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## **Promoting High, Sustainable and Inclusive Growth during the 'New Normal'**

**RONALD U. MENDOZA, PH.D.**  
FACULTY, ASIAN INSTITUTE OF MANAGEMENT

**MONICA ISABEL M. MELCHOR**  
RESEARCH ASSOCIATE, AIM POLICY CENTER

**JEAN REBECCA D. LABIOS**  
PROGRAM ASSOCIATE, AIM POLICY CENTER

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## THE AUTHORS

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**RONALD U.  
MENDOZA, PH.D.**  
Asian Institute of Management  
Stephen Zuellig Graduate  
School of Development  
Management  
AIM Policy Center



**JEAN REBECCA D.  
LABIOS**  
Asian Institute of  
Management  
Policy Center



**MONICA ISABEL M.  
MELCHOR**  
Asian Institute of  
Management  
Policy Center

# **Promoting High, Sustainable and Inclusive Growth during the ‘New Normal’**

**Ronald U. Mendoza  
Jean Rebecca D. Labios  
Monica Isabel M. Melchor**

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## **Introduction**

Much more sober economic growth prospects are expected to characterize the world’s largest industrial countries, under what some experts call the “new normal”.<sup>1</sup> Recent global economic reports acknowledge that the era of high economic expansion could be over; and that even as industrial countries are showing signs of growth, there are still challenging times ahead. New drivers of growth are likely necessary for the developing world; and if so, many countries will have to re-think their industrialization and development models.<sup>2</sup>

Yet, development ambitions remain high. It is no longer uncommon to find the overall policy goal in developing countries articulated in terms of achieving “high, sustainable and inclusive growth”. To simplify, “high” often refers to growth of at least 7-10% (i.e. growth that at least doubles GDP every 10 years); “sustainable” could refer to a broad range of efforts to protect the environment, minimize pollution and mitigate excessive greenhouse gas emissions; and “inclusive” could refer to growth that reduces poverty and inequality, suggesting that the majority of society participates in and benefits from the economic growth that takes place. So to put it simply, the bar has been raised, compared to previous catch-up eras. When measured against these targets, it is easy to see the difficult “balancing act” pursued by policymakers and reform managers in orienting their societies and economies toward these broad goals. With

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<sup>1</sup> Martin Wolf (2013) noted that the “new normal” could be that the entire global economy could be stuck in a growth malaise similar to what Japan has experienced in the past 2 decades or so.

<sup>2</sup> See IMF (2014), World Bank (2014) and ADB (2013a).

varying degrees of success along these parameters, perhaps only a few countries have managed to progress in all these policy targets in the past few decades.

The development policy literature recognizes the achievements of East Asian tiger economies such as Japan and South Korea, Southeast Asian newly industrialized countries (NICs) such as Singapore, Malaysia and Thailand, and in other regions, Ghana and South Africa in Africa, as well as Brazil and Mexico in Latin America. With the exception of South Korea, however, most of these countries remain in the middle-income country range. Most have encountered rough patches in their development trajectories (notably periodic financial and economic crises) and many now wonder whether or when they will achieve industrialized country status.

According to a recent study by the Asian Development Bank, about 35 out of 52 middle-income countries were in the middle-income trap in 2010. Thirty countries were in the \$2,000 to \$7,250 GDP per capita group for over 28 years; and an additional five countries were in the \$7,250 to \$11,750 GDP per capita group over 14 years. Very few middle-income countries appear able to break free from this range of development.<sup>3</sup>

And if the previous high economic performers can no longer rely on exports, and if they are unable to resuscitate their growth and development to decent rates, then they could fall into what economists call a “middle-income country trap”.

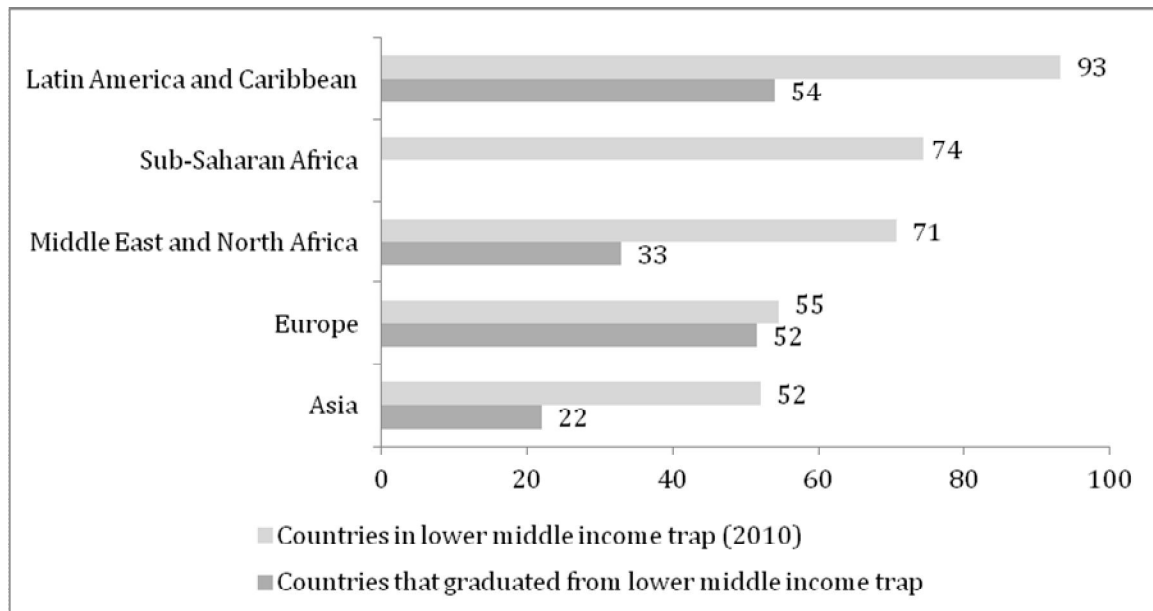
The so-called “trap” essentially entails a longer transition from one income category to another (see Figures 1 and 2). In Asia, the length of time needed to graduate from the lower middle income to the upper middle income group for those in the trap is, on average, more than twice the length taken by those who avoided the trap altogether (i.e. consider 69 total years needed by the Philippines as against 19 years taken by South Korea).

El Salvador remains an extreme case, projected to take almost 300 years to transition to upper middle-income status. As in Asia, countries in the Middle East and North Africa caught in the lower middle-income trap are estimated to take twice the amount of time to advance to a higher level compared to their more successful neighbors. And finally in Latin America and the Caribbean (the regions with the most countries stuck in the lower middle income trap), the duration is nearly twice those who successfully graduated as well.

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<sup>3</sup> See Felipe (2012).

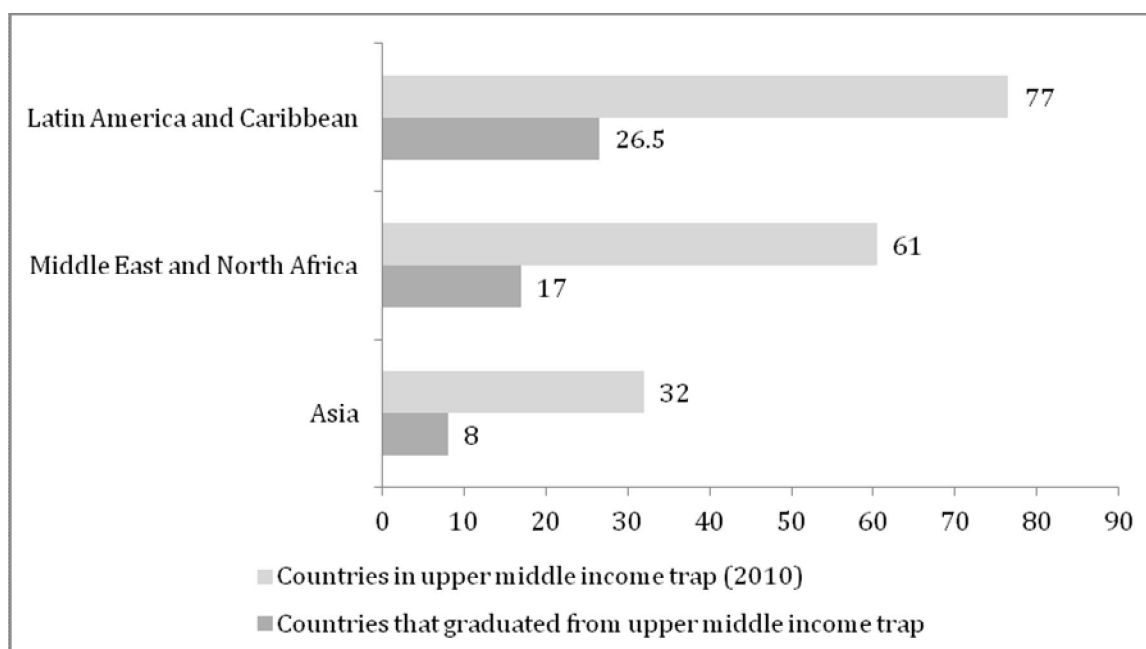
**Figure 1. Number of Years to Graduate from Lower Middle Income to Upper Middle Income Group**



Source: AIM Policy Center staff calculations based on data from Felipe (2012).

The trend is similar for those caught in the upper middle income trap, with the duration needed to progress to high income status nearly thrice that taken by those who escaped the trap in Latin America and the Caribbean. This effect may be partially explained by vastly divergent average GDP per capita growth rates. Those caught in the upper middle income trap grew at an average 1.98% from 2001-2010, in stark contrast to the 3.83% average growth rate of those not in the trap. Similarly, those in the lower middle-income trap grew at an average 2.37% compared to about 4.63% growth of their more successful counterparts.

**Figure 2. Number of Years to Graduate from Upper Middle Income to High Income Group**



Source: AIM Policy Center staff calculations based on data from Felipe (2012)

Note: Countries in upper middle-income trap in Asia refer specifically to Malaysia; countries graduating from upper middle-income trap in Middle East and North Africa refers to Israel, in Sub-Saharan Africa to Mauritius.

## **I. Rethinking Industrial and Development Policies**

At this point, we will abstract first from the more specific discussions on what constitutes a “trap” for middle-income countries. There is still a debate on whether they are “trapped” or development is simply much slower, compared to previous eras. Direct comparisons with the experience of already industrialized countries could also be less useful, for several reasons.

First, most countries face not only unique circumstances in their development but also unique historical periods vis-à-vis the global economy. For instance, the first wave of industrializers may have faced a much higher degree of labor mobility (resulting in mass migrations into former colonies such as what would later become Canada, the United States and Australia), while today’s industrializing economies operate in a world with slightly stricter border controls and much more overt policies to promote skilled labor inflows. (One could make a similar case for intellectual property rights protection and the acquisition of new technologies and resulting technological catch-up.)

In addition, it is also difficult to compare the economic and human development

trajectories of countries in differing regions and time periods because of the state of technology that may tend to change the expected economic and human development paths of countries—this includes dramatic improvements in agricultural, medical (notably vaccines) and information technologies.

Furthermore, it is also not possible to simply compare the policy scenario of today to those of earlier periods, given the pressing challenges brought about by climate change, the pressure on the world's resources (with a growing global population), far more integrated financial and economic markets (introducing new sources of volatility) and much more complex societal expectations on development and lifestyles (e.g. discussions on the “American dream” and the rise of the middle class in many large developing economies).

So instead of dwelling on what truly constitutes a “trap”, we simply acknowledge here that if growth and development tapers off for many middle income countries, then it will be practically impossible to catch up with the most developed countries in the world—it would simply take too long to be of any practical relevance for these developing countries' societies. Further, economic growth that is not inclusive (i.e. benefiting the wider swath of the population) nor environmentally sustainable (i.e. incorporating strategies to mitigate greenhouse gas emissions, pollution and environmental costs) will also be less likely sustained.

Export-oriented industrialization strategies dominated the emerging markets landscape in the last few decades, and a few countries managed to fuel their growth and development takeoff on the back of international economic integration. The literature in this area suggests that the more successful countries managed to meld deregulation and economic liberalization with phased support for key industries that were considered crucial to the industrialization push.

Key sectors in the economy developed a sufficient degree of competitiveness in order to compete successfully in international markets, often with heavy government support. Yet for those that managed to sustain their high growth, that same support did not appear detrimental to the competitiveness of these sectors, nor the over-all economy. In fact, competition and industrial policies among the most successful industrializers appear to have been crafted in lock step and implemented in a way that ushered rapid structural transformation.<sup>4</sup>

There is a view today that these original models of development will not necessarily work well in the present landscape where “global rebalancing” suggests that international export

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<sup>4</sup> See among others Chari and Henry (2014), Mendoza et al (2012) and Rodrik (2009).



markets are not necessarily going to be as strong as before, and more domestic sources of growth need to be found to carry part of the burden of “high, inclusive and sustainable growth”.

The World Economic Forum provides a simplified framework for understanding the 3-stage transition that most countries appear to go through—from resource mobilization stage, to efficiency enhancements stage, and finally to the innovation-driven growth stage (see Table 1). Using this framework, many middle-income countries are mired in the transition from stage 2 (efficiency driven) to stage 3 (innovation driven) economic structures.

Balancing concentration and competition within middle-income countries will remain a key challenge, and perhaps more so when these countries put greater priority on developing internal markets. Just like the challenges faced by countries that experimented with import substitution industrialization (ISI) policies in the 1960s and 1970s, focusing inwards puts greater onus on domestic institutions to maintain efficiency and competitiveness while also minimizing rent-seeking and corruption. Without the discipline of international competition, these institutions will need to reflect the mechanisms to organize and allocate resources in an efficient and sustainable way.

**Table 1. Three Main Stages of Growth (and the Interim Stages in Between) and the Countries in the World**

<b>Stage 1: Factor-driven</b> (38 economies)	<b>Transition from stage 1 to stage 2</b> (20 economies)	<b>Stage 2: Efficiency-driven</b> (31 economies)	<b>Transition from stage 2 to stage 3</b> (22 economies)	<b>Stage 3: Innovation-driven</b> (37 economies)
Bangladesh	Algeria	Albania	Argentina	Australia
Benin	Angola	Bosnia and Herzegovina	Barbados	Austria
Burkina Faso	Armenia	Bulgaria	Brazil	Bahrain
Burundi	Azerbaijan	Cape Verde	Chile	Belgium
Cambodia	Bhutan	China	Costa Rica	Canada
Cameroon	Bolivia	Colombia	Croatia	Cyprus
Chad	Botswana	Dominican Republic	Estonia	Czech Republic
Côte d'Ivoire	Brunei Darussalam	Ecuador	Hungary	Denmark
Ethiopia	Gabon	Egypt	Kazakhstan	Finland
Gambia, The	Honduras	El Salvador	Latvia	France
Ghana	Iran, Islamic Rep.	Georgia	Lebanon	Germany
Guinea	Kuwait	Guatemala	Lithuania	Greece
Haiti	Libya	Guyana	Malaysia	Hong Kong SAR
India	Moldova	Indonesia	Mexico	Iceland

<b>Stage 1: Factor-driven</b> (38 economies)	<b>Transition from stage 1 to stage 2</b> (20 economies)	<b>Stage 2: Efficiency-driven</b> (31 economies)	<b>Transition from stage 2 to stage 3</b> (22 economies)	<b>Stage 3: Innovation-driven</b> (37 economies)
Kenya Kyrgyz Republic Lao PDR Lesotho Liberia Madagascar Malawi Mali Mauritania Mozambique Myanmar Nepal Nicaragua Nigeria Pakistan Rwanda Senegal Sierra Leone Tanzania Uganda Vietnam Yemen Zambia Zimbabwe	Mongolia Morocco Philippines Saudi Arabia Sri Lanka Venezuela	Jamaica Jordan Macedonia, FYR Mauritius Montenegro Namibia Paraguay Peru Romania Serbia South Africa Suriname Swaziland Thailand Timor-Leste Tunisia Ukraine	Oman Panama Poland Russian Federation Seychelles Slovak Republic Turkey Uruguay	Ireland Israel Italy Japan Korea, Rep. Luxembourg Malta Netherlands New Zealand Norway Portugal Puerto Rico Qatar Singapore Slovenia Spain Sweden Switzerland Taiwan, China Trinidad and Tobago United Arab Emirates United Kingdom United States

Source: World Economic Forum ([www.weforum.org/issues/global-competitiveness](http://www.weforum.org/issues/global-competitiveness)).

## II. Boosting the Domestic Growth Engine

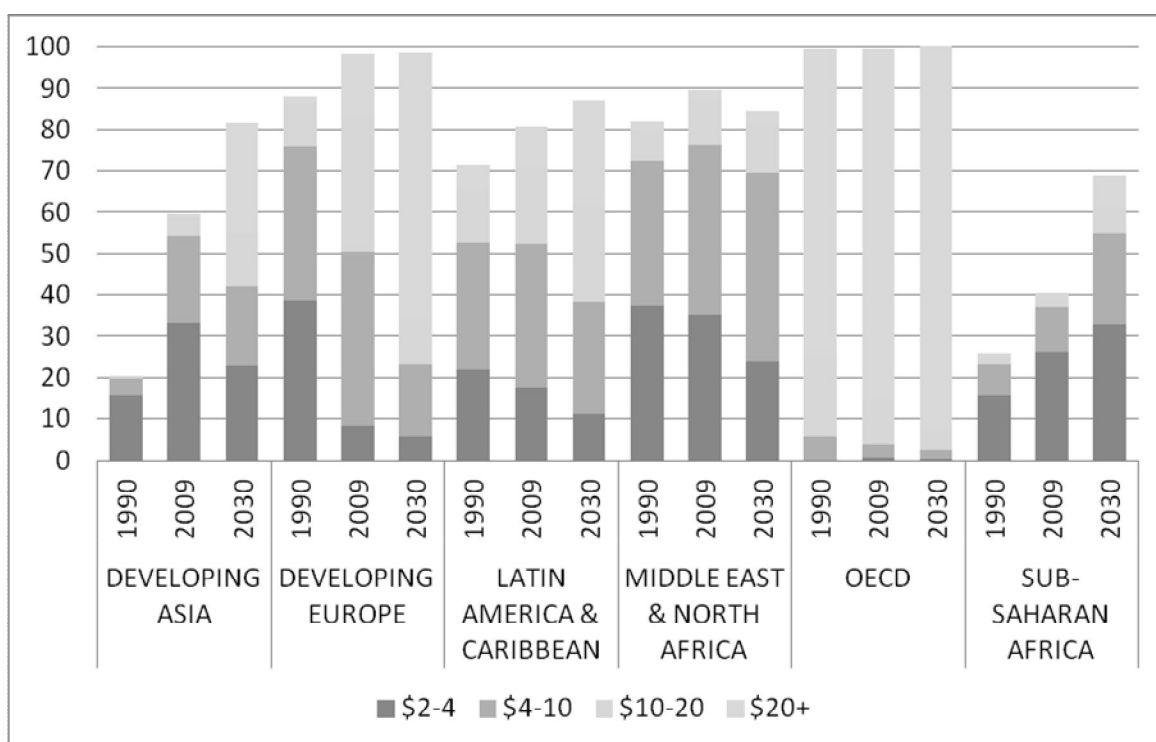
Global rebalancing requires that many emerging market economies also start to rebalance their domestic and international economy drivers. Robust export markets can no longer be considered a given. This puts the onus on domestic consumption and investment, notably driven by a burgeoning youth and middle class population in many emerging market economies. Even when assuming tempered growth figures, the middle class is projected to grow significantly in many developing regions, notably in Asia and Sub-Saharan Africa. Chun (2012) produces simulations

of the growth of the global middle class<sup>5</sup>, and the main results are illustrated in Figure 3.

As countries turn to their own domestic sources of economic growth, some analysts also expect that domestic institutions—notably as regards competition policy and market regulation—will play a key role in spurring and sustaining growth and investments.

Issues of fairness and consumer protection will be key, as the main wealth engine shifts from export-oriented industries to homegrown consumption and investments. Indeed, the Philippines has been a step ahead of other Asian economies on this front of relying on domestic consumption, given its historically small export sector and relatively larger domestic consumption-based economy, fueled by remittances.

**Figure 3. Percentage of Population by Region Living on More than US\$2 per Day (2005 PPP\$), 1990, 2009 and 2030 (Projected)**



Source: Chun (2012: 33).

Coherent competition and industrial policies will be key in promoting a “fair and level playing field” for both domestic and foreign firms as they begin to intensify their competition in domestic markets (while in the past a large part of production may have been geared for external

<sup>5</sup> Chun (2012) defines the middle class as those with daily expenditures between \$2-20 (2005 PPP \$).

markets). Some countries already have the framework for this: Brunei (Monopolies Act of 1932); Indonesia (Competition Act of 1999); Malaysia (Competition Act of 2010); Singapore (Singapore Competition Act of 2004); Thailand (Trade Competition Act of 1999); and Vietnam (Law of Competition 2005). Nevertheless, many others continue to lag, including: Cambodia, Laos, Myanmar and the Philippines, which have yet to introduce a more overarching competition policy framework (and law) that would introduce stronger predictability in this area. All these countries still have no generic competition laws, and at best they possess scattered industry-based laws and policies with fragmented enforcement and monitoring mechanisms.

With tempered growth, it is also more likely that there would be less tolerance for previous inefficiencies and certainly any perception of unfairness. And this includes, most notably, cases of corruption that may have been previously glossed over during better times. Trust in institutions that underpin a well functioning market economy will also become much more important, notably as the domestic economy carries the brunt of consumption and investments to drive growth.

World Bank metrics on the strength of institutions suggest that middle income countries on average are closing in on high income country averages in some areas such as macroeconomic management; but still lag significantly in certain areas such as in innovation policy, control of corruption and broader governance indicators (see Table 2). Data on corruption from Transparency International and data on judicial systems from the World Justice Project also similarly indicate that middle income countries still face a large gap in these areas (see Figures 4 and 5).

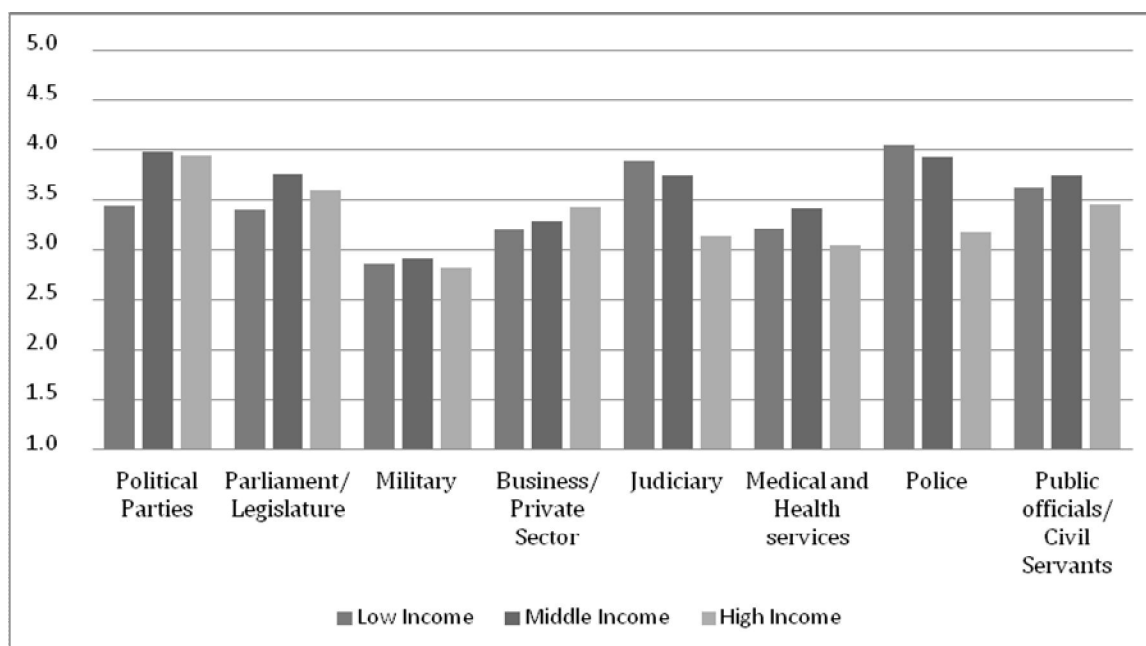
**Table 2. World Bank Scores on Selected Economic Regime, Governance and Innovation System Indicators per Income Category**  
(Average for Each Category, 1 to 10 from Weak to Strong Indicator)

Category	Variable	Low Income	Lower Middle Income	Upper Middle Income	High Income
Economic Regime	Soundness of Banks	2.98	4.31	4.81	6.23
	Intensity of Local Competition	2.94	3.38	4.05	8.02
	Domestic Credit to Private Sector as % of GDP	3.09	4.45	7.06	9.15

Category	Variable	Low Income	Lower Middle Income	Upper Middle Income	High Income
	Cost to Register a Business as % of GNI Per Capita	1.1	2.16	4.93	6.81
	Cost to Enforce a Contract (% of Debt)	0.74	2.87	5.21	7.3
Governance	Regulatory Quality	1.61	3.25	4.91	8.39
	Rule of Law	1.61	3.39	5.45	8.39
	Government Effectiveness	1.61	3.32	5.51	8.46
	Voice and Accountability	2.91	3.39	5.03	7.43
	Political Stability	1.88	3.32	4.83	7.69
	Control of Corruption	2.02	3.25	5.45	8.46
	Press Freedom	3.19	3.75	4.62	7.19
Innovation System	Intellectual Property Protection	3.28	3.36	4.89	8.28

Source: World Bank, Knowledge Assessment Methodology (2012).

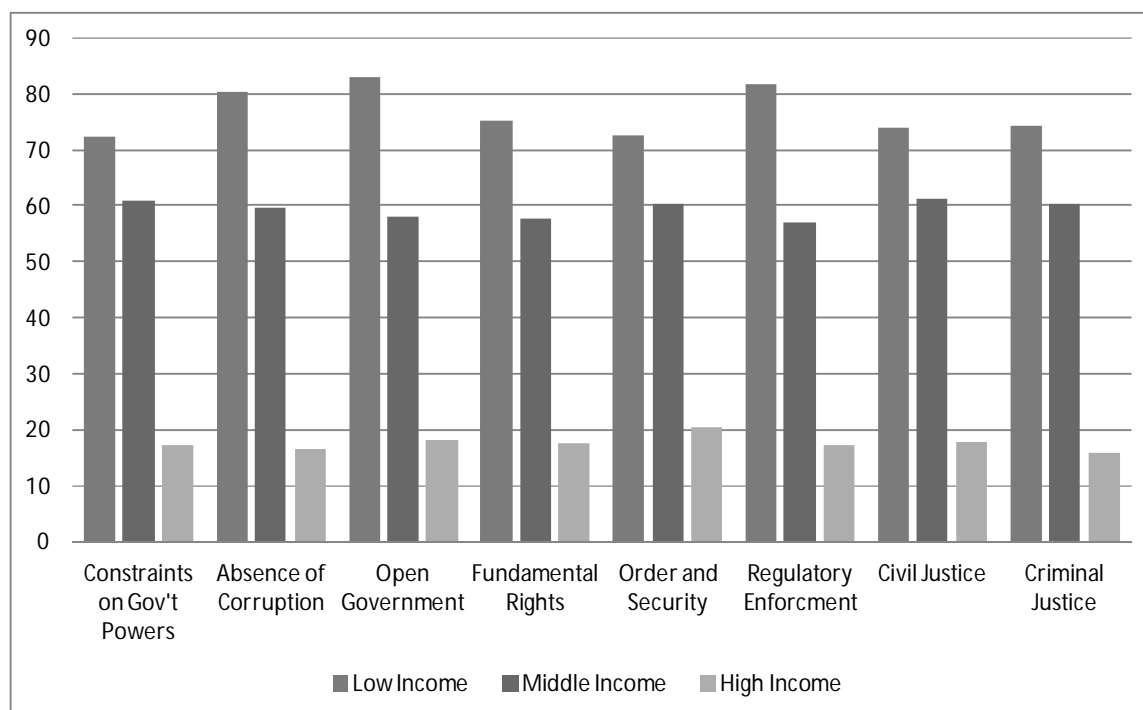
**Figure 4. Corruption Perceptions Index Score by Income Group, 2013**



Source: AIM Policy Center Staff calculations based on the data from Global Corruption Barometer 2013 and World Bank.

Note: Out of the 12 institutions measured from the Global Corruption Barometer, 8 were selected. The omitted institutions include education system, media, NGOs and religious bodies.

**Figure 5. World Justice Project Rule of Law Index 2014 Ranking by Income Group**

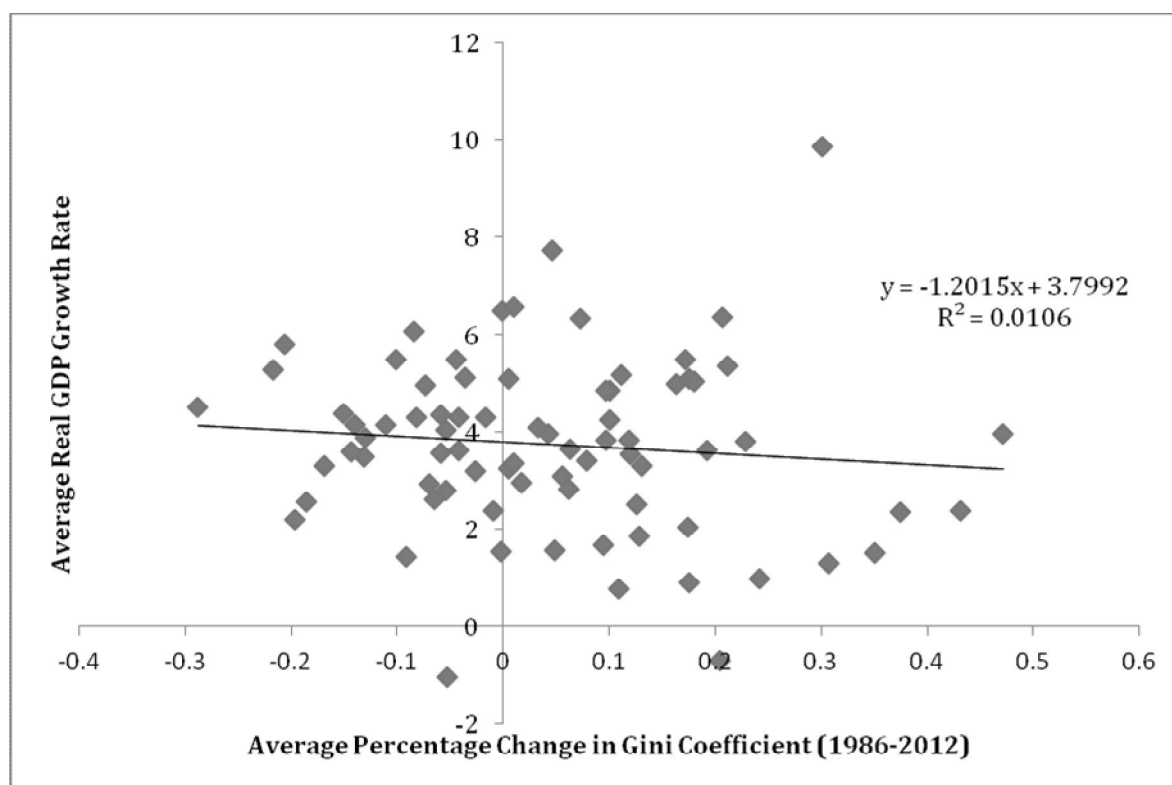


Source: AIM Policy Center Staff calculations based database from World Justice Project Rule of Law Index 2014 and World Bank.

### III. Addressing Inequality

High growth in the past decades also produced dramatic deepening of income inequality and yawning gaps in human development not just across —but also within — countries. A simple cross plot of real GDP growth juxtaposed against the percentage points change in the Gini coefficient for inequality suggests that developing countries have had a mixed record on the nature of inclusiveness of growth. In fact, in our analysis of countries with available data, 43 out of 75 countries experiencing average real GDP growth (or roughly 57%) displayed increasing inequality —30 of these were middle income countries (See Figure 6).

**Figure 6. Average Real GDP Growth and Percent Change in Gini Coefficient, 1986-2012 Period**



Source: AIM Policy Center staff calculations based on data from the World Development Indicators. Note that x-axis indicates the difference in average Gini coefficients between 1986-1995 and 2003-2012.

Economic openness increases competition, in turn producing both winners and losers. There is evidence that the aggregate (national and global) level “winnings” from economic openness, when managed well, will always trump the “losses” (thanks to specialization, efficiency, technological catch-up and all that). The challenge, however, lies in making sure those “winnings” are shared more broadly.

Studies have shown growth rates significantly associated with countries that engage themselves in economic openness and international trade of goods and services.<sup>6</sup> International trade facilitates productivity growth through innovation and technological development. When a country specializes in goods and services in which it has comparative advantage, efficiency is increased. Hence the reallocation of resources based on specialization generates economic gains and thus affects growth (and from a broader perspective, international trade spurs global

<sup>6</sup> See Andersen and Babula (2008).

economic growth). Economic openness can give access to foreign intermediate inputs (like access to knowledge in technological development and innovation), facilitating improvements in existing production of goods and services, as well as market expansion.

There are also concerns that the economies might not be able to catch up with the progress of their more advanced counterparts. This is because they might have difficulty in meeting the minimum level of labor and capital necessary to establish a strong foothold on trade. They may, for instance, lack basic and complimentary inputs, strong domestic institutions, general knowledge, R&D investments, and the like.

Economic openness is essentially a move towards economic integration. Note, for example, the Trans-Pacific Partnership (TPP) which is a proposed free trade agreement originally among Chile, New Zealand and Singapore but now has 12 member countries across the globe. The partnership is an initiative to facilitate ease in trade and investment for economic growth and development; however its progress is currently hampered by a lack of consensus in negotiations among member countries. Depending on the negotiations scenarios, the TPP could yield annual global income gains of up to \$295 billion (with the United States cornering \$78 billion). Experts also note that the TPP could open more room for free trade in the Asia-Pacific driving potential gains to negotiating countries of up to \$1.9 trillion.<sup>7</sup>

Nevertheless, these gains are not necessarily going to be spread evenly across the spatial and sectoral dimensions in each of the countries involved. Take any economy, couple the educated and skilled sectors that can compete with other sectors that cannot—and it would be easy to imagine how the few rich get richer, some of the more competitive are able to break into the middle class, and yet many of the poor get left behind. So this brings us to the situation we are in right now: entire countries have become divided, not just economically but also politically.

At this point, the economics and politics of many countries in the Asian region reflect deep inequalities in these two spheres, and analysts note that economic and political inequality may end up reinforcing each other.<sup>8</sup> Restoring everything to a more stable balance requires that all of Asia address inequality in its various forms. This must be accomplished in ways that do not erode the efficiency gains of the past decades. And the risk of creeping protectionism needs to be suppressed if decent and sustained growth levels are to be achieved over the long run.

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<sup>7</sup> Petri and Plummer (2012).

<sup>8</sup> Mendoza (2012).



#### **IV. Managing Reforms during the Era of the “New Normal”**

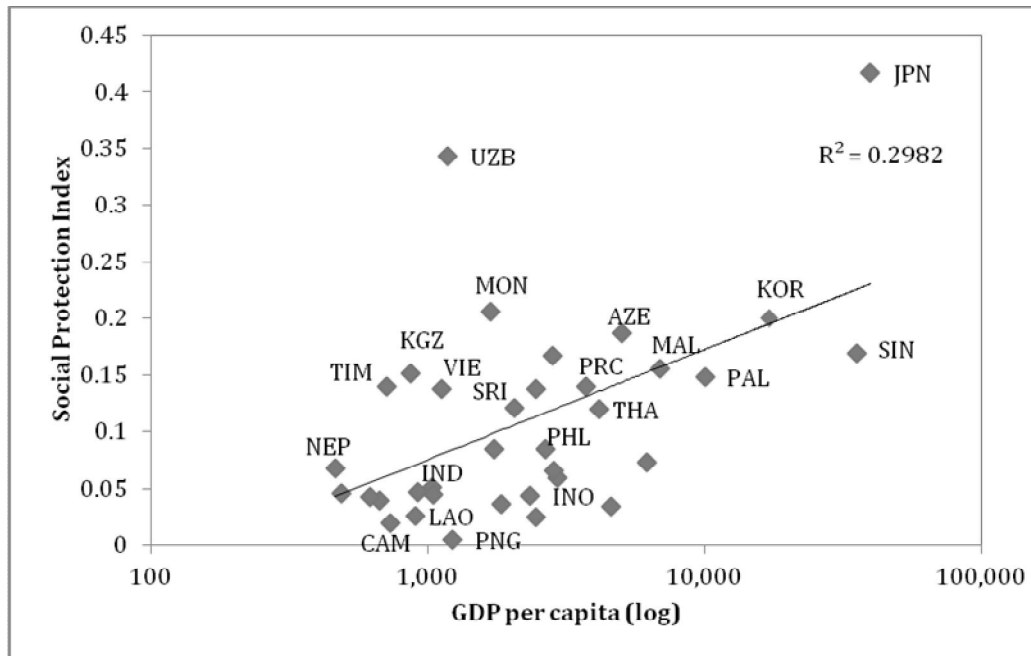
Addressing inequality through a growth model that rebalances the export orientation in the past could prove challenging—it must be done in a way that boosts domestic productivity, and avoids counter-productive protectionist tendencies in many countries. Managing those reforms will therefore require technical and managerial capabilities for the agencies that will design, consult and execute the new strategy. In summary, the key policy design and reform management challenges could center around:

- **Boosting human development and human capital investments** which may also produce long-term gains not just for individuals and their immediate families but also the country in terms of a more competitive labor force and empowered polity. This is part of what will build a larger middle class. Policies here could include boosting social protection, spanning education, health and other human capital investments. In many countries, these reforms will have to be managed making use of technical skills that promote evidence-based policy design and implementation, social marketing and communication and improving governance and management at the local government levels.

##### **Box 1. Social Protection**

The Social Protection Index (SPI) of the ADB gauges the effectiveness and characteristics of social protection programs across countries. The SPI is calculated by dividing a country's total expenditure on social protection by the total number of intended beneficiaries of all social protection programs. The index is comprised of three components, namely social insurance (contributory schemes meant to mitigate the impact of risks such as illness, old age and unemployment); social assistance (transfers to the poor or to those with little access to credit or insurance); and active labor market programs (programs to help people secure employment).

**Figure 7. Social Protection Index and GDP per Capita (2009)**



The figure above depicts a positive logarithmic relationship between a country's GDP per capita and its SPI. Many countries are not clustered close to the regression line, signifying that for the same general level of GDP per capita, some countries significantly exceed the expected SPI while others fall short. To illustrate, Japan has the highest SPI of 0.416, indicating that its social protection spending equals 41.6% of poverty-line expenditures. Papua New Guinea, in contrast, has the lowest SPI of 0.005 (or 0.5% of poverty-line expenditures). Recent analysis by ADB highlights the SPI of the Republic of Korea, 0.200 or 20% of poverty-line expenditures, as a realistic medium-term objective for middle-income countries in the Asia-Pacific region. ASEAN countries with relatively higher incomes – Malaysia, Singapore, Thailand – have relatively low SPI scores with social protection expenditure ratios ranging from a mere 3.5-3.7% of GDP, a range the report deems insufficient for their income per capita. The Republic of Korea, by contrast, has a social expenditure ratio of 7.9% of GDP.

The report indicates that some of the lower middle-income ASEAN countries – Indonesia, the Philippines, the Lao People's Democratic Republic – need to increase social protection expenditures. These countries have SPIs lower than 0.100 (i.e. less than 10% of poverty-line expenditures) – 0.006, 0.019 and 0.006 respectively. Their ratio of social protection expenditures is only at or below 2.5%.

Source: ADB (2013:17).

- **Providing space for public-private partnerships** where only state-owned or government-controlled enterprises and corporations used to operate. This could be one of the fundamental differences between the earlier models of rapid growth that were heavily state-led and new approaches that seek to leverage the private sector (both domestic and foreign). Public sector managers will need to be able to navigate this nexus between the public and private sectors in such a way that addresses the public policy goal while acknowledging that the private sector necessarily seeks decent market returns on investments.
- **Enhancing economic inclusiveness** notably on two fronts: a) involving the rural economy; and b) including small and medium scale enterprises (SMEs) more effectively in more dynamic value chains. These two offer direct channels to the large numbers of people left behind by the initial growth spurt in many countries. The challenge lies in including them in ways that also boost their productivity and enhance their competitiveness (hence not merely “subsidy-pushed inclusion”).
- **Strengthening domestic institutions and promoting fair competition** will also be critical in order to ensure that domestic consumption and investment patterns are firmly underpinned by strong trust in the regulation of the domestic market economy and a sense of fairness and predictability for both consumers and investors. While these issues are clearly important even before, they are likely to be even more critical as countries balance their export sectors with domestically driven growth engines—and these can only be sustained if regulatory institutions produce clear and impartial oversight, and there is a good balance between competition and industrial policy.
- **Investing in research and development (R&D) and fostering an environment of innovation** are vital to reaching higher levels of prosperity and improving national competitiveness. Middle income ASEAN countries such as Thailand, the Philippines and Malaysia trail behind South Korea in R&D expenditure (as % of GDP); and, more broadly, ASEAN overall continues to lag far behind South Korea, Taiwan, China and Japan in terms of patented technologies and inventions. This has potentially dire consequences as substantial investments in technology and R&D have been a key policy undertaken by governments of fast growing Asian economies, such as South Korea in the 1980s. A critical strategy underpinning the creation of an environment of innovation is

the promotion of Science, Technology, Engineering and Math (STEM) degrees and careers. This is a challenge for many ASEAN countries who lack graduates in these areas (in Thailand, the Philippines and Indonesia, graduates in STEM fields comprised a mere 10% of all tertiary graduates) (Tran, 2013).

- **Promoting crisis resilience** will also be key, particularly as the world is increasingly becoming shock-prone; and families and businesses need to cope and thrive despite the rising number of crises and aggregate economic and climactic disturbances. The Asian region is among the most vulnerable to natural hazards in the world—home to about 1 death per 1,000 square kilometers from natural hazards (double the global average of 0.5 deaths per 1,000 square kilometers) and accounting for about 50% of the world's estimated economic cost of disasters over the past 20 years. The estimated average loss incurred by the ASEAN from disasters is more than \$19 billion every 100 years, and yet less than 5% of disaster losses in developing Asia are insured as compared to the 40% in developed countries (ADB, 2013b). Unless measures to reduce disaster risk and improve preparedness are put in place, the increasing frequency of disasters has the ability to disrupt the region's economic growth and poverty reduction efforts.

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