s civil service bureaucracy places a significant fiscal burden on the government.

Formally, the central government is responsible for paying salaries to central government civil servants, while provincial governments and regency and/or municipal governments are responsible for paying local civil servants. In practice, however, the central government indirectly pays local government civil servants through fund transfers to regions allocated in the central government’s budget.

The central government’s expenditure on personnel (including salaries and allowances) has historically always been higher than capital expenditure, which is closely related to infrastructure spending. In 2011, for instance, 20% of central government expenditure was allocated to personnel, versus 13% for capital expenditure (Figure 5).

Personnel expenditure (Figures 6 and 7) also accounts for a significant portion of local government budgets at the provincial level (around 25% during 2006-09), as well as at the municipal and regency level (around 40-50%). Creation of new regencies and municipalities (which increases demand for local civil servants) is the main reason behind the high amount of personnel spending in local government budgets. By the end of the Suharto Administration in 1998, there were 341 municipalities and regencies; the number increased to 497 in 2011. According to the Minister of Interior Affairs Gamawan Fauzi, personnel spending accounted for more than 50% of 2011 local-government budgets across 294 (out of 497) regencies and municipalities.

The government must address not only the size of the bureaucracy, but also its lack of effectiveness and widespread corruption. According to the World Bank’s worldwide governance indicators, Indonesia lags behind Singapore, Malaysia, and Thailand both in terms of government effectiveness and control of corruption. To combat corruption, the government established the anti-corruption commission (KPK) in 2003.
11. Indonesia – Infrastructure and bureaucratic reform

To improve the efficiency and quality of its bureaucracy, the government has taken some measures, including the following:

1) Offering early retirement

In June 2011, Finance Minister Agus Martowardojo proposed a plan to reduce the number of civil servants by offering early pensions with a ‘golden handshake’, starting with MoF employees aged 50 or above. The proposal received positive feedback from the parliament and other government ministries.

Around 21% of Indonesia’s total civil servants are older than 50 (Figure 8). The normal retirement age in Indonesia is 56, but it can be extended for some jobs, such as teachers and lecturers. By offering early pensions to this segment of civil servants, we believe the government has two objectives: (1) to reduce the fiscal burden and (2) to accelerate bureaucratic reform by allowing younger civil servants (who are better educated and less exposed to the culture of corruption) to fill strategic posts.

2) Temporarily halting recruiting

In July 2011, a moratorium on civil servant recruitment was jointly signed by the finance minister, the minister of interior affairs, and the minister for administrative and bureaucratic reform. Based on this moratorium, the central government and local governments has suspended recruitment of new civil servants from 1 September 2011 to 31 December 2012.

3) Redistribution

The government will also redistribute civil servants across ministries, agencies and local governments, according to their expertise and the needs of the respective institutions. In 2010, around 49.6% of civil servants in Indonesia performed general functions (mainly administrative), 45.6% performed specific functions (with specific skills needed), and the other 4.8% were doing managerial jobs (e.g., as head of unit, head of department, or director). Indonesia still badly needs medical workers and educators (especially in areas outside Java), while it needs fewer administrators and clerks.

Figure 6: Provinces also have big payrolls
As % of total provincial spending

Figure 7: Local government payroll is the most bloated
As % of total regencies’ and municipalities’ spending

Source: Central Agency of Statistics
4) **Education and training**

The government must also address the education level of the bureaucracy. Around 38% of Indonesia’s civil servants have an education level of high school or lower, which does not provide them with the applied skills needed to properly perform bureaucratic functions (Figure 9).

To improve civil servants’ skills, the government offers scholarships for graduate education and training (either in domestic or overseas universities), not only through the Ministry of Education, but also other ministries and agencies. The government also has established partnerships with foreign governments and international donors to send selected civil servants abroad. In a recent controversial move, Trade Minister Policy even asked young civil servants in his ministry to obtain a minimum paper-based TOEFL score of 600 (after undergoing language training) to improve their communication and negotiation skills in dealing with foreign counterparties.

5) **Improvement in recruitment**

In January 2012, the government formed a consortium of 10 state universities to conduct selection of civil-servant candidates in the next period of recruitment (presumably in 2013). The involvement of universities is expected to ensure transparent and competency-based recruitment, as civil-servant recruitment in the past, especially in local governments, was often associated with nepotism, collusion, and corruption involving recruiters and high-level government officials.

**Conclusion – Moving slowly, but moving forward**

Infrastructure development and bureaucratic reform take time and have long-term objectives, so it is still early to judge progress. In general, we believe that the government is on the right track, but the achievements over the past year have mainly been in preparing the legal framework for reforms. Tangible results are yet to be seen.

On the infrastructure front, the issuance of the land-acquisition law for public interest represents a significant step forward, as the law gives certainty on the timing for dispute settlement pertaining to the amount of compensation offered by the National Land Agency (BPN) to the land owner (i.e., a maximum of 44 working days if the appeal is settled in the district court, or 88 working days if the appeal is taken all the...
way to the supreme court). The government has also issued a government regulation (Peraturan Pemerintah No. 56/2011) as a legal basis for the issuance of infrastructure Islamic bonds (sukuk bonds) for project financing.

It is more difficult to see progress on bureaucratic reform, as it takes longer for bureaucratic restructuring than for expediting infrastructure development. The government is understandably trying to avoid harsh measures, such as abrupt downsizing and firing, which would have significant socio-political costs, opting instead for softer measures, through temporarily halting recruitment and redistribution of existing civil servants.
Measures to boost the labour supply could help manage government debt and ageing

Increasing women’s participation and reducing unemployment among the elderly are key

Providing better employment protection to non-regular workers is also important

How labour-market reform can help

Since its bubble economy collapsed during the late 1990s, Japan seems to have been trapped in a vicious cycle. Despite a fragile recovery in the early 2000s, Japan has been troubled by sluggish growth and persistent deflation for the past 20 years – the ‘lost decades’. A declining and ageing population compounds the problems. Rising public debt and Japanese yen (JPY) appreciation are additional challenges. All of these pose significant risks to the economy and signal the urgent need for reform.

Japan attempted systemic reforms in the early 1990s and 2000s, including economic deregulation and structural reforms. But few of them bore fruit, either because of their slow pace or lack of coherence. The latest ‘new growth’ strategy, which was proposed in 2010, is regarded as ‘the third approach’ to revive the economy through reforms in areas including public finance, social security and the labour market. In this section, we will focus on labour-market reform.

Ageing population and low fertility

Japan has long been troubled by an ageing population and low fertility. According to the UN, people aged 60 years old or over currently constitute 31% of Japan’s population and are expected to increase to more than 40% by 2050. Meanwhile, Japan has a fertility ratio of 1.32, lower than many other developed countries (US: 2.07, Canada: 1.65, Germany: 1.36, and UK: 1.83) from 2005-10. As a result, Japan’s working-age population increased merely 1.99% in the 10 years, from 2000-09 (US: 10.92%, Australia: 16.77%, Germany: 2.27%, and UK: 7.13%), and contracted for the first time in 2010, by 0.01%. The labour force deteriorated at a much faster pace. From 2000 to 2010, the labour force declined by 2.6%, and total employment shrank by 2.9%.
In contrast, job supply shows a different picture. Average annual growth in jobs offered in 2010 and 2011 was 8.4% and 19.4%, respectively, and growth in new jobs offered was 10.0% and 14.8%, respectively. The job-to-applicant ratio improved to 0.65 in 2011 from 0.48 in 2009 (although it is still far below 1). As such, increasing the labour supply through labour-market reform is critical, especially given that Japan’s productivity level is still relatively high.

In fact, Japan’s labour productivity growth was impressive during the 2000-10 period compared with other G7 countries. Labour productivity growth averaged 1.66%, behind the US but well ahead of major European countries. Multi-factor productivity also increased 1.2% during this period, ranking Japan fifth among OECD countries. We expect labour-market reform to mitigate the negative impact of the ageing population and labour-supply shortage and help Japan’s economy regain growth momentum.

Three types of workers are key to reform

Female workers

Japan’s female-worker participation rate increased to 69.6% in 2010 from 63.8% in 2000 (OECD data) as women advanced socially. However, the participation-rate curve shows an M-shape, with the rate of prime-age (25-54) women ranking sixth-lowest in the OECD in 2009. In Japan, around 60% of female workers still withdraw from the labour force when their first child is born, generally before reaching the age of between 25 and 34.

The percentage of female employees is only 24%, the lowest among G7 countries and even lower than in some developing countries (The Corporate Gender Gap Report, 2010). The percentage of women holding ‘leadership positions’ in decision-making processes is also quite low, below 15% for most areas. Meanwhile, there is a wage gap of c.30% between men and women, regardless of whether they are full-time or part-time workers. According to the Gender Gap index,16 Japan ranked 101st out of 134 countries.

Figure 3: Japan’s labour productivity is not bad among G7

Average growth of labour productivity over 2000-10, %

<table>
<thead>
<tr>
<th>Country</th>
<th>2000-10 Growth</th>
</tr>
</thead>
<tbody>
<tr>
<td>US</td>
<td>2.5</td>
</tr>
<tr>
<td>Japan</td>
<td>2.0</td>
</tr>
<tr>
<td>UK</td>
<td>1.5</td>
</tr>
<tr>
<td>Germany</td>
<td>1.0</td>
</tr>
<tr>
<td>France</td>
<td>0.5</td>
</tr>
<tr>
<td>Canada</td>
<td>0.0</td>
</tr>
</tbody>
</table>

Sources: OECD, Standard Chartered Research

Figure 4: Unemployment rate rose after the financial crisis

<table>
<thead>
<tr>
<th>Year</th>
<th>Unemployment Rate, Male</th>
<th>Unemployment Rate, Female</th>
</tr>
</thead>
<tbody>
<tr>
<td>1991</td>
<td>1.0</td>
<td>1.5</td>
</tr>
<tr>
<td>1993</td>
<td>1.5</td>
<td>2.0</td>
</tr>
<tr>
<td>1995</td>
<td>2.0</td>
<td>2.5</td>
</tr>
<tr>
<td>1997</td>
<td>2.5</td>
<td>3.0</td>
</tr>
<tr>
<td>1999</td>
<td>3.0</td>
<td>3.5</td>
</tr>
<tr>
<td>2001</td>
<td>4.0</td>
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<td>5.0</td>
<td>5.5</td>
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<tr>
<td>2005</td>
<td>5.5</td>
<td>6.0</td>
</tr>
<tr>
<td>2007</td>
<td>6.0</td>
<td>6.5</td>
</tr>
<tr>
<td>2009</td>
<td>6.5</td>
<td>7.0</td>
</tr>
<tr>
<td>2011</td>
<td>7.0</td>
<td>7.5</td>
</tr>
</tbody>
</table>

Sources: CEIC, Standard Chartered Research

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16 A framework for capturing the magnitude and scope of gender-based disparities across health, education and political and economic empowerment released by the World Economic Forum in 2009.
12. Japan – Labour-market reform

**Older workers**

In 2010, the participation rates for those aged 60-64 and 65-69 were 60.5% and 37.6%, respectively, ranking Japan fourth among OECD countries. However, Japan is one of the top five among the OECD, with the highest unemployment rate for both the above-mentioned age groups. This ‘dual high’ ratio suggests that the elderly are motivated to find jobs, but there may not be many opportunities for them to continue working once they retire. The labour force for the 15-24 and 25-34 age groups decreased by 11% from 2007 to 2011, reflecting a lack of labour-supply among young people.

Those aged 60-69 are mainly the first baby boomers, who were born just after WWII. When asked until what age they want to continue working after retirement, 45.3% want to work until age 65 and 22.9% want to work as long as they are in good health, according to one government survey. So far, some 95% of companies that fall under a 2006 elderly employment law have programmes to accommodate workers between the ages of 60 and 65; however, companies are not embracing elderly workers and fewer than half can offers jobs to all the 60-year-olds who want them. Some have been unable to provide jobs that are attractive enough.

**Non-regular workers**

The term ‘non-regular workers’ here refers to part-time, temporary and dispatched workers. Japanese companies reduced long-term employment by doubling the number of non-regular workers between 1990 and 2008, taking the percentage of non-regular workers of total employment to a record high of 34%. This is why the term ‘labour-market dualism’ is often used in reference to Japan’s labour market in recent years.

Fluctuations in the workload and reduction of wage costs are two main reasons corporates have used non-regular workers in the past two decades, as Japan’s sluggish economic growth, corporate cost-cutting and labour-market deregulation transformed the employment landscape.

Compared to regular workers, who are entitled to a decent income, indefinite contracts and a high level of job security, non-regular workers experience the opposite. Their hourly wage is only 60% that of regular workers, a gap which is too large to be explained by the productivity gap. Smaller bonuses further widen the

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**Figure 5: Non-regular workers in Japan are on the rise**

<table>
<thead>
<tr>
<th>Year</th>
<th>Part-time</th>
<th>Temporary</th>
<th>Dispatched</th>
<th>Other</th>
</tr>
</thead>
<tbody>
<tr>
<td>2005</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>2006</td>
<td></td>
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<td>2007</td>
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<td>2008</td>
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<td>2009</td>
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<td></td>
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<tr>
<td>2010</td>
<td></td>
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<td></td>
</tr>
</tbody>
</table>

Sources: Ministry of internal affairs and communications, OECD, Standard Chartered Research

**Figure 6: Labour force growth for different age groups**

<table>
<thead>
<tr>
<th>Age Group</th>
<th>2005</th>
<th>2006</th>
<th>2007</th>
<th>2011</th>
</tr>
</thead>
<tbody>
<tr>
<td>15-24</td>
<td>31.0</td>
<td>31.5</td>
<td>32.0</td>
<td>32.5</td>
</tr>
<tr>
<td>25-34</td>
<td>33.0</td>
<td>33.5</td>
<td>34.0</td>
<td>34.5</td>
</tr>
<tr>
<td>60-64</td>
<td>31.0</td>
<td>31.5</td>
<td>32.0</td>
<td>32.5</td>
</tr>
<tr>
<td>65-69</td>
<td>31.0</td>
<td>31.5</td>
<td>32.0</td>
<td>32.5</td>
</tr>
</tbody>
</table>

Sources: CEIC, Standard Chartered Research
earnings gap. The total income of non-regular workers including bonuses and overtime is only 54% of that of regular workers. More than 10mn non-regular workers in Japan are now ‘working poor’. Income inequality among working-age people in Japan has increased since 2003. In addition, they have less on-the-job training and less social security. Employers are reluctant to invest in training for non-regular workers who may not stay. Around 40% of non-regular workers are not covered by employment insurance, although they are the first hit during a financial crisis.

**What needs to be done?**

**Boost the participation rate of women**

The Basic Law for a Gender-equal Society has been implemented for more than 10 years in Japan, and women’s participation in the work force has gradually improved. However, progress has been slow. There is a marked lack of role models for professional women. Social and cultural practices make women reluctant to seek jobs after having children or even getting married. The stereotype that men should take prime responsibility in the workplace, while women should take care of the housework, is still dominant. As such, reshaping the role of women in Japan and advocating a new dual-earner household model are important.

In addition, a successful work-life balance and a working environment that motivates women and provides them with opportunities to realise their potential will influence their decisions to continue working after marriage and childbirth, and during child-rearing. As such, the government and employers should improve the availability of affordable and high-quality nursery and kindergarten programmes for pre-school children to alleviate child-care concerns. The government plans to increase the percentage of women in leadership positions to 30% by 2020 from less than 15% currently in most areas.

Some argue that encouraging women to participate in the labour force may further push down Japan’s fertility rate. However, this is not necessarily so. If society allows more flexibility and encouragement for mothers to continue working after they have children, this would help to dispel anxiety and smooth the transition to professional worker from homemaker. With the proper social and structural support, women could go back to work without as much pressure from the family and society, even after they have children.

**Improve the hiring environment for older workers**

Older people in Japan are generally highly motivated and qualified for work, even after they retire. Many of the first baby boomers (age 60-69), who grew up during Japan’s era of rapid economic growth and formed a high-quality workforce have valuable talents and accumulated impressive professional skills during their working lives. More importantly, they are more motivated to continue working after retirement than their peers in other countries.

It is estimated that the first ‘boomer’ generation makes up 5.4% of the total population (2000 national census). Making good use of their talents would be helpful to the job market and economic growth, as they are still capable of working and can act as mentors for young talent. In addition, if the pension eligibility age is raised accordingly, increasing employment among the elderly can help to reduce the government’s fiscal burden, as social-security expenditure is one of the largest components of government spending.
Either raising the mandatory retirement age, currently set at 60, or providing more flexibility to employers to let retired people remain employed as long as their physical condition allows, are practical ways to push down the unemployment rate among the elderly. In 2011, the Ministry of Health, Labour and Welfare proposed to allow people to work up to age 70 by increasing job facilities for people aged above 60 (the life expectancy at birth in Japan was 82.7 from 2005-10, according to World Population Prospects 2010). Although the proposal was rejected at end-2011, we think the plan is reasonable and could be part of future social-security reform aimed at improving Japan’s fiscal position and creating sustainable economic growth. The Cabinet also aims to increase the employment rate for people aged 60-64 from 57.0% in 2009 to 63% in 2020.

Some may worry that keeping the elderly at work will crowd out young workers or new graduates. However, we do not agree. Senior workers can provide valuable advice and on-the-job training for new joiners, who lack experience and need guidance at the beginning of their career paths. As employers will offer mainly non-regular jobs to the elderly, this will not necessarily affect new joiners, who may assume more permanent roles.

Provide better employment protection to non-regular workers

Non-regular workers face a couple of issues. The big income gap and insufficient social-security coverage are the most serious, in our view. Revisions of the Employment Insurance Law in 2009 and 2010 relaxed the eligibility requirement from workers employed at least one year to those employed 31 days or more. The next step is to enforce the extended coverage. Japan reportedly is among the most lenient countries as far as allowing companies to evade payment of social insurance premiums, with almost no criminal indictments. Enhancing the regulation of tax collection and social insurance contributions might help improve compliance.

It is also hard for non-regular workers to become regular workers. For those who are interested in becoming regular workers, education and age are most important. The more highly educated and younger the non-regular worker is, the bigger the chance he can move to regular status. Hence, universal higher education and the enhancement of campus career preparation and planning for graduates are helpful. Providing broad secondary education, public vocational training and diversified career paths can also help. Establishing a standard system of certification of professional skills to ensure effective training is another way to facilitate the transition. However, female and older non-regular workers are less willing to change their current employment type than male or younger workers, as they prefer work flexibility and convenience and less pressure. For them, increasing insurance coverage and raising hourly wages would be the most practical reform.

Conclusion – Growth is needed to combat debt and ageing

The labour market is far from the only area to need reforms. Another major target should be to deregulate the services sector, particularly retail and distribution, where productivity lags far behind the manufacturing sector. Meanwhile, controlling Japan’s ever-rising public debt and managing the fast-ageing population will be critical over the next decade. Reforms to boost the labour supply can play an important role by helping to boost economic growth. Measures to keep older people in work could also help deal with the problems of ageing, including low incomes.
13. Nigeria – Escaping the oil curse

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- Strong growth, oil and favourable demographics drive optimism about Nigeria’s prospects
- Despite a decade of strong growth, some evidence suggests poverty is increasing
- Important reforms have been initiated, but more is needed for transformative GDP growth

Reforms to drive more meaningful growth

Since its transition to civilian rule in 1999, Nigeria has seen the longest sustained period of growth in its non-oil economy since independence\(^\text{17}\) in 1960, giving rise to claims that Nigeria may finally have overcome its long-running susceptibility to the ‘resource curse’. Governance has improved, important fiscal reforms have been put in place, and in the last decade, growth has accelerated further, averaging close to 7% per annum. Importantly however, Nigeria has not been severely tested by weaker oil revenue over this time. For much of the last decade (FY12 is the only exception) the benchmark price of crude oil assumed in Nigeria’s Federal Government Budget has risen steadily.

In many ways, Nigeria still exhibits classic symptoms of a ‘rentier’ economy, a resource-rich economy, where activity remains dependent on the ‘rent’ generated by natural resources, often to the detriment of other economic activity, and despite the country’s vast potential. Rentier economies are typically seen as allocation rather than production economies\(^\text{18}\). Government is seen as pivotal to wealth creation, with job creation demands leading to bloated bureaucracies. In rentier economies, government spending as a % of GDP is typically high.

While this is not strictly true of Nigeria (spending is around 27% of pre-rebased GDP, suggesting it will be even lower when GDP is properly measured), Nigeria remains overly dependent on oil – a non-renewable resource – for its fiscal and export revenue (c.73% and 97%, respectively). When oil is stripped out of consolidated government revenue, it falls to only 7% of GDP\(^\text{19}\), far below the Sub-Saharan African (SSA) average. Meanwhile, recurrent expenditure has the greatest share of

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\(^{17}\) Nigeria ‘Employment and Growth Study’, World Bank, November 2009.
\(^{19}\) According to IMF data, Article IV Country report released July 2012, other estimates suggest an even lower figure.
government spending, much of it on overhead costs and wages. In other words, most of the country’s resources are devoted to the cost of running government, with little long-term benefit.

Another key characteristic of a rentier economy is that there is often a vast difference between median real per-capita incomes and the numbers derived by dividing GDP by the size of the population. In Nigeria, nominal per-capita income is estimated at USD 1,545, yet as much as 60-70% of the population is thought to live on USD 1 a day, and 90% of the population subsists on less than USD 2 a day. With Nigeria’s GDP due to be rebased for the first time since 1990, an exercise that may drive up per-capita income by as much as 40%, the disparity is likely to be greater still.

Rentier economies tend also to be characterised by the absence of long-term policy making. Typically, there is little willingness to forego consumption today in order to generate future savings. With ever-increasing demands on government resources, it becomes difficult to rein in spending. Political systems in rentier states, where there is a strong sense of entitlement, make reforms difficult – especially where costs are borne in the short term and the benefits of reforms are only seen in the medium to long term. This phenomenon continues to complicate the reform agenda in Nigeria.

The relative autonomy of fiscal earnings (where revenue is derived independently of the domestic economy) weakens political accountability. The result tends to be short-term horizons, a preference for liquidity and quick returns, and the relative absence of long-term investment that economies need for meaningful transformation.

‘Development states’ have long been seen as those where long-term planning is possible. Rentier states, in contrast, may see rapid growth short-term (especially during resource booms), but long-term, meaningful change can be hobbled.

There are two key reasons for speeding up the pace of reform in Nigeria. The first is demographic. Nigeria, already SSA’s most populous economy, is expected to become the third most populous economy globally by 2055. The second is evidence suggesting that even trend growth above 7% in Nigeria’s non-oil economy has been insufficient to secure lasting gains.

Consolidated government revenue data published by the IMF suggests that Nigeria receives approximately USD 50bn of oil revenue annually. Other estimates, from the Federal Government, are even lower. Even if this amount were split between Nigeria’s 167mn people, it would account for less than USD 0.85 per person, per day – even at a time of unusually high oil prices. Were oil prices to weaken from current highs, Nigeria would find itself in a difficult position.

Nor is there much evidence that the non-oil economy might act as a safeguard in the event of a sustained decline in oil earnings. Reports of doubled real incomes in family agriculture in the decade since Nigeria’s transition to civilian rule – as outlined in a 2009 World Bank Report – are now widely contested. Nigeria’s own Poverty Profile Report (2012) found that despite the oil boom and robust headline GDP growth in the non-oil economy, the incidence of both relative and absolute poverty in Nigeria appears to have risen.

21 Ibid.
22 For all three tiers of the Federation – federal, state and local government.
24 MTEF figures from the Federal Ministry of Finance suggest the number is even lower, at c. USD 45bn.
13. Nigeria – Escaping the oil curse

The report estimates that by 2010, 69.0% of Nigerians were living in absolute poverty (Figure 2). 61.2% of Nigerians were living on less than USD 1/day, up from 51.6% in 2004, with marked regional differences in the incidence of poverty. Income inequality, measured by Nigeria’s Gini coefficient, has worsened marginally, from 0.43 in 2004, to 0.45 in 2010. From a political risk perspective, subjective poverty (the number of survey respondents identifying themselves as poor) increased to 93.9% nationally in 2010, from 75.5% in 2004. Despite continued strong headline GDP growth, early survey evidence suggests that poverty likely rose further in 2011, with relative poverty at 71.5%, absolute poverty at 61.9% and dollar-a-day poverty up to 62.8%.

Amid a deteriorating security situation which is significantly correlated with the regional distribution of poverty in Nigeria, the data serves as a timely reminder of the need to accelerate reform. With global risks also significant, there is a need for Nigeria to right-size spending now, to rebuild its buffers against an external crisis. We suggest a list of reforms that might help Nigeria overcome its rentier characteristics and set it on the path of more sustainable reform.

10 Reforms to drive structural transformation in Nigeria

1) Extend the time-horizon of policy
2) Boost long-term savings
3) Reduce vulnerability to the oil cycle
4) Create the fiscal space for infrastructure spending
5) Establish costs for ‘deviant behaviour’
6) Reduce fiscal discretion
7) Live with low oil prices
8) Strengthen institutions
9) Maintain technocratic reform teams
10) Break the cycle of political patronage

Lengthen term-horizons
Short-term thinking constrains investment, depriving resource economies of important growth and transformation opportunities. On a micro-level, this manifests itself in weak implementation of Nigeria’s capital budget, a recurring issue, regardless of the amounts earmarked for development expenditure. Measures to introduce performance targets for all ministries are a step in the right direction, although Nigeria’s political system – still driven by the politics of ethnicity rather than service delivery – is a disabling factor. Short-term performance targets aligned to a long-term delivery schedule (in the power sector, for example) would be a clear win.

Boost long-term savings – From ECA to a sovereign wealth fund
Nigeria has done much to try to improve its record on long-term savings, although its current efforts may not be enough. In 2004, Nigeria enacted an oil price-based rule for the first time. Windfall oil revenue occurring whenever oil prices exceeded the budget benchmark would be diverted to an excess crude account (ECA) belonging to the Federation. Initially successful, some of the budget deficit of 2005 was financed using ECA savings. ECA proceeds also contributed significantly to Nigeria’s FX reserves accumulation – for a while, at least.

A major shortcoming of the ECA was the absence of clear rules governing withdrawals, which could be done at presidential discretion. From USD 20bn at end-
13. Nigeria – Escaping the oil curse

2007, the ECA was whittled down to only USD 0.3bn by end-2010. Although ECA balances have increased since then, frequent withdrawals, often to augment revenue when oil output disappoints, remain the norm.

Recognising these shortcomings, legislation allowing Nigeria to establish a sovereign wealth fund has been passed. Under the new system, withdrawals from long-term savings would be subject to set rules. The fund itself would have three components: a future-generation fund, a Nigeria infrastructure fund, and a stabilisation fund, seen as a ‘last resort’ source of financing for budget deficits. Should oil and gas revenues fall below budget forecasts, the government could request support from the stabilisation fund at the end of each financial quarter.

Despite the passage of legislation establishing the sovereign wealth fund (SWF), operation has been subject to delay following a legal challenge by state governors. According to Nigeria’s Constitution, oil earnings belong to the Federation (i.e., the three tiers of government), suggesting that a SWF run by the federal government, involving ‘forced’ savings on the other tiers of government, would be unconstitutional. At the time of writing, political agreement allowing the SWF to be operational has been secured, but outside of a set amount of seed capital, it is not clear that all windfall oil earnings will be diverted to the SWF on a regular basis. From the perspective of establishing long-term savings for all tiers of government, this is sub-optimal, and other means of encouraging long-term savings, and more meaningful fiscal responsibility, should still be devised.

Make Nigeria less susceptible to the oil cycle
Apart from creating healthier fiscal buffers to smooth revenue during times of oil-price weakness, Nigeria needs to do much more to boost non-oil revenue. Currently import and excise duties, corporate income tax, and VAT constitute the largest contributors to non-oil revenue. But the amounts mobilised are so small, they call into question the actual size of Nigeria’s economy. Alongside an ongoing effort to right-size government (as much spending is on the operations of government, adding very little to the rest of the economy), more of an effort is needed to broaden the tax base.

Figure 3: Nigeria is over-reliant on resource taxes
Revenue collection mix, selected African economies

Figure 4: Plan to rebalance recurrent, capital spending
Spending excl. statutory reserves, debt service, NGN trn

Politcs has been a key stumbling block to the establishment of a sovereign wealth fund
Nigeria should do more to broaden its tax base

Sources: OECD 2010, *denotes 2006 data
Sources: Reuters, FMFN, Standard Chartered Research
13. Nigeria – Escaping the oil curse

Infrastructure, infrastructure, infrastructure

Although plans to rehabilitate Nigeria’s power sector have been accelerated, focusing on cost recovery and establishing the conditions for greater private-sector involvement, an emphasis on creating the fiscal room for infrastructure development is still needed. The SWF legislation includes an infrastructure fund, which will generate returns through investment in basic infrastructure. However, given that much basic infrastructure provision will still need to be done on non-commercial terms, the absence of sufficient fiscal room for infrastructure spending may constrain meaningful development.

Securing the necessary support for fiscal consolidation may be difficult. As during Nigeria’s failed attempts at fuel subsidy removal, if the benefits of reform are only likely to be seen long-term, while the costs are experienced upfront, the odds are very much stacked against reform. Fiscal consolidation will need to be carefully thought through, with near-term sweeteners to make reform more palatable.

Create costs for deviant behaviour

Nigeria’s rising importance as a frontier market, and its attraction of greater short-term, liquid portfolio flows, may serve as a useful guard against any departure from a reform agenda. The abolition of the minimum 1Y holding period for foreign investment in Federal Government of Nigeria (FGN) bonds in 2011, as well as the promise of Nigeria’s GBI-EM index inclusion in late 2012, have both boosted investor interest in the Nigerian market. Improved turnover in Nigerian bond markets should bring with it the benefit of greater sanction in the event of reform slippage. However, so far, investors have demonstrated a greater receptivity to high yields than any consideration of long-term fiscal reform.

Reduce fiscal discretion

Despite having a Fiscal Responsibility Law in place, which limits the size of the fiscal deficit to 3% of GDP, more needs to be done to lessen fiscal discretion. Given the blowout in spending prior to Nigeria’s April 2011 elections (in 2010, spending increased c. 50% y/y), rules aimed at ensuring the longer-term sustainability of spending increases should be put in place. Adherence to rules based on non-oil revenue generation, or paying greater attention to sustainability of the non-oil primary deficit would help. (For example, the growth rate of the previous year’s non-oil revenue might serve as an upper limit on any new spending increase.)

From a savings perspective, state and local governments should be encouraged to adopt similar practices. This can be done through a variety of means. For example, the Central Bank of Nigeria (CBN) has already initiated granting ‘liquidity status’ to debt issued by state governments that have passed fiscal responsibility legislation of their own. Such liquidity status allows debt issued by state governments to be admissible as collateral at the CBN’s discount window, potentially boosting demand for state government debt.
13. Nigeria – Escaping the oil curse

Oil price-based fiscal rules should be strengthened; Nigeria needs to live within its means

Mimic low oil prices
High oil prices discourage reform and often lead to greater state involvement in the economy (albeit in states with weak records on service delivery) and wasteful spending. Worse still, in Nigeria excessive government spending has often contributed to high costs of sterilisation in order to ensure price stability, with high interest rates subsequently crowding out private-sector lending. (While there is little real-sector lending to begin with, more attractive returns on FGN debt mean that lending to the private sector is even less likely than would be the case with more modest government spending. However, the pursuit of price stability often leaves the authorities with little alternative).

Poor controls on spending and waste are especially damaging to a country’s long-term economic prospects. Outside of the usual ‘Dutch disease’ concerns about discouraging local production, the non-renewable nature of hydrocarbons is often forgotten during oil-price booms. It is difficult for governments to resist calls for increased spending when oil prices are high. A finite resource is typically squandered on spending that brings little lasting benefit to the economy. This emphasises the importance of sticking with an oil price-based fiscal rule. The best way for Nigeria to prepare for potential slumps in the oil price is to live well within its means, even when oil prices are well supported.

Botswana – with its history of fiscal surpluses – did this with its diamond revenue, and benefited during times of crisis. Nigeria has a history of failing to do this adequately, exposing it to oil-price volatility. Plans to create a financial return on Nigeria’s oil savings through the SWF framework are positive, but do not yet go far enough. A country of 167mn people, with one of the fastest population growth rates globally, needs to try even harder to achieve long-term fiscal sustainability.

Strengthen institutions
Lobbying by special interest groups has frequently constrained micro-level reforms, which remain important to Nigeria’s growth environment. Greater autonomy for key institutions may be the solution in some cases. In other instances, achieving the necessary level of institutional strength may be useful in the long term. Increased transparency, more robust disclosure requirements, and improved governance practices – strengthening the rule of law, securing property rights and greater sanctions for errant behaviour, should all contribute to institutional strength.

Establish technocratic reform teams
Nigeria’s greatest reform successes have occurred when technocrats, relatively independent of the political process, have been appointed to key roles. A former World Bank MD as Coordinating Minister for the Economy, an Agriculture Minister who built a career with the Alliance for the Green Revolution in Africa, a Communication Technology Minister with a well-established private-sector reputation, a Securities and Exchange Commission head who was formerly a vice president of the African Development Bank, and an outspoken central bank governor willing to resist political pressure in order to ensure financial and price stability all bode well for the reform process. However, with technocrats with little political base of their own in key positions, strong political backing for the reform process from the Executive remains essential.
13. Nigeria – Escaping the oil curse

Break the cycle of patronage politics
Given that politics is seen as key to securing resources in a rentier economy, breaking the cycle of patronage politics remains all-important. Improving the business climate, fostering private-sector growth and respecting property rights should help create alternatives to politics as a means of wealth creation. Any measure that reduces the extent to which economic activity is concentrated around resource rents, or granting special monopoly privileges should help break the cycle of patronage politics.

Conclusion – Focus on long-term growth is key
It is instructive to consider Nigeria’s most successful reforms of recent years. The growth of mobile telephony was considered something of a game changer in the country, and almost a decade on, growth rates of 30% y/y are not uncommon. A number of success criteria have been identified: First, there was little direct competition with the state. Service provision by the state-owned telephone company was inadequate, allowing space for the private sector, but almost as crucially, the provision of new services did not displace pre-existing vested interests. Power sector and fuel reforms are seen as more difficult, because they do not promise immediate benefits. Finally, it is argued that the high returns available in the telecoms sector played a significant role in the success of mobile telecoms. The same may not hold true – at least in the very short run – for other reforms.

Nigeria’s challenge is to replicate this success in the other areas. Although many of the reforms needed to unlock growth potential are micro in their focus (agriculture, banking, power, oil, etc.), the broad macro underpinnings of the reform environment should not be ignored. Moving away from resource rents is an important common theme. This can only be done through a greater emphasis on long-term planning, fiscal consolidation, macroeconomic stability and the creation of new space for reform. Most of all, the system of patronage that has held Nigeria back for so long needs to change. Oil and gas, even given Nigeria’s vast resources, are not going to determine development in the future. But structural transformation, rising incomes, capital formation and productivity gains do hold much promise for the future. It is important that Nigeria change from being an ‘allocation’ to a ‘production’ state, and that reform is allowed to succeed.

Nigeria has seen successful telecom reforms; crucially, no vested interests were displaced, which might make it difficult to replicate this success in other sectors

14. Singapore – The search for total factor productivity

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- Singapore is now focusing on improving its TFP to sustain growth and increase real wages
- The government is actively implementing schemes for businesses and individuals
- Quality education will be required to bring Singapore to the next level of development

**A continually advancing economy**

Singapore has adopted a state-led growth strategy since its independence in 1965. The strategy has worked well. Singapore is one of the 13 countries highlighted by the Growth Commission report that has had high and sustained growth since World War II. Its per-capita GDP grew from USD 516 (SGD 1,580) in 1965 to USD 43,867 (USD 59,813) in 2010.

Singapore has pursued strategies that are aligned with its overall growth objectives. The country has stayed open and actively goes after foreign investment and know-how; its leadership is pragmatic and strongly committed to growth, and it invests heavily and encourages saving. It facilitates market allocation of resources and strives to provide a stable and favourable macroeconomic environment for businesses and investors. From 2000 to 2011, Singapore managed 5.7% y/y average growth every quarter, despite a highly volatile external climate that witnessed the dot-com crash and the global financial crisis.

A country’s long-run growth can be attributed to labour input, capital investment and total factor productivity (TFP) – what is left after the other inputs are accounted for. As a country becomes more developed, it becomes more difficult to maintain a high rate of growth. Singapore is no exception. The government already lowered the country’s potential growth rate to 3-5% from 4-6% in 2010. Labour input steadily increased its contribution to growth until 2009, before investment became more important during the volatile years after the financial crisis. But infrastructure is already relatively developed. And with labour input set to slow, TFP growth will be a central growth driver.

**Figure 1: Contributions to growth**

<table>
<thead>
<tr>
<th>Year</th>
<th>Labour Input</th>
<th>Capital Input</th>
<th>TFP Growth</th>
</tr>
</thead>
<tbody>
<tr>
<td>2000</td>
<td>2</td>
<td>4</td>
<td>0</td>
</tr>
<tr>
<td>2005</td>
<td>4</td>
<td>4</td>
<td>4</td>
</tr>
<tr>
<td>2006</td>
<td>4</td>
<td>4</td>
<td>4</td>
</tr>
<tr>
<td>2007</td>
<td>4</td>
<td>4</td>
<td>4</td>
</tr>
<tr>
<td>2008</td>
<td>4</td>
<td>4</td>
<td>-2</td>
</tr>
<tr>
<td>2009</td>
<td>4</td>
<td>4</td>
<td>0</td>
</tr>
<tr>
<td>2010</td>
<td>4</td>
<td>4</td>
<td>10</td>
</tr>
</tbody>
</table>

Sources: Department of Statistics, Standard Chartered Research
TFP is elusive

Despite its impressive growth credentials, Singapore has found TFP growth – which is exogenous and not due to factor accumulation – elusive and highly pro-cyclical. According to the Ministry of Finance, TFP growth averaged about 1.8% per annum from 2000-10, about one-third of average GDP growth over the period. However, TFP growth was exceptional (and probably misleading) in 2010: From 1999-2009, productivity growth averaged only about 1.2%, or one-quarter of average GDP growth for the period. With labour input possibly slowing in the years ahead (the government is slowing the inflow of foreign workers) and investment already at over 20% of GDP, higher productivity may be required to sustain annual growth at about 5% – the top end of Singapore’s potential growth rate.

Population growth increased by 3.3% (CAGR basis) from 2006-11, higher than the 2.3% recorded from 2000-11. Various signs – such as the increased occurrence of train breakdowns due to increased frequency to meet higher ridership, unhappiness about over-crowding, and the sharp rise in property prices – suggest that the current infrastructure needs to catch up with population growth. The government has already underlined its intent to slow the inflow of foreign workers. This will slow overall population growth. With labour input lower, and investment unlikely to be boosted beyond its current level, productivity has to be raised.

On a more positive note, Singapore appears to have improved on this front over the years. Alwyn Young’s influential 1994 comparative study found that Singapore’s early growth was entirely attributable to factor accumulation. Average TFP growth per annum during the 1966-90 period was negative at -0.3%. Comparatively, Hong Kong (over the 1966-91 period) registered an annual TFP growth rate of 2.3%, South Korea (1966-90) 1.6% and Taiwan (1966-90) 1.9%.

Measures to boost productivity

Results on labour productivity (different to TFP productivity, but related) released by the Ministry of Trade and Industry show that labour productivity growth has become more volatile in the past five years. Goods-producing industries show considerable
14. Singapore – The search for total factor productivity

upside in productivity gains, though with high volatility. A key current challenge is to
improve labour productivity in the services sector.

In 2010, the government established the high-level National Productivity and
Continuing Education Council (NPCEC) to advance the productivity initiative, and to
raise wages over the long term without compromising competitiveness. One target
was to raise local median wages to SGD 3,800 per month by 2020 from SGD 2,633
as of June 2011. This translates into a CAGR of 4.2%, higher than the 2.9% p.a.
increase recorded from 2001-10 (most of that increase occurred during the second
half of the decade).

The government has tried to increase research and development efforts, deepen
workers’ skills, foster a creative-thinking culture, and encourage entrepreneurship.
This was most recently manifested in the government’s budget for FY12. The
government enhanced the Productivity and Innovation Credit for a third consecutive
year, increasing cash payouts to companies that invest in improving productivity and
innovation. Foreign worker dependency ratio ceilings (the maximum permitted ratio of
foreign workers to total workforce) were lowered to encourage higher productivity. This
trend is set to continue in coming budgets as Singapore focuses on improving the
value added from companies and people.

Over the years, Singapore has relied heavily on cheap foreign labour. This has
meant low productivity, particularly in non-tradables sectors, as employers do not
have to raise workers’ productivity. The decision to restrict foreign worker inflows will
force employers to raise productivity or risk being priced out of the market as
business costs increase. If a company cannot raise productivity amid higher costs, it
will be forced to relocate, leaving only companies with high productivity.

The structural shift in Singapore’s economy

To achieve strong and sustained growth over the past few decades, Singapore has
constantly reformed its economic structure. It set up the Economic Development
Board (EDB) in 1961 to focus on developing the manufacturing sector, which was
instrumental in setting up industrial estates such as the Jurong Industrial Estate. Once
manufacturing had set roots, the government began to transform the sector from a
labour-intensive one to one characterised by automation and higher capital and
technology intensity. Manufacturing is still an important pillar of growth for the
14. Singapore – The search for total factor productivity

economy. However, due to high cost and wage pressures, the sector has moved towards producing high value-added goods to remain relevant in a high-income economy.

The biomedical sector has been a success story on this front. Recently, the industry has been instrumental in supporting GDP growth, despite the sluggish manufacturing sector as a whole. The high-technology nature and specialisation of the industry provides the scope and potential for productivity and innovation to filter through and add value to the economy. In fact, value-added per worker in the pharmaceutical sector is the highest in Singapore’s manufacturing sector (as of 2010, value-added per worker in the pharmaceutical sector was SGD 1.8mn, compared to the industry’s SGD 111,000). The focus on higher value-added industries will help Singapore meet growing competition from other centres and raise its overall worker productivity.

The fact that the manufacturing sector faces global competition has directly facilitated the sector’s restructuring into higher value-added industries. However, while services have grown in economic importance, some services sectors have seen stagnating wages and productivity due to the inflow of cheap foreign labour and their non-tradable nature. It is widely acknowledged that construction, for example, will require a revolution to raise productivity and wages. Similarly, the retail sector has fallen behind on this front. For example, the ratio of the average earnings of an employee in the hotel and restaurant industry to the average earnings of the services industry was 0.38 in 2006. By 2010, this ratio had deteriorated to 0.36. In part, this has also resulted in a widening income gap in Singapore. While the manufacturing sector has managed to climb up the value chain, there is a dire need for some industries in the services sector to catch up.

Education is crucial
Finding that elusive TFP is not just about greater automation and training. Innovation is a crucial ingredient to transform Singapore into a knowledge-based economy. Hence, the importance of education cannot be overstated. Statistically, Singapore has performed commendably on this front. It ranks highly on the quality of its education system, according to the World Economic Forum. Its universities are among the highest-ranked in Asia.

<table>
<thead>
<tr>
<th>Figure 6: Singapore is ranked highly in education quality</th>
<th>Figure 7: Labour force with tertiary education</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Top 10 countries out of 144 surveyed; mean score of 3.9</strong></td>
<td><strong>% of total labour force, 2007</strong></td>
</tr>
<tr>
<td><strong>Score</strong></td>
<td><strong>Malaysia</strong></td>
</tr>
<tr>
<td>Switzerland</td>
<td>6.0</td>
</tr>
<tr>
<td>Finland</td>
<td>5.8</td>
</tr>
<tr>
<td>Singapore</td>
<td>5.8</td>
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<tr>
<td>Qatar</td>
<td>5.7</td>
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<tr>
<td>Belgium</td>
<td>5.4</td>
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<tr>
<td>Canada</td>
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<td>Barbados</td>
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<tr>
<td>Iceland</td>
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<tr>
<td>Ireland</td>
<td>5.3</td>
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<tr>
<td>Lebanon</td>
<td>5.3</td>
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</tbody>
</table>
Singapore’s strategy has been to rely on polytechnic graduates for its industrial labour force. Polytechnic courses (mainly engineering, accountancy, biotechnology, business studies) have evolved over the years to shift skill sets towards technology-intensive industries. Many polytechnic graduates pursue tertiary education as well. High enrolment in polytechnics emphasises Singapore’s commitment to becoming a high-value industrial hub.

Tertiary education has become more commonplace as Singapore progresses economically. Tertiary degree holders constituted 17% of the resident labour force in 2000, and this rose to 28.3% as of 2011. However, this is still low compared to countries such as the US, where the tertiary labour force was 61% of the total (based on 2007 data).

**Spurring creativity**

Nonetheless, a relentless push to increase the number of workers with tertiary education may not be the best approach, as the strategy should complement the structure of the economy. More importantly, in terms of innovation, the quality of education may be more important than the quantity (i.e., years of education). The quality of education is more difficult to define, and the results more intangible. Singapore’s education system has been adjusted to offer more choices for students. Specialised and independent schools have been set up. They include the Sports School, the NUS High School, the School of the Arts (SOTA) and, more recently, the School of Science and Technology. In addition, more elective programmes are offered for students who are gifted in languages, art, music, and sports. These changes are intended to provide an appropriate and well-rounded education to students.

Rote learning has given way to an educational approach that attempts to foster more creativity in the hopes of spurring innovation and creating world-class enterprises. Singapore’s education culture will have to continue to change. More risk-taking needs to be taught and advocated, while making mistakes should be encouraged, not frowned upon. Admittedly, results will only be seen in a generation’s time. And given the small size of Singapore’s population, more diversified systems of education will be required to prevent the loss of a whole generation who may be ill equipped to adapt to the new environment should the education strategy prove flawed.

**Conclusion – Boosting TFP while maintaining the social compact**

Singapore has always pursued active management of the economy and society. The search for TFP is no different. Fortunately, the government has introduced many reforms to improve productivity. Reforms aimed at boosting productivity will help Singapore move to the next level in its economic development.

One challenge is that the productivity reform has to implemented while maintaining the social compact. Hence, more focus is needed on sectors that have fallen behind. The current measure to restrict cheap foreign labour appears to meet both requirements. To improve overall productivity, the economy has to shift towards a knowledge-based one that relies on ideas, creativity and innovation. Here, the quality of education, not just the quantity, will be key to helping Singapore meet new challenges in the future.
15. South Korea – Boosting the services sector

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- Trend growth has persistently slowed since the 1970s
- Weak productivity growth in the services sector is key
- Government measures rightly focus on liberalisation

Reversing the long-term decline in growth

In Korea, reform is considered the most effective way to stop the trend of slowing economic growth. People are generally satisfied with the competitiveness of the export-oriented manufacturing industry, so the demand for reform usually focuses on the services sector, which needs a boost in productivity. Government efforts have concentrated on the services sector, mainly by encouraging competition through liberalisation and deregulation. Korea is currently ranked 19th in the World Economic Forum’s Global Competitiveness Index and 31st in the Economic Freedom Index from the Heritage Foundation, making it a leader among Asian emerging-market (EM) economies.

A key concern about the Korean economy is the long-term slowdown in GDP growth. Annual average growth declined to 4.5% in 2000-11 from 10.2% in 1971-79 (Figure 1). Many people focus on the decline in GDP growth in 2000-11 compared with 1990-99, which was apparently caused by the Asian financial crisis in 1997-98. Some also argue that the global financial crisis of 2008-09 further lowered Korea’s long-term average growth rate to below 4%. This looks plausible considering GDP growth of 3.6% (actual) in 2011 and 2.6% (forecast) in 2012.

A services-driven slowdown

The fall in GDP growth in the 2000-11 period compared with the 1990-99 period was mostly driven by the services sector (Figure 2). Average services-sector growth fell to 3.7% in 2000-11 from 6.4% in 1990-99, while average growth in manufacturing declined to 7.3% from 7.7% during the same period. The slowdown in GDP growth in 1980-89 compared with 1971-79 was mostly driven by the manufacturing sector; this seems like a natural development, as 18% growth could not be sustainable for long. The slowdown in 1990-99 compared with 1980-89 was driven by both the manufacturing and services sectors. As of 2010, manufacturing and services accounted for 31% and 58% of total value-added.

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**Figure 1: A long-term trend of slower growth**

GDP growth, annual average (%)

![Graph showing GDP growth trends from 1971-79 to 2000-11](source)

**Figure 2: Growth of manufacturing and services sectors**

Annual average (%)

![Graph showing growth of manufacturing and services sectors from 1971-79 to 2000-11](source)

Source: The Bank of Korea
Meanwhile, information technology (IT) has contributed the most to sustaining Korea’s growth momentum. The IT sector’s value-added growth remained in the double digits in the 1981-95 and 1996-2004 periods. Aside from the IT sector, all other industries, including non-IT manufacturing and services industries, showed a significant slowdown in 1996-2004 compared with 1981-1995 (Figure 3; distribution services includes wholesale and retail trade, restaurants and hotels, and transport). Here we again see a slowdown in the services industry in recent years, though the timeframe was a bit different.

**Total factor productivity is the key to boosting services**

Raising total factor productivity (TFP) is crucial to boosting growth in any sector, especially because it has become more difficult to increase the supply of labour or capital in Korea. Korea’s low fertility rate fundamentally limits labour supply, and it is not easy to raise women’s labour-market participation rate or to promote immigration. One of the main obstacles to growth in the Korean economy is the anticipated decline of the labour force due to the dwindling population. Also, it seems difficult to significantly increase the supply of capital, considering that the investment-to-GDP ratio is already high at 30%, the second-highest in Asia after China’s.

The importance of TFP in boosting growth is clearly seen in the IT sector (Figure 4). The growth contribution from TFP in this sector increased in 1996-2004 compared with 1981-1995; this allowed the sector to maintain its stellar 16-17% growth. This is generally thought to be an outcome of fierce global competition and swift technological development.

Admittedly, only the finance and business services sector was significantly affected by the deterioration in TFP (its growth contribution declined to -3.5ppt in 1996-2004 from 2.3ppt in 1981-95). The slowdown in other sectors between the two periods is better explained by weakness in the supply of labour or capital. We focus on the uniform deterioration of TFP growth in all major industries except the IT sector. In particular, all sub-components of the services sector showed negative growth contributions from TFP during the 1996-2004 period. This is worrisome and has likely been the major driver of generally lacklustre growth in Korea’s services sector.

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15. South Korea – Boosting the services sector

The importance of TFP in boosting Korea’s services-sector growth is also revealed in the comparison with developed countries (Figure 5). Korea enjoyed a significantly higher growth contribution from TFP in the IT sector and other manufacturing sectors compared with the US and EU-15 from 1996-2004. But the growth contributions from TFP in all three services sectors were lower in Korea than in the US and EU-15. Enhancing TFP is the key to promoting Korea to the developed-economy stage by boosting less competitive services sectors.

Government efforts to promote services

The promotion of the services sector to enhance the long-term economic growth outlook has been an important policy goal of the Lee Myung-Bak government. The government has announced numerous policy measures to promote different parts of the services sector since 2008, and plans to introduce a ‘Services industry development law’ in 2012 or 2013.

Government measures on the services sector are focused on health care, education, tourism, broadcasting/cultural content and business services, while they do not generally deal with two other key sectors – the financial and retail industries. In other words, the government concentrates on personal and social services among the three categories of service industries we identify in Figure 4. It appears that the government wants to supervise, not encourage, the growth of the financial industry.

The emphasis is on deregulation and liberalisation to encourage competition, instead of direct action to support specific sectors or businesses, as in the 1960-80s under the name of industrial policy. Korea has now reached a level of complexity and sophistication in which industrial policy probably does not work well. Also, the government seems to think that encouraging competition through deregulation and liberalisation is the most effective way to enhance TFP. We agree.

Of course, the usual obstacles to reform measures, from interest groups and the general public, apply here. Political factors also seem to explain why the government excludes the retail industry from the list of key services industries. Regulations against large foreign players are popular among voters, considering that many retail businesses are run by the self-employed.

Figure 5: Korea’s TFP growth lags in services

Growth contribution from TFP 1996-2004, annual average ppt

<table>
<thead>
<tr>
<th>Sectors</th>
<th>Key tasks</th>
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<tbody>
<tr>
<td>Health care</td>
<td>Introduce ‘for-profit’ hospitals</td>
</tr>
<tr>
<td>Education</td>
<td>Attract foreign schools and colleges</td>
</tr>
<tr>
<td>Tourism</td>
<td>Expand accommodation facilities</td>
</tr>
<tr>
<td>Broadcasting and culture</td>
<td>Strengthen intellectual property rights</td>
</tr>
<tr>
<td>Business services</td>
<td>Open legal and accounting services</td>
</tr>
</tbody>
</table>

Source: Pyo et al.(2008)

Source: Standard Chartered Research
15. South Korea – Boosting the services sector

Health care – Liberalisation is controversial
Health-care services often dominate discussion of services-sector development. There seems to be agreement that the fundamental quality of Korea’s health-care services is excellent. However, strict regulations and a lack of liberalisation (i.e., competition) prevent health-care services from becoming a globally competitive industry, according to the government. The government has allowed hospitals and clinics to actively attract foreign patients and introduced medical tourist visas in 2009. The number of foreign patients increased significantly to 122,297 in 2011 from 27,480 in 2008.

Deregulation and liberalisation of the health-care industry continues to be a hot political topic. The government is trying to introduce ‘for-profit’ hospitals in specific areas to attract more foreign patients: foreign-owned hospitals in Economic Free Zones and domestically owned hospitals in Jeju Free International City. It also plans to allow private firms to provide health-related services like diagnosis and consulting. But opposition parties fiercely oppose these ideas, as they worry that the partial privatisation of health services may eventually hurt the public health-care system, including the national health insurance plan that covers every Korean.

Education – Attracting foreign institutions
The main task in developing education services is to attract foreign schools and colleges. Five foreign institutions already have opened campuses in the Free Economic Zone. The primary challenge here is to attract first-class institutions in competition with leading cities like Singapore and Dubai. Opposition from the Korean people is minimal; many Koreans are willing to attend branches of foreign institutions instead of studying abroad if the quality is right.

Tourism – Growing rapidly
Improving tourism services for overseas (especially Chinese) travellers appears to be the primary goal of Korea’s tourism industry. Tourism has become a booming industry, mainly because of the increasing number of Chinese tourists. The number of foreign visitors rose to 9.8mn in 2011 from 7.0mn in 2008, and the number of Chinese visitors surged to 2.1mn from 1.2mn during the same period.

The government has encouraged an increase in accommodation facilities (especially mid-priced hotels) by deregulating zoning restrictions, introducing property investment immigration visas to promote foreign investment in the tourism industry, and improving tourist packages. The government has also made efforts to improve tourism services for domestic travellers, to shift Koreans’ demand from overseas travel towards domestic travel.

Broadcasting and culture provide great opportunities
Developing the cultural-content industry (movies, drama, music, etc.) is another of the government’s key policy goals, as Korean TV dramas and pop music have increased in popularity in the global market. The government is also keen on developing the broadcasting industry, as it is crucial to supporting the cultural-content market. The government has strengthened intellectual property rights for cultural content, and is promoting investment in the industry by contributing venture funds and guarantees. It has also allowed increased access to cable TV channels and eased restrictions on ground-wave broadcasting channels.
15. South Korea – Boosting the services sector

**Business services are opening up due to US and EU FTAs**
Opening the market to foreign companies is important in promoting business-related services. Legal and accounting services will be open to foreign firms within a few years, due to Free Trade Agreements (FTAs) with the US and the EU. Though opposition parties oppose the Korea-US FTA, they focus on its potential impact on industries such as agriculture, manufacturing and health services; the opening of business services is widely welcomed.

**Conclusion – Competition will be crucial**
Now that Korea is a developed country, it will never be able to repeat the rapid economic growth of the 1970s and 1980s. But with per-capita income still trailing that of Japan and especially the US, there is still some catching up to do. Manufacturing is highly competitive and Korea has expanded its list of world-class companies over the last decade. The focus now is rightly on the services sector. The approach is a mixture of liberalisation to promote competition and help for specific sectors where opportunities can be identified. Both are needed, especially for new sectors. In our view, liberalisation and an emphasis on competition will bring long-term results, especially in promoting TFP.
Sri Lanka – Improving the climate for investment and trade

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- Shrinking trade and a weak private sector are the legacy of conflict and protectionism
- The state is reducing its heavy presence, but needs to act further
- Improving the performance of state companies is a key priority

**Huge opportunity, with the conflict over**

Reforms to boost private investment and trade will be critical in Sri Lanka’s efforts to sustain its post-war growth momentum and generate higher per capita GDP growth. During the first wave of reforms starting in 1977, Sri Lanka’s economy was transformed from one of the most inward-oriented economies, characterised by stringent trade and exchange controls and pervasive state intervention, into the most open economy in South Asia. However, despite progressive reforms over the past two decades, the outcome has fallen well short of the country’s development potential. Investment is still not high enough and trade has been declining as a percentage of GDP. The challenge for the authorities’ is to increase domestic investment from the current 29.9% of GDP to around 35% to sustain growth in the 7-8% range.

The end of the civil conflict in May 2009 and two years of rapid growth since (above 8%) have now provided the government with the platform to work with the private sector to boost private investment and trade reforms. However, to move forward it requires a sound policy framework and well-managed public finances. The State’s strong presence is perhaps the biggest hindrance. Foreign and local private investment has been held back by factors such as inefficiencies in government bureaucracy and corruption. Lack of transparency, ease of doing business and the regulatory framework are impediments to attracting FDI.

Sri Lanka’s economy continues to progress towards greater economic freedom. On the Economic Freedom Index (EFI), Sri Lanka’s score is 58.3, making its economy the 97th freest (out of 179 countries). It also compares well with its South Asian counterparts and is ahead of competitors like Vietnam and Indonesia. In fact, Sri Lanka was ranked 16 out of 41 countries in the Asia-Pacific region, having made solid gains in trade, monetary and business freedom.

**Figure 1: Most problematic factors for doing business in Sri Lanka**

<table>
<thead>
<tr>
<th>% of responses</th>
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<tbody>
<tr>
<td>Tax rates</td>
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<tr>
<td>Tax regulations</td>
</tr>
<tr>
<td>Inflation</td>
</tr>
<tr>
<td>Inefficient government bureaucracy</td>
</tr>
<tr>
<td>Policy instability</td>
</tr>
<tr>
<td>Corruption</td>
</tr>
<tr>
<td>Inadequate supply of infrastructure</td>
</tr>
<tr>
<td>Access to financing</td>
</tr>
<tr>
<td>Restrictive labour regulations</td>
</tr>
<tr>
<td>Foreign currency regulations</td>
</tr>
</tbody>
</table>

Sources: The Global Competitiveness Report 2012-2013, Standard Chartered Research
16. Sri Lanka – Improving the climate for investment and trade

Tax reforms have been positive, but protectionist tendencies prevail
Much of Sri Lanka’s improvement in the World Bank’s Doing Business Index can be attributed to regulatory reforms, in which Sri Lanka has been one of the most active countries, particularly in the areas of ‘protecting investors’ and ‘paying taxes’. Sri Lanka is well ahead of its regional competitors (Figure 3), having improved its ranking in 2012 to 89 out of 183 countries from 98 in 2011. Amendment of the Colombo Stock Exchange listing rules requiring greater corporate disclosure on transactions helped Sri Lanka improve its ranking to 46 from 74 in the ‘protecting investors’ category. Substantial tax reforms implemented in 2011 – reducing tax costs to businesses by abolishing the turnover tax and reducing the rates for corporate income, value-added and nation-building taxes – have also helped Sri Lanka to improve its ranking. Nevertheless, roadblocks to economic freedom are considerable.

Although good progress has been made on tax reforms, the system still provides very high and variable levels of protection to import-substitution industries. The present import tax structure could have serious consequences for growth, as it may deter long-term business commitments in production and trade. There is a risk that foreign capital and labour will be disproportionately pulled into highly protected import-substitution manufacturing industries with lower rates of return. To attract and sustain private investment inflows, more reforms to address remaining anomalies in the tax system are necessary. The WEF Global Competitiveness Report (GCR) 2012-13 highlights tax rates as the second-most problematic factor for doing business in Sri Lanka.

Political stability has helped the reform process
Political stability needed for capturing the full benefits of economic liberalisation was missing for much of the post-reform period, when more protectionist policies came into play. As a result, exports fell from 27.9% of GDP in 2004 to 17.8% in 2011 (ADB: Key Indicators for Asia and the Pacific, 2012). Merchandise trade overall, including imports, declined from 66.4% of GDP in 2004 to 44.4% in 2010. The sharp drop witnessed between 2008 and 2009 is consistent with the move to more protectionist trade policies after 2004.

Sri Lanka’s main trade policy thrust continues to be aimed at achieving greater integration into the world economy. Attracting FDI through multilateral, bilateral and regional negotiations through incentives geared at encouraging exports and...
16. Sri Lanka – Improving the climate for investment and trade

Investment is paramount to achieving this. Leveraging off India’s and China’s strong growth potential is also important. Sri Lanka is currently a signatory to five preferential trade agreements; however, among preferential partners, only trade with India and China is significant. The EU (33% of exports) and the US (19%) are Sri Lanka’s main export markets, with only 6.5% of Sri Lanka’s exports going to India and 1.3% to China in 2011.

Manufacturing sector’s share of GDP needs to rise

Trade reforms have helped transform Sri Lanka’s economy from a primary product exporting economy with a heavy reliance on three primary commodities – tea, rubber and coconut – into one in which manufactured products dominate exports. Expansion of the industrial base through greater focus on industries with higher value-added potential is high on the authorities’ reform agenda, but this will require investment in new technology and human capital.

Analysis of the 9th pillar of competitiveness, ‘Technological readiness’ for FDI and technology transfer, shows that Sri Lanka lags behind its regional competitors. It is ranked 50th in 2012-13, compared to India (44), Malaysia (16) and Thailand (47). For Sri Lanka, the major challenge is to improve the local business environment and its absorptive capacity to become a more attractive investment destination for multi-national companies.

Scope to follow East Asia’s export-oriented manufacturing model

The manufacturing sector’s share of GDP has remained unchanged since the sector’s impressive growth in the 1990s, which exceeded 16% thanks to a firm political commitment to reforms and favourable macroeconomic conditions. Manufacturing performance was underpinned by a dramatic shift in ownership structure – state-owned enterprises (SOEs) accounted for over 60% of manufacturing output at the time of the first wave of reforms, but since then, public-sector dominance has eroded in the face of rapid output growth from private-sector ventures and privatisation of SOEs. Standard labour-intensive manufacturing has been the main attraction for foreign investors, which are heavily concentrated in the garment industry. Sri Lanka has had a free trade regime for the garment sector for over two decades, unlike its South Asian

Figure 4: Exports are on a declining trend
% of GDP (current market prices)

![Graph showing exports as a percentage of GDP declining over time.](Sources: ADB, Standard Chartered Research)

Figure 5: Fewer procedures required to start a business
No. of procedures

![Bar chart showing fewer procedures required to start a business.](Sources: The Global Competitiveness Report 2012-13, Standard Chartered Research)
counterparts, where high protectionism prevails in major segments of the sector. Yet, the manufacturing sector’s share of GDP is still just 16%. The end of the war and the ensuing political stability should help to improve country risk perceptions and performance of the sector.

Sri Lanka has the potential to follow the export-oriented manufacturing model of East Asia, with the benefit of a relatively well-educated work force (Sri Lanka had a literacy rate of 91.9% in 2010,\(^{28}\) the highest in South Asia). But it needs reforms to facilitate investment and trade in order to increase the manufacturing sector’s share of GDP.

**Labour market freedom must improve**

Sri Lanka, as highlighted in the Global Competitiveness Report 2012-13, is transitioning from the factor-driven stage to the efficiency stage in the Global Competitiveness framework. The idea is that in the early stages of development, countries rely mainly on low-skilled manufacturing, taking advantage of cheap labour. But continued growth depends on raising skills and improving efficiency. Sri Lanka had moved ahead of its regional counterparts, India and Bangladesh, in 2011-12, reaching a ranking of 52 out of 139. However, it dropped 16 places to 68 out of 144 in the 2012-13 rankings and ranks behind India (59), largely due to the macroeconomic stability pillar (ranked 127), which showed the largest decline. Delayed policy action by the authorities in addressing the worsening balance-of-payments position at end-2011 is likely to have had a significant impact on this result. It is important to note that the World Economic Forum opted not to use the 2012 Executive Opinion survey data in the computation of the 2012-13 GCR due to inconsistencies resulting in significant deviations from the 2011 results.

In the 2012-13 GCR, Sri Lanka fares well on basic drivers of competitiveness such as health and primary education (ranked 44, down 9 places) but well ahead of India (101). Its main weaknesses include a worsening macro environment on account of climbing debt and twin deficits, and a declining saving rate (22.1% of GDP in 2011). Information communication technology (ICT) use remains low and the labour market, the weakest aspect of Sri Lanka’s performance (ranked 129), remains inefficient,
16. Sri Lanka – Improving the climate for investment and trade

crippled by rigidities and high redundancy costs. That said, Sri Lanka has made good progress in complex areas such as business sophistication (ranked 31) and innovation (ranked 58). However, relative market size and macro stability, key factors considered in the compilation of the GCR, with countries like India and Indonesia benefiting from their size advantage, has left Sri Lanka lagging behind (Figure 1). On a positive note, compared to its regional competitors, fewer procedures are required to start a business (Figure 5). Also, tougher policy measures implemented by the authorities in H2-2012 to address the recent macro instability – LKR depreciation and an 18% cap on banks’ credit disbursements – should help improve Sri Lanka’s ranking.

Further reforms are necessary to boost FDI inflows

Investors have shown renewed interest following the end of the civil conflict in May 2009. However, Sri Lanka still finds it challenging to attract FDI. Inflows slowed in 2009 and 2010 to USD 384mn and USD 435mn, respectively, from USD 690mn in 2008 largely on account of the global downturn and the cautious approach taken by investors. Since then, the slight improvement in FDI inflows is largely on account of the positive change in investor sentiment, due to the ensuing political and overall macro stability in 2011. Yet FDI still contributes only about 2% of GDP and accounts for c.10% of aggregate investment of 28% of GDP. FDI inflows in 2012 remain below expectations at just USD 452mn at end-July, well short of the central bank’s USD 2bn 2012 target due to weak global risk sentiment and also local factors – policy inconsistency and lapses in governance, which have led to a loss of confidence. A policy move such as the passage of the expropriation bill in November 2011, which nationalised certain assets of underperforming enterprises undermined policy consistency and may continue to deter investors.

Need to speed up approval process for FDI; improve bureaucracy

Historically, sluggish investment has been attributed to Sri Lanka’s cumbersome FDI approval process. While the war obviously impeded Sri Lanka’s ability to realise its potential for attracting FDI and hampered capturing the benefits of economic opening through delays and inconsistencies in the implementation of reforms, excessive bureaucracy appears to be an even bigger stumbling block. In fact, inefficient government bureaucracy is listed as one of the top five most problematic factors (Figure 1) for doing business in Sri Lanka (Global Competitiveness Report 2012-13).

Sri Lanka has made considerable efforts to attract FDI through trade liberalisation, an emphasis on private-sector development, liberalisation of its investment regime through streamlining of the state-run Board of Investment (BOI), and the opening up of both domestic and foreign infrastructure and services to the private sector. Regulatory efficiency has been enhanced through the establishment of a streamlined business formation process, statutory tariff rates have been reduced and import surcharges have been eliminated, but more needs to be done.

Transparency of policy-making improves

The visible shift towards investment-friendly policies and the acceleration of the liberalisation process are encouraging; however, political risk factors continue to weigh on investor sentiment. Sri Lanka must follow through with reforms to reduce bureaucratic red tape and increase transparency, particularly in government procurement, and increase the predictability of government policies.
16. Sri Lanka – Improving the climate for investment and trade

According to the GCR 2012-13 report, Sri Lanka scores 4.3 (compared to 3.8 in 2010-11) on the ‘transparency of government policy-making’ indicator (1 = impossible; 7 = extremely easy), which measures the ease with which businesses can obtain information about changes in government policies and regulations affecting their activities. It has moved ahead of emerging economies like Vietnam (3.9) and Indonesia (4.2), and is on par with India (4.3). Sri Lanka’s large cabinet still poses challenges to policy-making. The 2010 budget cabinet reshuffle helped to reduce the number of ministerial positions from 51 to 37, but the number of deputy ministers remains high at 39. The average size of the government (share of expenditure as % of GDP) was 21.4% in 2011, according to central bank statistics.

Restructuring of SOEs has started; productivity gains expected

To inspire confidence, the government needs to transmit clearer signals about the roles of the public and private sectors. The heavy state presence in the economy driven by populist policies continues to hamper private-sector development and is an ongoing concern for investors. The SOE sector accounts for a significant share of the economy and has crowded out the private sector, thus constraining growth. There are currently 81 SOEs, including banks, utilities and airlines, accounting for 17.2% of GDP, with the turnover of the largest five SOEs exceeding the turnover of all 245 companies listed in the Colombo Stock Exchange. SOEs in Sri Lanka have been underperforming due to non-cost-reflective pricing policies often aimed at achieving social objectives. The Department of Public Enterprises Performance Report (2010) cited lack of good governance, low employee productivity, weak financial management and lack of internal controls, and structural deficiencies as the key contributing factors to the large losses incurred by SOEs.

The sheer size of the SOE sector makes it a crucial determinant of the overall productivity of the economy. Hence, the reform process should focus on strengthening efforts to improve the performance of SOEs. The need to address the poor governance and operational inefficiencies of SOEs has become significant, as failure to do so will have negative repercussions for growth. The recent adjustment of key administered prices to make them more cost-reflective is a good start. A number of reforms measures aimed at making SOEs more commercially efficient with less reliance on government assistance have been introduced, but progress has been slow. The Ministry of State Resources and Enterprise Development has been recently tasked with restructuring 23 SOEs; the boards of strategic SOEs have had private-sector managers appointed; and regulatory functions have been built up through institutions such as the Public Utilities Commission. However, challenges remain.

Conclusion – Good progress, with more to do

To accelerate growth, it is imperative that the public sector increase its investment to provide adequate hard and social infrastructure (health and education) and, even importantly, that policy predictability improve. Public-sector investment fell to 3.1% of GDP in 2004 during the conflict. In 2011 it was 6.2% of GDP, which is very encouraging. The public sector must be an equal partner, sharing the role of facilitator with the private sector. Creating an enabling domestic environment has been a top priority for the current government, but the private sector, widely viewed as the ‘engine of growth’, continues to respond inadequately. This suggests that further reforms are necessary to encourage participation – good governance and efficient public service must prevail.
17. Taiwan – Leveraging mainland China’s rapid growth

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- Disappointing growth, despite a strong private sector
- Growth will be boosted by faster integration with mainland China
- More companies should consider developing own-brand products

The search for a new growth model

Taiwan’s economy has underperformed its peers in the Asian region in the past decade. The island’s economic growth averaged a mere 3.9% during 2001-10. This pales in comparison with South Korea, Hong Kong and Singapore, known also as the Asian dragons (Figure 1). Also, its per-capita income, estimated at USD 21,592 in 2011, has trailed behind South Korea’s (USD 23,749) for eight years in a row (Figure 2).

There is a growing fear that unless a significant effort is made to reinvigorate the island’s growth potential, Taiwan will remain a laggard among the Asian dragons. This will make it harder to address the structural issues stemming from the low birth rate and the rapidly ageing population, which could impede the ability to keep the economy on a sustainable growth path in the longer term.

Nevertheless, the economy is still deemed to be highly competitive. According to the latest Global Competitiveness Report 2012-2013, Taiwan is ranked thirteen out of a total of 144. It is also ranked among the top countries in Asia, behind only Singapore, Japan and Hong Kong. It scores well in many areas, including infrastructure, higher education and training, technology readiness, health care, as well as innovation. However, there is also room for improvement in terms of labour market efficiency as well as the need to enhance the overall macroeconomic environment. The latter, in particular, has gained wide interest and debate both in the private and public sectors.

Many believe that the island urgently needs to seek alternative growth sources and refine its current economic development model. This means moving away from the current growth strategy that depends largely on the US and European markets and diversifying into new markets. It also means reviewing the reliance on traditional low-cost contract manufacturing, known as the original-equipment (OEM) or original-design (ODM) manufacturing models.

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*Figure 1: Taiwan’s economy has underperformed*

Change in per-capita income (USD); Average GDP growth (%)

*Figure 2: Taiwan has trailed South Korea since 2004*

GDP per capita in USD

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Sources: IMF, Bloomberg, Standard Chartered Research

Sources: Bloomberg, Standard Chartered Research
17. Taiwan – Leveraging mainland China’s rapid growth

The reliance on OEM/ODM means that Taiwanese producers have to compete on cost, while remaining vulnerable to the rise and fall of their ‘big-name’ overseas buyers. Indeed, many argue that the difficulty for local manufacturers of shifting from being middle-man producers is a major reason for stagnant wages, which have also taken a toll on domestic consumption and stifled the island’s growth potential (Figure 3).

According to a recent study provided by the Council of Labour Affairs (CLA), the average salary earned by university graduates in their first job continuously declined between 2006 and 2010. The share of new college graduates with a starting monthly salary of less than TWD 30,000 (approximately USD 1,000) jumped to 37% in 2010 from 25% in 2004. As a result, the overall share of labour income to nominal GDP fell to a record low during the period (Figure 4).

Meanwhile, the corporate operating surplus as a share of net disposable income jumped significantly from 36% in 1996 to 42% in 2009. This was accompanied by an almost three-fold increase in overseas income, which we believe came largely from Taiwan companies’ operations in mainland China.

Redefining the relationship with mainland China

Mainland China’s rapidly expanding economy is likely the best answer to Taiwan’s search for a new growth market, amid anticipation of further improvements in cross-strait relations. This is especially true when one considers Taiwan’s unique geographic advantage and socio-cultural ties with mainland China. Indeed, tight restrictions on direct cross-strait trade and investment links have often been cited as a key factor preventing the domestic economy from enjoying the benefits of being right next to one of the world’s fastest-growing economies.

Many have blamed restrictions on bilateral trade and investment flows for placing a heavy burden on Taiwan businesses with increasingly significant operations in mainland China. They have prevented the reverse economic linkages that would have otherwise been possible, and instead resulted in lopsided trade and capital flows. Such restrictions have also contributed to the rapid hollowing-out of the local manufacturing sector, which has resulted in the loss of manufacturing jobs as well as potential investment.

![Figure 3: Taiwan’s wages are barely increasing](image1)

**Figure 3: Taiwan’s wages are barely increasing**
*TWD (LHS); % y/y (RHS)*

![Figure 4: Labour income share are declining fast](image2)

**Figure 4: Labour income share are declining fast**
*Wage income as % of GDP*
17. Taiwan – Leveraging mainland China’s rapid growth

Overall investment as a percentage share of GDP persistently declined from over 25% during the 1990s to around 20% in 2011. Some argue that this has benefited South Korean exporters, whose market share in mainland China has risen at the expense of their Taiwanese counterparts (Figure 5).

While there have been ongoing efforts to further liberalise cross-strait economic links after the ruling Nationalist (KMT) government returned to power in 2008, many are of the view that the steps taken so far have been small and gradual. In a survey conducted by Commonwealth Magazine in December 2011, about 35% of Taiwanese business executives claimed that the Economic Cooperation Framework Agreement (ECFA) signed in June 2010 had little or no impact on their business, even though nearly half of the 349 respondents thought that it could benefit business in the future, after Taiwan and mainland China further broaden the scope of the trade pact during the next round of negotiations (Figure 6).

With incumbent President Ma Ying-jeou now serving another four-year term, there are rising calls from the local business community for Taiwan to accelerate moves to expand ties with mainland China if it is to unlock its growth potential. Local industry experts are optimistic that expanding cross-strait economic ties and removing trade barriers will see increased foreign direct investment, which will also positively impact the local job market.

A study conducted by the Chunghwa Institute for Economic Research (CIER), a local think tank, estimated that the full implementation of the ECFA will boost Taiwan’s economic growth by 1.65-1.72ppt, attract USD 8.9bn in additional foreign investment, and help create 260,000 jobs.

A leading European automaker is considering setting up a manufacturing plant in Taiwan, attracted by the island’s strength in advanced technology, strong supply chain, good managerial skills, and adequate infrastructure. This is likely linked to the fact that the next round of trade negotiations between the two sides under the ECFA agreement is expected to include tariff exemptions for vehicles bound for mainland China. The company estimates that the plant will assemble at least 100,000 vehicles annually and is expected to serve more than the local market. It believes that with high-quality and cost-competitive auto parts, Taiwan could become an integral part of regional production for the company’s expansion in Asia.

Sources: Bloomberg, Standard Chartered Research

Sources: Commonwealth Magazine, 27 December 2011
Potential gains for Taiwan will be even greater if it is able to integrate further with mainland China’s growing consumer market as China continues to move up the value chain and modernise its economy. The growing number of middle-class consumers presents a great opportunity for Taiwanese firms and businesses looking to tap into the growing retail wallet across the straits. According to the Council for Economic Planning and Development (CEPD), total retail revenue in mainland China under the 12th Five Year Plan could reach CNY 32trn (USD 5.0trn) by 2015. This will be more than twice the CNY 15.7trn recorded in 2010. It will also be three times the size of mainland China’s total exports (USD 1.6trn) recorded in 2010.

An important factor is the expected shift in mainland China’s import content, with a rising concentration of consumer goods. This will include imports of key electronics components, where Taiwan is already a leading player in the global supply chain. This will be positive for local producers, including the more than 50,000 Taiwanese SMEs currently operating in mainland China. In order to be able to tap into this rapidly growing market, however, Taiwanese producers must diversify away from the current growth strategy, which largely considers mainland China as a low-cost manufacturing base for exports. It also requires Taiwanese manufacturers to shift away from being OEM/ODM middle-men and move up the value chain to becoming own-brand manufacturers (OBM).

Moving up to own-brand production

In recent years, Taiwan exporters have started to experiment with OBM manufacturing as a means to secure higher profit margins. For Taiwanese producers based in mainland China, the need to shift away from the increasingly competitive low-price OEM/ODM model is becoming even more pressing given rising production costs, shortages of labour, intensifying competition from local mainland Chinese producers in the OEM/ODM space, an appreciating currency, and thinning profit margins.

However, the transformation to OBM will not be easy. Taiwanese producers are known to be extremely competitive in terms of cost management, but lag behind in terms of brand management. Taiwanese producers may be daunted by the costs of acquiring the necessary technical and management know-how, including the need to invest heavily in research and development (R&D), brand marketing, and distribution channels. Costs are very high, and there is no guarantee of a positive outcome.

According to local industry experts, ready access to a large potential market is another key ingredient for firms to successfully migrate to the OBM model. Unlike their South Korean counterparts, they lack a sizeable home market; this makes such a shift highly risky for local producers, especially SMEs.

Also, the potential conflict of interest with their ‘big-name’ multinational clients, risking ‘biting the hand that feeds them’, is a strong hindrance. For example, if a Taiwanese producer tried to create its own brand – i.e., via a dual-track production model – after having achieved a technical breakthrough, its foreign partners could use every means at their disposal (such as lawsuits) to block it.

Nonetheless, in a bid to help local producers move up the value chain, the Ministry of Economic Affairs kick-started the Branding Taiwan Plan in 2006 with the aim of creating a more conducive environment for the promotion of Taiwanese brands globally. This came after the government commissioned the Taiwan External Trade Development
17. Taiwan – Leveraging mainland China’s rapid growth

The government can do more to lessen the financial burden for companies seeking to migrate to OBM

Council (TAITRA) in 2003 to work with brand appraisal consultants to study the transformation process from OEM/ODM to OBM. The aim is to create a substantial data bank, including successful case studies, for aspiring local OEM/ODM producers seeking to make the transformation to OBM.

Furthermore, studies have shown that the ability to continue to roll out new products and/or designs is critical if a firm is to stay successful as an OBM. However, this suggests that firms must continue to accumulate self-owned patented technology that can only be acquired over a long period, and make substantial investments in R&D. As such, the government has introduced various tax and financial incentives in recent years to nurture a culture among local corporates to boost R&D spending. In 2010, the government announced the Statute for Industry Innovation, which governs tax credits eligible for R&D expenses. This is primarily to serve as an extension to the Statute of Upgrading Industry, under which tax credits for most R&D expenses expired on 31 December 2009.

Still, many think the government can do much more to lighten the burden on local Taiwanese companies in terms of R&D expenses. A recent report (provided by consulting firm Ernst & Young) suggested that the tax incentives applicable in Taiwan are far less attractive than those in Asian competitors such as South Korea, Singapore, and mainland China. According to the report, only firms incorporated in Taiwan are allowed to write off these costs, and only 15% of eligible R&D expenditure can be granted as a tax credit. This is further subjected to a cap of 30% of total corporate tax payable.

In comparison, the maximum tax credit allowed in South Korea is 20%, or 30% for SMEs. More importantly, this applies regardless of where the business is incorporated. Local industry experts think that this largely explains why Taiwan has persistently lagged behind South Korea in terms of the size and share of R&D expenses as a percentage of GDP (Figure 7). Taiwan will need to take a more aggressive stance in promoting R&D spending if it seeks to compete and attract the necessary talent to close the gap with its Asian competitors.

Figure 7: A comparison of R&D expenditure between Taiwan, South Korea and Japan, 2000-2010

<table>
<thead>
<tr>
<th>Year</th>
<th>Taiwan USD mn</th>
<th>% of GDP</th>
<th>South Korea USD mn</th>
<th>% of GDP</th>
<th>Japan USD mn</th>
<th>% of GDP</th>
</tr>
</thead>
<tbody>
<tr>
<td>2000</td>
<td>8,746</td>
<td>1.94</td>
<td>18,582</td>
<td>2.30</td>
<td>98,896</td>
<td>3.04</td>
</tr>
<tr>
<td>2001</td>
<td>9,378</td>
<td>2.06</td>
<td>21,286</td>
<td>2.47</td>
<td>103,933</td>
<td>3.12</td>
</tr>
<tr>
<td>2002</td>
<td>10,476</td>
<td>2.16</td>
<td>22,507</td>
<td>2.40</td>
<td>108,166</td>
<td>3.17</td>
</tr>
<tr>
<td>2003</td>
<td>11,690</td>
<td>2.27</td>
<td>24,009</td>
<td>2.49</td>
<td>112,275</td>
<td>3.20</td>
</tr>
<tr>
<td>2004</td>
<td>13,109</td>
<td>2.32</td>
<td>27,879</td>
<td>2.68</td>
<td>117,453</td>
<td>3.17</td>
</tr>
<tr>
<td>2005</td>
<td>14,527</td>
<td>2.39</td>
<td>30,618</td>
<td>2.79</td>
<td>128,695</td>
<td>3.32</td>
</tr>
<tr>
<td>2006</td>
<td>16,572</td>
<td>2.51</td>
<td>35,296</td>
<td>3.01</td>
<td>138,613</td>
<td>3.40</td>
</tr>
<tr>
<td>2007</td>
<td>18,493</td>
<td>2.57</td>
<td>40,743</td>
<td>3.21</td>
<td>147,768</td>
<td>3.44</td>
</tr>
<tr>
<td>2008</td>
<td>20,512</td>
<td>2.78</td>
<td>43,906</td>
<td>3.36</td>
<td>148,719</td>
<td>3.44</td>
</tr>
<tr>
<td>2009</td>
<td>21,572</td>
<td>2.94</td>
<td></td>
<td></td>
<td>137,909</td>
<td>3.33</td>
</tr>
<tr>
<td>2010</td>
<td>23,468</td>
<td>2.90</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

Sources: Taiwan National Science Council, Standard Chartered Research
Conclusion – Integrate with China and develop brands

There is growing recognition on the part of both the government and the business community that Taiwan urgently needs to reinvigorate its economy. In order to unlock its growth potential over the medium-term, the island will need to accelerate the process of normalising economic ties with mainland China. Taiwanese producers also need to rethink their current growth strategy, which primarily considers mainland China a low-cost overseas production base for exports. Until recently, this has allowed them to delay the upgrades and changes needed to stay competitive.

Taiwanese producers also need to shift away from low-cost OEM/ODM models, which are widely blamed for the delay in structural change that has prevented the island from moving up the value chain. This not only results in stubbornly low wages but has also weakened domestic demand and caused Taiwanese producers to lose market share to South Korean rivals. Although the government has provided various incentives to help incubate promising local enterprises into ‘own-brand’ producers, much more needs to be done if the island is to close the gap with its key Asian rivals.
18. Thailand – Boosting labour productivity

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- Thailand appears stuck in the middle-income trap
- Improved education and training are needed
- Better logistical networks will also be important for improved manufacturing productivity

Labour productivity growth is lagging

Despite repairing its macroeconomic fundamentals after the Asian crisis in 1997, Thailand appears to be caught in the ‘middle-income trap’. International scores on both the Economic Freedom Index and the Global Competitiveness rankings show that its performance has dropped over the past decade. While there are a number of areas needing further reforms, we will focus on increasing labour skills and boosting fixed-capital formation, which are both crucial to improving labour productivity. Labour productivity is critical both in generating growth directly and in encouraging foreign investment.

Disappointing growth rates

The Thai economy has recovered well from the severe financial crisis in 1997, rebuilding economic fundamentals and achieving sound external finances, low corporate indebtedness, a prudent fiscal position, and healthy household saving. This has been achieved mainly on the back of a robust export performance, driven by a weaker Thai baht (THB) after the currency devaluation in July 1997 and the diversification of Thai exports in terms of both destination and product.

Despite these strong macroeconomic fundamentals, Thailand is showing relatively low growth momentum. GDP growth averaged only 3.1% p.a. from 1996-2010, just one-third of the growth rate of 9.9% p.a. from 1987-95 During the long period from 1960-97, Thailand grew at more than 7% p.a. on average, putting it in our 7% Club and earning it a place in the Growth Commission’s high-growth group. Yet even during the world boom of the last decade, from 2003-07, Thailand managed only 5.6% average growth. Other Asian countries at the same stage of development, whether Korea in the 1980s or China currently, have been able to grow much faster.

Sources: BoT, Standard Chartered Research
Caught in the ‘middle-income trap’
Thailand ranks as an upper-middle-income economy, according to the World Bank, and there are fears that it has become stuck in the so-called ‘middle-income trap’. This situation occurs when, after an initial spurt of ultra-rapid economic growth from low levels, a country slows abruptly and is unable to achieve continued rapid growth. As already noted, such a slowdown is not inevitable – Japan, Korea, Singapore, Taiwan and Hong Kong never suffered, and China seems to be avoiding it so far. But the Growth Commission’s study of the 13 economies that have achieved sustained growth above 7% during the post-WW2 period found seven – including Thailand – that slowed significantly at the middle-income stage.

Once entered, the middle-income trap can be hard to escape. Moreover, in the words of the Growth Commission Report, “The politics of a country that has lost its growth momentum are fraught. Without growth, unequal societies become trapped in zero-sum games.” Thailand’s growth rate is still respectable – better than, for example, 1980s growth in Brazil, one of the first countries to be labelled this way – but Thailand’s considerable political tensions in recent years have added to the difficulty of achieving fast growth.

The labour market is critical to escaping a middle-income trap
The middle-income trap is a controversial subject. Its exact causes and remedies are disputed, but one key factor is labour supply. As the economy moves from low income to middle income, the supply of cheap labour from the rural sector slows, and the economy needs to move from labour-intensive industries to more capital- and skill-intensive industries.

The services sector grows, and the domestic economy becomes a more important driver of growth. Wages rise and shortages of skilled labour emerge. Pressure from countries that are lower on the development ladder is often intense and, for Thailand, competition from China’s particularly competitive economy has hurt. China is now overtaking Thailand in terms of per-capita GDP. Thailand is not only struggling to deal with rapidly rising wages domestically, but is also competing with low wages in nearby countries, including Indonesia and Vietnam.

As countries make the transition from middle income towards high income, two key requirements for maintaining strong growth are improving the skill levels of the workforce and maintaining and enhancing the attractiveness of the economy for both domestic and foreign investment. Prior to 1997, Thailand achieved an investment-to-GDP ratio above 40%, fuelling rapid growth. This was likely excessive, creating too much capacity, particularly in the property sector. In 1998, investment collapsed to 20% of GDP before crawling slowly back up. It has fluctuated around 25% in recent years, not high enough to support GDP growth beyond the 5-6% level. In comparison, India and China have both been investing at or above 40% in the last decade.

According to the Global Competitiveness Report, Thailand scores relatively poorly in the areas of technological readiness, health and primary education, and higher education and training, all of which hurt the efficiency of the work force. These are not the only areas for potential improvement: The Economic Freedom Index highlights problems with corruption and many areas closed to foreign investment. But we will focus on skills and raising investment.
18. Thailand – Boosting labour productivity

The good news is that, despite its vulnerability to the global cycle and local event risks – a military coup and the imposition of capital controls in 2006, civil unrest in 2008 that closed Bangkok’s main airport for a time, and strife in Bangkok’s central business district in 2010 – Thailand was able to keep moving forward during the 2008-11 period. The country recovered quickly from the global recession in 2009, and although floods in 2011 were a major setback, a recovery is expected in 2012. However, to achieve a higher growth rate, important reforms are needed.

Reforms needed to upgrade potential growth

Improving manufacturing productivity is particularly important if Thailand is to maintain traction in its export-led growth model. This is because the shortage of skilled labour in manufacturing is likely to worsen in the foreseeable future due to two major factors – an increasing mismatch between demand and supply of labour, and a shift in the labour force to the non-manufacturing sector due to the changing lifestyles of the new generation.

Mismatch between supply of and demand for labour

On the ground, we observe an increasing mismatch between demand for and supply of labour. A World Bank study found that “Thailand has an oversupply of social science graduates, while lacking graduates in the fields of science, engineering, and health sciences, with a significant mismatch between the training provided in higher education institutions and the skills needed in the labour market”. 29

Statistics show a rising number of employed workers attaining tertiary education levels (undergraduate and above) in ‘academic’ disciplines. Meanwhile, the number of employed workers attaining degrees in ‘vocational’ disciplines has risen only slowly. Figure 3 shows the number of employed workers classified by the level of education attained. It suggests that the supply of workers with social science degrees has steadily increased, resulting in a mismatch with increasing demand for skilled workers to serve the manufacturing sector.

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18. Thailand – Boosting labour productivity

A shift in the labour force towards non-manufacturing

On top of this, Thailand’s new generation seems to favour a change in lifestyle, preferring to become ‘white-collar’ employees than ‘blue-collar’ factory workers. This trend has formed in recent years, and is likely to gain momentum. Figure 4 shows the number of employed workers by sector. Notably, there has been a shift of skilled labour into the services sector, including financial services, wholesale and retail businesses, hotels, restaurants, health care, telecommunications, logistics, design and advertising. Moreover, the pace of growth in the number of employed workers in the services sector has outpaced that of manufacturing since 2007.

This is a natural trend in a middle-income economy, as we noted earlier. But it may aggravate the shortage of skilled labour in the manufacturing sector. Concurrently, we foresee two related factors that reinforce the need to boost labour productivity. The first is rising unit labour costs (Figure 6), and the second is the ageing population. Unit labour costs are currently on an upward trend, and are likely to increase at a faster pace in the future, due partly to strong political pressure to boost the minimum wage. Higher productivity growth would offset some of these wage pressures.

Meanwhile, demographics are shifting as the population ages. The population aged under 15 has constantly decreased over the past 10 years given the low birth rate (Figure 5). In 1996, there were around 16.4mn people under the age of 15. However, this had dropped by 2.9mn to 13.5mn people at the end of November 2011, which suggests that the supply of new labour will continue to decline over time. Given increasingly limited labour resources, employing them effectively becomes even more important.

Policy implications

Given these concerns, and the focus on raising labour skills and productivity and boosting fixed capital investment, what does Thailand need to do?

Upgrade labour skills

Thailand has improved its higher education system, including increasing access, improving the governance of the system, increasing the number of private universities, and founding new institutions. However, the system still faces a number of formidable challenges. According to a World Bank study (January 2010, Towards
18. Thailand – Boosting labour productivity

a competitive higher education system in a global economy), there are several areas for improvement. These include the quality of education, the diversity of institutions to cater to the diversity of students and needs, higher education for specific skills, and university-industry linkages.

To improve education quality, there is a need to provide a strong incentive for students to complete secondary school, and to pursue further specialised academic training. For a diversified system of higher education, Thailand should emphasise practical skills in response to the needs of the labour market, and provide training in professional fields. The provision of specialised education, such as occupational training and specific basic skills necessary to enter the labour market, is also vital. Finally, Thailand should promote greater collaboration between higher education institutions and industry in order to give students opportunities to access specialists’ expertise and absorb know-how.

Boost fixed-capital investment

As we have already noted, education and training are key issues for many companies in Thailand and for those considering investments. The World Competitiveness Report cites an inadequately educated work force as the greatest barrier to doing business, after political factors. Progress in this area could significantly enhance Thailand’s attractiveness. However, this will take time, and it is far from the only area of weakness. For example, the Economic Freedom Index ranks Thailand 60th overall in the world, but 117th in the investment freedom component, reflecting an overall investment regime which “lacks efficiency and transparency”.

Thailand could also improve its infrastructure. Some countries struggle to make public investment projects happen due to limited financial capacity. In Thailand, the problem is not so much money as a lack of political stability. A related problem is the lack of a clear regulatory environment, notably in the telecommunications sector. The following infrastructure areas are particularly important:

- **Transportation:** There is scope for improvement; this sector is currently dominated by the road network in terms of both passenger and freight transport. Upgrading the rail system nationwide would not only lift the efficiency of the logistics network, but would also reduce transportation costs.

- **Telecommunications:** In the current digital world, the quality of this sector is closely linked with competitiveness. Thailand’s approval of the long-awaited telecom reform to upgrade to the 3G spectrum from 2G is crucial to reducing telecommunications costs for Thailand.

- **Water management:** In addition to the need to further expand the piped water supply, Thailand needs to improve the efficiency of its waste-water management system and re-establish long-term measures to prevent future flooding and drought.
19. UAE – Reversing the trend in labour productivity

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10 October 2012

- The UAE’s growth has been driven by higher inputs over the last two decades
- Sustainable growth will need to come from productivity gains
- A highly productive work force and sustainable growth are important

Sustainable growth, with labour-productivity gains

The United Arab Emirates (UAE) economy has seen solid average real GDP growth of 6% over the last two decades. Between 1990 and 2010, the economy grew from USD 64bn to USD 179bn. Growth was driven by the hydrocarbon sector, heavy investment in infrastructure and a population increase. The population, made up of nationals and non-nationals, grew from a mere 1.8mn in 1990 to nearly 8mn in 2010. This enabled the UAE to create a well-developed infrastructure and a strong non-oil economy.

During two decades of economic gains, labour productivity actually contracted. This trend compares unfavourably with other Gulf Cooperation Council (GCC) countries and other emerging-market (EM) economies (Figure 1). Increased use of capital and labour helped drive the headline growth rate, which served the UAE well during its phase of rapid development. However, the medium term should see a gentler pace of infrastructure spending and oil output near capacity levels. The quality and sustainability of growth are a key focus. Increased labour productivity (output per person) is a driver of economic growth. Increases in labour productivity are the basis for long-term increases in wages and a means by which an economy can reduce unemployment rates (World Bank). This is relevant to the UAE’s young national population.

The UAE aims to become a knowledge-based and highly productive economy, as outlined in its UAE Vision 2021. The Vision sees sustainable growth, built on a skilled and knowledgeable work force and attractive investment laws bringing in global expertise, as key. These ambitions trickle down to the medium term; building a competitive, knowledge-based economy is one of the seven strategic priorities highlighted in the UAE government strategy for 2011-13. Authorities point to improved labour productivity as a means to achieve this.

We identify the trends in labour productivity and assess the potential causes behind the contraction in labour productivity. We look at labour-market distortions, education and the transient nature of the population as possible explanations. We conclude with recommendations that could help change the trend and support the UAE in achieving its vast economic potential.

Figure 1: Labour productivity is falling in the UAE
Average annual growth rate %

<table>
<thead>
<tr>
<th>Country</th>
<th>GCC</th>
<th>East Asia</th>
<th>South/ South East Asia</th>
<th>Latam</th>
</tr>
</thead>
<tbody>
<tr>
<td>1992-2000</td>
<td>BH</td>
<td>KW</td>
<td>OM</td>
<td>1.3</td>
</tr>
<tr>
<td></td>
<td>OM</td>
<td>QA</td>
<td>SA</td>
<td>-0.3</td>
</tr>
<tr>
<td>2000-08</td>
<td>1.3</td>
<td>-0.1</td>
<td>5.5</td>
<td>-1.7</td>
</tr>
<tr>
<td>2008</td>
<td>1.7</td>
<td>2.7</td>
<td>0.9</td>
<td>-0.1</td>
</tr>
<tr>
<td>2009</td>
<td>1.8</td>
<td>2.7</td>
<td>1.8</td>
<td>-1.6</td>
</tr>
<tr>
<td>2010</td>
<td>1.8</td>
<td>-7.3</td>
<td>7.6</td>
<td>-2.1</td>
</tr>
<tr>
<td></td>
<td>1.8</td>
<td>-3.9</td>
<td>2.6</td>
<td>4.1</td>
</tr>
</tbody>
</table>
| Source: ILO

The UAE saw two decades of 6% average real GDP growth, driven by increased use of capital and labour, but growth in labour productivity has contracted.
19. UAE – Reversing the trend in labour productivity

Labour-productivity trends

Nearly two decades of growth contraction

Labour productivity in the UAE underperforms, both among the Gulf Cooperation Council (GCC) countries, and relative to other EM regions. However, despite the trend of nearly two decades of falling labour productivity, the UAE’s 6% average annual GDP growth rate place it high among the countries featured in Figure 1 during this time. Only China and India outperformed the UAE, with average real GDP growth rates of around 10% y/y (China) and 6.4% (India) over the two decades.

The UAE’s unfavourable trend in labour productivity has been masked by the headline growth rate, which was driven by increased oil output and infrastructure spending. However, oil output levels are near capacity. While the project pipeline looks healthy over the next few years, the spending approach is more conservative. Gains in labour productivity will be needed to drive headline growth.

Factor 1

A services-based economy

The UAE economy is largely composed of services-based industries – an intentional outcome of strategic planning using the country’s at-hand resources. Features such as a distinct geographic location and a small population base have driven the development of the UAE’s trade, logistics, retail, financial, and hospitality sectors. However, gains in labour productivity are more widely associated with manufacturing than services-based industries. In the US, labour productivity growth rates fell post-1973, coinciding with the shift away from manufacturing to the increased role of services in driving the total output of the economy. Across major geographic regions for which there is data, the International Labour Organisation (ILO) notes lower labour productivity growth rates for wholesale and retail trade, including hotels and restaurants versus manufacturing, during 1980-2001.

However, not all services are equal; services which better incorporated the use of technology, for instance, maintained positive labour-productivity growth rates over the span of nearly 40 years in the US, starting in 1960 (Brookings Institution, 2000). The likes of finance, real estate and wholesale trade are included in this. Admittedly, a downward bias is often a feature given the difficulty of measuring the output of intangible services.

The make-up of the UAE economy is a likely first contributor to the trend in labour productivity. However, this is not a dead-end story; more and more economies are moving towards services (even China, the world’s manufacturer, has seen its share of services double in the last three decades to just over 40% of GDP in 2011) and reversing the trend in labour productivity is possible in the UAE. Leveraging on the UAE’s development of world-class infrastructure and creating a regulatory environment which lends itself to a dynamic and competitive labour market are key factors which can bring this goal into sight.
19. UAE – Reversing the trend in labour productivity

Factor 2
Labour-market distortions – Growth with imported inputs

The UAE has seen massive population growth of 344% over the last two decades, correlated to the oil and infrastructure-spending boom of the time. The expatriate population predominates, making up 89% of the total population as of 2010. Translating oil revenue into infrastructure projects has meant the heavy importation of a work force in the construction sector (Figure 4). This sector, currently the biggest employer in the UAE, is characterised as having a predominantly male work force with a low education level, mainly originating from South East Asia and the Indian sub-continent.

This model has worked, given the country’s small population base. It has also led to the development of world-class infrastructure which we believe will benefit the economy over the longer term. The UAE is the only country in the Middle East/North Africa (MENA) region featured in the top 10 global ranking for infrastructure by the World Economic Forum in its Global Competitiveness Report 2011-12 (GCR). The quality of port and air-transport infrastructure backs the high score. Equally important is the soft infrastructure surrounding what have become key industries.

The UAE is ranked 7 (out of 142 countries) by the GCR, in terms of the efficiency of merchandise entry and exit. This is key to the strong efforts made in building a world-class infrastructure in transport and logistics. Hard infrastructure spending has been, and continues to be a key policy focus. We estimate that between Q1-2005 and Q3-2011, the UAE awarded USD 36.3bn in infrastructure projects, mainly for roads and transportation. We also estimate that between 2012 and 2015 another USD 21bn will be awarded to mainly transport-related infrastructure projects. These infrastructure achievements (both hard and soft) should lead to improvements in labour productivity (Figure 3).

Labour-market distortions – The Kafala system

The ‘sponsorship’ system in the UAE, locally known as Kafala, allows expatriate workers to earn legal entry to work in the country with an individual or firm acting as the sponsor. The Kafala system has two main distorting impacts: first, it results in a...
19. UAE – Reversing the trend in labour productivity

high degree of immobility in the labour market as employees are tied to their sponsors. The sponsorship system is common across the GCC (with the exception of Bahrain, which announced a change in its labour laws in 2009), and 'labour-market rigidities’ are cited as either the top one or two most problematic factors of doing business in the region. The UAE, as a small, open economy continuing on its path of encouraging foreign and local private investment, can benefit from addressing such rigidities to further improve the business environment. Second, there is no differentiation between the importation of a high-skilled or low-skilled worker, and this encourages the demographic make-up described above.

It is interesting to note that the free-zone areas of Dubai do not apply the sponsorship system and labour mobility is greatly enhanced as a result. A free-zone authority acts as the sponsor and employees can switch between employers within the free zone. Here, the Dubai Economic Council (DEC) notes higher labour productivity compared to equivalent firms outside the free zones. This is true despite the presence of higher labour costs in the free zones.

Labour-market distortions – Nationalisation laws
The nationalisation scheme sets minimum quotas on the number of nationals working at particular firms, effectively protecting the national work force from open competition in the labour market. The process meets specific needs of the population and aims to facilitate the movement into the private sector, which education and training would be able to achieve over a longer term. It is important to highlight that the problem of lower labour productivity in the UAE applies to the entire labour force, which is dominated by expatriates (96% of the total work force).

That said, it is worth taking a closer look at the nationalisation scheme, which presents some real distortions in the labour market and creates a few challenges. First, as firms adhere to the quotas, there can be a shift in focus from skills and development to maintenance and plain adherence to quotas. This will not help improve labour productivity. Second, such regulation can increase the costs of a business, through employment of a less competitive worker. Third, a wage differential exists between nationals and non-nationals, which is not necessarily linked to the level of skill/education (DEC, 2011). The public sector currently employs over 60% of the national work force; such dependence widens the gap between private- and public-sector salaries (Figure 5). Maintaining the wage differential within the private sector can negatively affect labour productivity, increase business costs further, and act as a disincentive to seeking higher levels of education.

Figure 3: Dubai free zones

The majority of firms in the free-zone areas of Dubai exhibit higher labour productivity relative to firms in equivalent industries outside the free zones. According to the DEC, the majority of firms in the Dubai free zones exhibit higher levels of value added per worker* compared to firms in equivalent industries outside the free-zone areas (annual output of the firm net of intermediate inputs, generated by one unit of labour, 2011). The DEC describes a ‘three-angle’ model which relays the success of the free-zone areas: (1) Asset management, relating to the quality and availability of physical infrastructure; (2) one-stop shopping for regulatory and value-added services; the free zones see a more integrated and streamlined soft infrastructure, where investors deal with a single government authority to fulfil their operational requirements, including the application of labour regulations; (3) the attraction of foreign investment; as an example, foreign ownership is not capped (at 49%) as it is outside the free zones.
19. UAE – Reversing the trend in labour productivity

Factor 3

Education

Higher skill levels and education are linked with higher rates of labour productivity. This can be seen using the free zones once again as an example. Firms in the Dubai free zones attract a more highly skilled labour force, which is a contributing factor to the higher labour productivity in these areas. Firms in the free zones are also incentivised to provide training, which can have a positive spill-over into the broader economy, given the ability for workers to move around more freely within the free zone (DEC).

While the UAE sees high rates of enrolment in secondary education (95%), the rate drops sharply for higher levels of education. The tertiary enrolment rate of the UAE, according to the GCR, is at 30.5%, only slightly higher than the 28% average of the GCC. Overall, only 14% of the UAE work force holds a university degree, according to the UAE National Bureau of Statistics.

It is encouraging to note that the labour market shows a positive correlation between wages and higher education levels (Figure 6), suggesting that there are material rewards to pursuing higher education. It is also positive to see that the UAE’s overall quality of education places it in the top 20 countries in the world (rank 17), according to the GCR. Qatar, in comparison, ranks 4 out of 144 countries.

Factor 4

A transient population

The transient nature of the UAE population ties together issues regarding labour regulations and education. The free zones, where there is increased labour mobility through sponsorship of a single authority, allow hiring to take place from an available pool of labour (as opposed to outside the free zones, where the loss of an employee can mean re-hiring from abroad). This can lower the cost of re-training within the free zones. Indeed, we see that firms in the free zones are more likely to provide training than their counterparts outside. Ultimately however, expatriates – which make up the great majority of the UAE work force – will leave the emirates, allowing skills to exit the emirates too. The non-committal relationship with the expatriate workforce may explain the UAE’s low level of public spending on education as a percentage of GDP.

Figure 4: Employment breakdown by economic activity

<table>
<thead>
<tr>
<th>Economic Activity</th>
<th>% of Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>Hotels/restaurants</td>
<td>5%</td>
</tr>
<tr>
<td>Government services</td>
<td>6%</td>
</tr>
<tr>
<td>Real Estate</td>
<td>7%</td>
</tr>
<tr>
<td>Transport</td>
<td>9%</td>
</tr>
<tr>
<td>Other</td>
<td>10%</td>
</tr>
<tr>
<td>Manufacturing</td>
<td>13%</td>
</tr>
<tr>
<td>Wholesale/retail trade</td>
<td>17%</td>
</tr>
<tr>
<td>Construction</td>
<td>33%</td>
</tr>
</tbody>
</table>

Source: UAE National Bureau of Statistics

Figure 5: Wages and hours worked per sector

<table>
<thead>
<tr>
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Source: UAE National Bureau of Statistics
19. UAE – Reversing the trend in labour productivity

(Figure 7). The UAE underperforms among GCC countries (for which there is consistent data for comparison purposes) as well as a number of EM economies.

**Recommendations**

**Balancing short-term needs with longer-term ambitions**

The UAE has a young population, with the 0-19 age bracket forming the largest segment of the national population. Higher labour productivity and sustainable economic growth can help meet the upcoming employment needs of this population. The recommendations that follow work towards the UAE vision which looks toward a more skilled and highly educated work force, sustainable growth, and the development of a knowledge-based and highly productive economy.

First, the UAE can benefit from a worker entry system that focuses on skills, encouraging inflow into areas where there is a shortage of skills and limiting the inflow of unskilled labour. Second, lessons can be learned from the free-zone model where higher labour productivity is found; where possible, the UAE can look to implement free-zone features such as more flexible labour laws without the traditional Kafala system. We have already seen that firms in the free zones attract a more highly skilled work force, are more encouraged to provide training and exhibit higher labour productivity. This approach can also counter the transient nature of the population to some extent. Third, a reduction in the wage differential between nationals and non-nationals is needed in order to encourage the national workforce to seek higher education and move into the private sector. This improves the skill base of the national workforce and reduces dependency on the public sector for jobs. At the same time, the private sector needs to refocus from meeting quotas to training and developing the skills of local workers.

The wage differential can be translated into a subsidised form of training for nationals in the private sector so that firms are encouraged to hire, and skills are further enhanced. Finally, creating a more permanent skilled work force in the UAE can be facilitated by granting permanent residency to selected workers who can be classified using metrics such as skill level, education/qualification and level of monthly income. Retaining skills within the emirates and creating a longer-term view of workers could result in positive spillover into the broader economy.

**Figure 6: Wages, AED according to level of education**

*A positive relationship between wages and higher education*

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**Source:** UAE National Bureau of Statistics

**Figure 7: Public spending on education**

*Selected economies (% of GDP)*

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**Source:** World Bank
Driving the fiscal deficit back down to more sustainable levels is a major challenge
High debt and weak growth is a toxic combination, worsened by political paralysis
Beyond a 90% debt-to-GDP ratio, history suggests that growth is negatively impacted

Summary
The US economy is one of the freest and most dynamic economies in the world. It ranks 7th on the World Economic Forum’s Competitiveness Index and 10th on the Heritage Foundation’s Economic Freedom Index. Still by far the largest economy, the US retains a long list of world-class companies. Now it faces huge challenges, including the ongoing deleveraging of the consumer sector, an ageing population, and a decaying infrastructure. The biggest challenge is dealing with the projected high fiscal deficits in the coming years, while growth remains fragile. Getting the balance right is critical for the US to navigate out of these difficult times.

The US needs to rein in its fiscal deficit, with a balance between cutting back and ensuring the tightening can be absorbed by the economy without triggering a recession. While it is clear that the rising Federal debt problem remains high on the agenda, making sure that action to restrain debt does not derail the recovery is the first priority. Although the likelihood of a second US recession in the near term remains low, the main risk comes from the government trying to cut the deficit too fast, in our view.

If current legislation remains in place, it would result in a fiscal drag of at least 3% of GDP in 2013 and 1.4% in 2014. It would be difficult for monetary policy to offset such a rapid pace of tightening. Final decisions on the 2013 fiscal stance will not be taken until very late in the year, which is itself a source of uncertainty, damaging growth. We expect this fiscal drag to be tempered. If nothing is done, the negative impact, particularly on Q1-2013 growth, would be dramatic. A new recession now, as well as being painful for the economy and damaging to the financial system would worsen the long-run fiscal outlook significantly. The very best outcome, tax reform combined with a credible long-term plan to gradually eliminate the deficit, along with better control of entitlement spending could emerge, but the political environment makes this result very uncertain.
The US will not have as much room to improve its debt-to-GDP ratio as Japan due to the higher share of foreign ownership.

20. United States – The fiscal policy challenge

US government debt is too high

A crisis point is not necessarily going to be reached any time soon. US public-sector debt (including state and local) stood at 98% of GDP at end-2011 in gross terms according to the OECD, with net debt of 74%. In contrast, Japan’s debt was estimated at 212% gross and 127% net. Japan has not suffered a crisis yet, either. But Japan can probably sustain a higher level than the US because there is solid buying of Japan’s debt by its own residents. This is not the case for the US, which may mean that confidence in the US sovereign debt market will erode earlier than in Japan. However even if a crisis is avoided, a gross debt-to-GDP level beyond 90% has historically been associated with slow economic growth (Figure 3).

Any plan to deal with the fiscal deficit must be well thought out or it could do more harm than good, boosting the debt-to-GDP ratio rather than decreasing it. This fiscal backdrop keeps the Federal Reserve, given its dual mandate of price stability and full employment, firmly pinned in a corner. Any fiscal austerity will require offsetting monetary support in order to keep the nascent labour-market recovery on track. Fed Chairman Bernanke has repeatedly warned that the current budget policies mean the US will face a “sizable structural budget gap” if steps are not taken to reach fiscal sustainability. The Fed Chairman has also repeatedly stated that the government’s tax policies and spending priorities should be reformed to reduce the deficit and to increase incentives to invest in both physical and human capital.

Lurking in the background are the rating agencies, which have been particularly proactive in downgrading countries that show a reluctance to ‘get their house in order’. Standard and Poor’s has already downgraded the US and threatens to do more if it believes fiscal policy will not take a more sustainable path following the presidential election. Worries over a situation similar to the present European crisis reaching the US may well rise over the next few years. One piece of good news is that we do not foresee the US losing its premier reserve currency status any time soon. The situation could become much more tenuous once other country’s capital markets rival the US’ in terms of depth and liquidity. This is not something we worry about yet.

Figure 3: Beyond a certain level, debt likely to stunt growth
US average real GDP growth, % y/y

Figure 4: Foreigners own 32% of US gross public debt
Investor base for outstanding US Treasuries and JGBs

Sources: usgovernmentspending.com, Standard Chartered Research
Sources: Federal Reserve, BoJ, Standard Chartered Research
We forecast that employment will not regain its 2007 peak before July 2014; meanwhile, the population is up by 20mn

20. United States – The fiscal policy challenge

The balance-sheet recession means private-sector recovery is slow

All these challenges are being faced in the aftermath of a major balance-sheet recession in which the recovery period is much longer than usual. On the assumption that job growth in 2012 will average 150,000 per month and 180,000 longer term, it will take almost seven years for employment to return to the pre-recession peak, more than three times as long as the seven previous post-WWII recessions. This would mean that the level of employment in November 2007 would not be revisited until July 2014, despite population growth of almost 20mn. Even the more optimistic assumption of 250,000 monthly payroll additions longer term would only see a return to previous peak employment in December 2013.

We discuss the present projections and the scenarios for fiscal policy plus political challenges for finding a way to reduce the fiscal drag in 2013 and 2014. For the medium term, the contentious issue is how to deal with entitlements as the population ages. It is possible that the fiscal situation and market stress will have to get much worse before enough of a consensus can be reached to deal with this issue.

Figure 5: The 2009 recession is the worst for job losses in post-WWII history

Employment change since peak, by recession, months

Sources: Bloomberg, Standard Chartered Research

Current CBO budget projection indicates weak growth in 2013

The CBO updated its budget and economic outlook in August 2012. Its baseline projection shows a federal deficit of USD 1.1tn in FY12 under the assumption that current laws generally remain unchanged. This equates to 7.3% of GDP, which is 1.4ppt below the deficit recorded in FY11, though still higher than any deficit between 1947 and 2008. But the baseline projection sees the deficit drop markedly over the next few years, reaching 2.4% by 2014 and averaging 1.1% of GDP over 2013–2022, helped by an assumed 4.3% GDP growth in 2014-17, with 2.4% thereafter. The baseline scenario assumes the expiration of all of the so-called Bush Tax cuts at end-2012 as well as the 2ppt payroll tax cut enacted in 2011-12, among other measures. This would be a massive drag on the economy.

The August release saw a notable decline in the baseline growth forecast from the 1.1% Q4-2012/Q4-2013 to a particularly weak economic expansion in FY13, with only -0.5% annual GDP growth. This fits with our view of a very weak start to 2013
20. United States – The fiscal policy challenge

without any fiscal agreement being reached. We look for a more staggered approach as too much deficit reduction, particularly in the near term, would be damaging to the already fragile recovery.

The baseline scenario assumes the expiration of all of the so-called ‘Bush Tax cuts’ at end-2012 as well as the 2ppt payroll tax cut enacted in 2011-12, among other measures. This would be a massive drag on the economy. The CBO projects a particularly weak economic expansion in FY13, with only 1.2% annual GDP growth. In our view, achieving even 1.2% growth would be difficult. Too much deficit reduction, particularly in the near term, would be damaging to the already fragile recovery. However, too little action could bring a market crisis, as we have seen in Europe.

A more gradual, but credible, long-term deficit-cutting plan would allow governments and households to strengthen their financial situations, while lessening the negative impact of austerity policies on growth. Under different scenarios the results vary. To illustrate the budgetary consequences of extending some tax and spending policies that have recently been in effect, the CBO lists several fiscal policy options and projections under “alternative fiscal scenarios.” These include:

- **Expiring tax provisions** (other than the payroll tax reduction) are extended
- **The alternative Minimum Tax** (AMT) is indexed for inflation after 2011
- **Medicare’s payment rates** for physicians’ services are held constant at their current level (rather than dropping by 27% in March 2012 and more thereafter, as scheduled under current law)
- **The automatic spending reductions** required by the Budget Control Act in the absence of legislation reported by the Joint Select Committee on Deficit Reduction do not take effect (leaving in place the discretionary caps established by the Act, which would otherwise be subject to those reductions).

The average deficit would be significantly higher under the “alternative fiscal scenario”, including all the listed assumptions and would average 5.6% of GDP over 2012-22. The assumption that tax policies will be extended has the biggest effect on the deficit, costing 2.7% of GDP on average over the next decade.
20. United States – The fiscal policy challenge

The medium-term challenge

Health costs weighing more and more heavily

The aging of the US population and the rising cost of health care are fundamentally changing the backdrop for fiscal policy. At present there are 4.6 people of working age, 20-64 years old, for each person aged over 65 years. As the so-called baby boomers, defined as those born between 1946 and 64, retire over the next 18 years, the ratio of workers to retirees will drop rapidly to 2.8 by 2030. After this point the ratio is forecast to only edge down by 0.1 during each of the following decades to reach 2.6 in 2050. This ageing population will add to the pressure on already stretched health-care and Social Security spending.

The US provides universal health coverage for people over 65, and while there are large patient co-payments (co-pays), the gradual ageing of the population as well as extension of treatments has already seen health-care costs balloon as a percentage of GDP, from 1.1% in 1972 to 5.6% in 2011. Costs are projected to rise to 6.7% by the end of 2022. Since the US has high immigration, the change in the dependency ratio will not be as aggressive as in Europe or Japan, but it will become a bigger challenge each year through to 2030.

Health-care costs are the major driver of increased entitlement costs, but it is unlikely that the electorate will allow politicians to significantly roll back coverage. However, it is hard to argue against the evidence that the US gets a poor return on the amount that it spends on health care (Figure 9). The US is a huge outlier compared to all other OECD countries in this regard. Moves to make the health-care system more efficient, in line with the rest of the OECD, would make a major difference in helping to get the US back onto a sustainable medium-term fiscal path. We do not expect defence spending to be even close to entitlements as an issue for the medium-term deficit. Already the budget has been reduced in this area (Figure 8).

Figure 8: Health costs keep increasing

Government outlays (% of GDP)

![Figure 8: Health costs keep increasing](image)

Figure 9: US health spending much higher than elsewhere

Life expectancy vs. health spending, per capita, USD PPP

![Figure 9: US health spending much higher than elsewhere](image)
20. United States – The fiscal policy challenge

President’s budget projects a constant increase in entitlement outlays

Data from the White House shows that while total Federal spending as a share of GDP has been generally flat since WWII (Figure 11), this has not been true for entitlement spending over the past 60 years. Entitlement outlays, including health, Medicare, income security and veteran benefits, cost 15.4% of GDP in 2011, up from 5% of GDP in 1950. The White House Budget Office (OMB) expects the expense to dip down to 14.8% of GDP in 2017.

In 2010, President Obama created the National Commission on Fiscal Responsibility and Reform to identify policies to improve the fiscal situation in the medium term and to achieve fiscal sustainability over the long run. Last November, it crafted a USD 4trn deficit reduction plan (Figure 14). It pushes for a comprehensive tax reform that sharply reduces rates, broadens the tax base, simplifies the tax code and reduces ‘tax expenditures’, or the deductions and exemptions offered by the tax code; for example, deductions allowed for mortgage interest payments. The proposal also calls for reforms to corporate taxes to ‘make America the best place to start a business and create jobs’. The unintended consequence of pushing for such large-scale tax reform is that it leaves corporates uncertain about whether to invest now or wait until after the presidential election.

There is no political agreement on the best step forward, with Republicans looking for spending cuts to do the majority of the heavy lifting, while Democrats prefer to increase income taxes on higher earners to help narrow the deficit. Identifying the problem is far easier than finding a solution to it.

Taxes – An issue revisited, again and again

While all but six US states have sales tax, there is no federal sales tax. Nor is there a value-added tax (VAT, also called a goods-and-services tax or GST in Canada and Australia). A VAT is generally seen as the most efficient, fairest way to tax consumption. Canada introduced a GST at the federal level in 1991 (currently at 5%), and most provinces have additional taxes, with some harmonised with the Federal tax. Australia introduced a GST in 2000, currently at 10%. While the UK has a rate of 20%, this has risen from 10% when the tax was introduced in 1973. The Nordic countries – Sweden, Denmark, Finland and Norway – all have a 25% VAT rate.

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*Human resource spending includes social and employment services, health care and veterans’ benefits.

Sources: OMB, Standard Chartered Research
20. United States – The fiscal policy challenge

While this may appear to be a simple solution, there is little political will for it, particularly given the shaky US consumer recovery. Republicans fear that a GST would open the way to a much larger government sector and they may be right. Total government spending in the US runs at around 35% of GDP normally (though it is about 42% currently). In Canada it normally runs just above 40% of GDP, while in some of the Nordic countries it is over 50%. Americans still need to pay directly for health insurance, which is not necessary in other countries, but even so, there is a gap in the size of the government between the US and Europe.

In February 2012 President Obama announced his intention to cut the US corporate tax to 28% from the current 35%, which would bring US corporate tax more in line with countries such as New Zealand and Norway, but still above much of the European Union (Figure 12). The main stumbling block is that in order to reduce the tax rate without reducing the tax receipts, there will need to be a mass simplification of the US tax code; this would require a removal of many of the tax ‘loopholes’. This will spark much discussion, with the White House having already spent a year working on the first major simplification of the tax code since the early 1980s.

All that is required for the Bush tax cuts to expire is for Congress and the President to fail to agree on a suitable compromise to extend them before the end of 2012. After the last round of elections in 2010, the lame duck session passed the Tax Hike Prevention Act of 2010, a particularly favourable set of tax cuts which maintained the Bush tax cuts and trimmed Social Security taxes from 6.2% to 4.2%. We expect an equally dramatic end to 2012 – except this time the Bush tax cuts may well be allowed to end. The President has the power of veto and can simply allow the tax cuts to expire, drastically narrowing the fiscal deficit, but also increasing the tax burden on US tax payers.

Figure 12: US corporate tax rate is uncompetitive

Corporate tax rate in selected OECD countries (%)

Figure 13: US state tax revenue is close to pre-crisis level

US state tax revenue, quarterly SA (USD bn)
20. United States – The fiscal policy challenge

Conclusion – Action urgently needed, but may disappoint

The ideal result over the next couple of years would be a new credible long-term plan agreed between the President and Congress providing:

- A gradual **tightening of the budget position** spread over a four- to five-year period, weighted towards lower spending, but not ruling out higher tax revenues
- The aim should be a **budget surplus within 7-10 years** based on credible economic assumptions
- **Tax reform** stripping out all or most of the loopholes, but maintaining or even reducing tax rates
- A procedure for revising the plan as time passes, which credibly constrains the government from ramping up spending or cutting taxes unless ‘paid for’ within the plan
- Progress on **reducing entitlement spending** perhaps by raising entitlement ages, requiring larger co-pays or excluding some areas, combined with ways to control costs

It says a lot about the uncertainty of the US government process that while we think markets could be favourably surprised at how well the government does on this list over the next couple of years, it is possible that the policy paralysis will continue. Worse than this would be to accidentally do too much tightening in 2013 and derail the recovery. Most likely, the outcome will be modest progress in reducing the deficit though possibly not in time to prevent a sharp fiscal drag in Q1-2013.

In our forecasts we assume that the existing sharp tightening planned for 2013 will be scaled back, but still be relatively large: The political timetable makes the first year of a presidential term the easiest time for politicians to introduce austerity. We also assume that there will be some tax reform because the government almost has to do something. With uncertainty about tax rates likely to continue for some time and 2013 likely to be a year of greater fiscal tightening than 2012, our expectation is that the economic recovery will continue at only a moderate pace. To instil greater confidence and accelerate growth, the government needs to show that it is ready to tackle the fiscal challenge.
20. United States – The fiscal policy challenge

Figure 14: The National Commission on Fiscal Responsibility and Reform’s USD 4trn deficit-reduction plan

**Six basic principles and detailed action plan**

**Six basic principles**

- Avoid disruption to the fragile economic recovery (small cuts in 2011 and 2012 and big cut in 2013)
- Protect the disadvantaged by not cutting SSI, Food Stamps or Worker’s Compensation
- Discuss defence spending cuts, but only in the context of national security as the top priority
- Protect important investments like education, infrastructure and high-value-added research
- Reform the broken tax code
- Cut wasteful spending

**Plan details based on principles**

- Overall, USD 4trn needs to be cut over 10 years, stabilizing the debt-to-GDP ratio and putting it on a downward trajectory
- Discretionary spending cuts: A 2012 freeze, a 5% cut in 2013, followed by growth of about half the rate of inflation through 2020
- Comprehensive tax reform: USD 80bn deficit cut in 2015, reaching USD 180bn in 2020 by eliminating the alternative minimum tax
- Health-care cost containment: To achieve USD 500bn in health-care savings near-term; long-term, federal health costs should be put in a budget; plan to eliminate state gaming of Medicaid, reform federal employee health-benefit programme and reform TRICARE
- Mandatory savings: Reduce low-priority and wasteful spending
- Social Security reform to ensure long-term solvency: No proposed reforms of Social Security to reduce the deficit; the proposed reform is to ensure that the programme remains strong and financially viable for future generations (75-year solvency of Social Security)

Sources: National Commission on Fiscal Responsibility and Reform, Standard Chartered Research
Disclosures Appendix

Recommendations structure

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Apart from trade ideas described below, Standard Chartered Research no longer offers specific bond and CDS recommendations. Any previously-offered recommendations on instruments are withdrawn forthwith and should not be relied upon.

Standard Chartered Research offers trade ideas with outright Buy or Sell recommendations on bonds as well as pair trade recommendations among bonds and/or CDS. In Trading Recommendations/Ideas/Notes, the time horizon is dependent on prevailing market conditions and may or may not include price targets.

Credit trend distribution (as at dd Month 2012)

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Credit trend history (past 12 months)

Please see the individual company reports for other credit trend history.

Regulatory Disclosure:

Subject companies: -

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