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Staying the Course

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LIST OF ABBREVIATIONS

AEC	ASEAN Economic Community
APEC	Asia-Pacific Economic Cooperation
APIS	Annual Poverty Indicators Survey
ASEAN	Association of Southeast Asian Nations
bbl	barrel
BIS	Bank for International Settlements
BNM	Bank Negara Malaysia
BRICS	Brazil, Russia, India, China, and South Africa
CLMV	Cambodia, Lao PDR, Myanmar, and Vietnam
CPI	Consumer Price Index
EMBIG	Emerging Market Bond Index Global
EMEs	emerging market economies
FAO	Food and Agricultural Organization
FDI	foreign direct investment
FY	fiscal year
GDP	gross domestic product
GST	General Sales Tax
GVCs	global value chains
H1 / H2	first half / second half
ICP	International Comparison Program
ICT	information and communications technology
IMF	International Monetary Fund
IPAs	Investment Promotion Agencies
kCal	kilo calories
LPG	liquefied petroleum gas
LRMC	Light Rail Manila Corp.
NBS	National Bureau of Statistics (of China)
NIE	Newly Industrialized Economy
OECD	Organisation for Economic Co-operation and Development
PBOC	People's Bank of China
PMI	Purchasing Managers' Index
PPP	public-private partnerships
PPP	purchasing power parity
qoq SAAR	quarter-on-quarter seasonally adjusted annualized rate
Q1/Q2/Q3/Q4	first/second/third/fourth quarter
R&D	research and development
REER	Real Effective Exchange Rate
RERF	Revenue Equalization Reserve Fund
SAAR	Seasonally Adjusted Annual Rate
SAR	special administrative region
SBV	State Bank of Vietnam
SOE	state-owned enterprise
TC Pam	Tropical Cyclone Pam
TiVA	trade in value-added database (OECD/WTO)
UNCTAD	United Nations Conference on Trade and Development
vat	value-added tax
WTO	World Trade Organization
Yoy	year-on-year

Regions, World Bank Classification and Country Groups

ASEAN-4	Indonesia, Malaysia, the Philippines, and Thailand
ASEAN-5	Indonesia, Malaysia, the Philippines, Thailand, and Vietnam
EAP	East Asia and Pacific
ECA	Europe and Central Asia
G7	Canada, France, Germany, Italy, Japan, the United Kingdom, and the United States
HIY	High-Income Countries
LAC	Latin America and the Caribbean
Mekong-4	Cambodia, Lao PDR, Myanmar, and Vietnam
MENA	Middle East and North Africa
NIEs	Newly Industrialized Economies
PICs	Pacific Island Countries
SAS	South Asia
SSA	Sub-Saharan Africa
WLD	World

Countries

Developing East Asia and Pacific countries

CHN	China
FJI	Fiji

LIST OF ABBREVIATIONS (continued)

Countries (continued)

IDN	Indonesia
KHM	Cambodia
LAO	Lao People's Democratic Republic
MMR	Myanmar
MNG	Mongolia
MYS	Malaysia
PHL	Philippines
PNG	Papua New Guinea
SGP	Singapore
SLB	Solomon Islands
SPICs	Small Pacific Island Countries
THA	Thailand
TMP	Timor-Leste
VNM	Vietnam

Northern Pacific Island countries

FSM	Micronesia, Federated States
MHL	Marshall Islands
PLW	Palau

Small Pacific Island countries

KIR	Kiribati
TON	Tonga
TUV	Tuvalu
VUT	Vanuatu
WSM	Samoa

All other countries

AFG	Afghanistan
ARG	Argentina
ARM	Armenia
AUS	Australia
AZE	Azerbaijan
BGD	Bangladesh
BOL	Bolivia
BRA	Brazil
BRN	Brunei Darussalam
CHL	Chile
COL	Colombia
CRI	Costa Rica
DEU	Germany
DOM	Dominican Republic
ECU	Ecuador
EGY	Egypt
FRA	France
GBR	United Kingdom
HKG	Hong Kong SAR, China
HND	Honduras
IND	India
JPN	Japan
KOR	Republic of Korea
LBR	Liberia
LKA	Sri Lanka
LSO	Lesotho
MDA	Republic of Moldova
MDG	Madagascar
MDV	Maldives
MEX	Mexico
MKD	Macedonia
MLI	Mali
NAM	Namibia
NIC	Nicaragua
NPL	Nepal
NZL	New Zealand
PAK	Pakistan
PAN	Panama
PER	Peru
POL	Poland
PRY	Paraguay
RUS	Russian Federation
SGP	Singapore
SLV	El Salvador
SRB	Serbia
TUR	Turkey
TWN	Taiwan, China
TZA	United Republic of Tanzania
UGA	Uganda
URY	Uruguay
USA	United States
VEN	Venezuela
ZAF	South Africa
ZMB	Zambia
ZWE	Zimbabwe

LIST OF ABBREVIATIONS (continued)

Currency Units

B	Thai baht
CR	Cambodian riel
D	Vietnamese dong
F$	Fiji dollar
K	Myanmar kyat
K	Papua New Guinea kina
Kip	Lao PDR
₱	Philippine peso
RM	Malaysian ringgit
RMB	Chinese renminbi
Rp	Indonesian rupiah
SI$	Solomon Islands dollar
Tog	Mongolia
US$	Timor-Leste
US$	United States

PREFACE AND ACKNOWLEDGMENTS

The *East Asia and Pacific Economic Update* is a joint product of the Office of the Chief Economist, the East Asia and Pacific Region, and the Macro and Fiscal Management Global Practice, prepared in collaboration with the Poverty Global Practice and the Development Prospects Group. The report was supervised by Nikola Spatafora, under the guidance of Sudhir Shetty (Chief Economist, East Asia and Pacific Region).

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Throughout the report, geographic groupings are defined as follows:

East Asia and Pacific comprises Developing East Asia and Pacific, and the Newly Industrialized Economies.

Developing East Asia and Pacific comprises Cambodia, China, Indonesia, Lao People's Democratic Republic (PDR), Malaysia, Mongolia, Myanmar, Papua New Guinea, the Philippines, Thailand, Timor-Leste, Vietnam, and the Pacific Island Countries.

The **Pacific Island Countries** comprise Fiji, Kiribati, the Marshall Islands, the Federated States of Micronesia, Palau, Samoa, the Solomon Islands, Tonga, Tuvalu, and Vanuatu.

The **Newly Industrialized Economies** comprise Hong Kong SAR, China; Singapore; and Taiwan, China.

The ASEAN member countries comprise Brunei Darussalam, Cambodia, Indonesia, Lao PDR, Malaysia, Myanmar, the Philippines, Singapore, Thailand, and Vietnam.

The ASEAN-4 comprise Indonesia, Malaysia, the Philippines, and Thailand.

The ASEAN-5 comprise Indonesia, Malaysia, the Philippines, Thailand, and Vietnam.

This report is based on data available through September 18, inclusive.

EXECUTIVE SUMMARY

Since the last East Asia and Pacific Economic Update *was published in April, greater uncertainty about the global economy has weighed on the performance and prospects of developing East Asia and Pacific (EAP). The pace of recovery in high-income economies has remained gradual while the widespread slowdown in developing economies has intensified, particularly in commodity producers affected by lower commodity prices. Global trade grew at its slowest pace since 2009, as import demand in emerging economies fell. The prospect of monetary tightening in the United States and continued moderation in China's growth led to greater volatility in financial markets in recent months.*

Growth in developing EAP eased over the first half of the year. This mostly reflected a gradual slowdown in China, in line with earlier predictions, stemming from policy efforts to tighten nonbank credit, and from a buildup of excess industrial capacity and decelerating exports. Growth also slowed in Malaysia and, to a lesser degree, Indonesia; picked up less than expected in Thailand; but was buoyant in Vietnam and, to a lesser degree, the Philippines. Domestic demand broadly slowed in the larger economies, except for the Philippines. Regional and global trade flows were sluggish, except for Vietnam.

Lower prices for oil and other commodities have underpinned slowing inflation. This trend has increased the scope for authorities in some countries to ease monetary policy. In real terms, policy rates have fallen in most major regional economies, although they generally remain close to or higher than their levels in recent years.

As global energy prices fell, Indonesia and Malaysia faced a negative shock to oil- and gas-related public revenues, but also seized the opportunity to sharply reduce fuel subsidies. Fiscal consolidation has been pronounced in the Philippines. Public debt remains moderate in Thailand, but is rising rapidly in Vietnam, where implementation of fiscal consolidation plans remains essential. Mongolia and Papua New Guinea need to respond to the end of the commodities boom and secure their public finances, including by strengthening public financial management to improve the efficiency of spending and service delivery.

Regional currencies generally continued to depreciate against the U.S. dollar. However, the U.S. dollar has strengthened on a global basis since mid-2014, amidst continued quantitative easing in the Euro Area and Japan. Consequently, most regional currencies have experienced moderate trade-weighted real exchange rate changes over the last six months. In mid-August, the adjustment in China's system of exchange-rate fixing caused a 2 percent depreciation; this led to a bout of volatility in regional currency markets, which has since abated.

Looking ahead, growth in developing EAP is expected to ease, from 6.8 percent in 2014 to 6.5 percent in 2015 and 6.3 percent over 2016–17. This reflects mainly a moderate slowdown in China. Aggregate growth in the Association of Southeast Asian Nation (ASEAN) economies will be roughly stable at 4.3 percent in 2015, rising to 4.9 percent by 2017, with increasing support from global growth and export demand, particularly from high-income economies.

In China, growth is expected to meet this year's indicative target of about 7 percent, and to continue moderating thereafter. Sustained reforms will support a further rebalancing of domestic demand from investment to consumption. Investment growth will decelerate, owing to tighter credit and more subdued

property sector conditions. The shift from capital and resource-intensive manufacturing to services will continue, facilitated by policies to reduce excess industrial capacity and ease business regulations in services.

Among the large ASEAN economies, growth conditions will be most buoyant in the Philippines and Vietnam. In Indonesia and Malaysia, the outlook for business profits and household incomes is clouded by weak global commodity prices. In Thailand, uncertainty and economic vulnerabilities will continue to weigh on growth. Most of the smaller economies will see stable or slower growth in 2015, before picking up again.

This baseline growth scenario for developing EAP is more uncertain than usual because the course of the global economy remains unclear in several respects. The risks center on the trajectory of, and spillovers from, China's economic rebalancing and the pace of the likely increase in U.S. policy interest rates. These factors could affect global growth; shift key asset and commodity prices, exchange rates, and investment flows; and contribute to bouts of financial volatility. While the region has broadly weathered the immediate impact of the mid-August volatility and uncertainty, policy makers need to be aware that future developments could generate financial stress and disruption in the context of a global economy that remains fragile.

The baseline growth projections for China assume a further gradual slowdown in 2016–17. This transition to more moderate but more sustainable growth is conditioned on continued reforms, both to enable economic restructuring and to address the vulnerabilities built up since the global financial crisis. However, the accumulated imbalances present a risk of a sharper-than-expected slowdown in investment, a significant tightening of credit conditions, and increased capital outflows. China has sufficient policy buffers to address these risks and prevent a sharp slowdown; however, continued demand stimulus would erode these buffers over time.

If China's growth were to slow more than expected, the effects would be felt in the rest of the region through both trade and financial channels. The key trade effects would be mediated through developments in commodity prices, exports of non-commodity merchandise to China, and receipts from Chinese tourists. Financial spillovers would arise through a decline in outward FDI from China and an increase in volatility.

The baseline is predicated also on a gradual, smooth tightening of external financing conditions, with U.S. policy rates expected to start rising in the coming months. While this increase has been anticipated and is likely to prove orderly, there is a risk that markets could overreact in the short term, causing currencies to depreciate, bond spreads to rise, capital inflows to fall, and liquidity to tighten more sharply than projected.

The risks to global and regional growth, and to the cost and availability of external financing, call for a continued focus across the region on sound macroeconomic management, and on mitigating external and fiscal vulnerabilities. The scope for countercyclical fiscal and monetary policy is likely to be limited, particularly in commodity exporters and in countries where domestic demand growth was highly leveraged. Exchange rate flexibility will help buffer shocks, but depreciations could generate significant balance-sheet risks that will need to be monitored and managed.

In China, the key short-term policy challenges are to reduce leverage in the economy, and continue rebalancing it toward consumption and services. This policy mix will likely slow short-term growth (as assumed in the baseline scenario in this Update), but will also reduce risks of an eventual sharp slowdown. Specifically, the process of deleveraging and rebalancing will be associated with slower but more sustainable growth than the credit- and investment-intensive boom observed after the global financial crisis. And some

reforms could boost economic activity and growth even in the short term, including removing barriers to entry in restricted sectors, reducing administrative and regulatory burdens, and improving the allocation of land.

Across the rest of developing EAP, prudent fiscal management, based on realistic assumptions and targets, is a priority. Taking steps to strengthen public revenues on a sustainable basis remains the major underlying fiscal challenge in many countries. Weaker global commodity prices have exposed the narrowness of Indonesia's revenue base. Well-sequenced and coordinated tax policy and administrative measures are urgently needed to expand its tax and nontax revenues. Malaysia remains heavily dependent on fiscal revenues from the oil and gas sectors, although the introduction of a general sales tax in April has helped diversify the revenue mix. In the Philippines, reforms to boost tax revenues will support priority expenditure, including on infrastructure.

Countries should sustain and build on recent momentum to reform energy pricing policies. Indonesia needs to improve implementation of its new retail gasoline and diesel pricing system, including through regular and transparent price adjustments. Liquefied petroleum gas subsidies remain high in several countries in the region, and should be redirected. China and Vietnam have increased fuel taxes, and other countries where fuel taxes are currently low should consider doing so, as well. Lower global energy prices also make this an opportune time to move toward greater cost recovery in electricity. In Indonesia, electricity subsidies still amount to 0.6 percent of GDP. Electricity subsidies are also a significant drain on public revenues elsewhere in the region, reflecting both subsidies to utilities (Thailand, Timor-Leste, and some of the smaller Pacific Island Countries) and the accumulation of contingent liabilities from public utilities (Vietnam).

Monetary authorities in the major regional economies may appropriately maintain their current, moderately accommodative stance. Inflation pressures and risks remain contained in the short term. However, the scope for further monetary easing is in many cases constrained by the need to safeguard financial stability.

For commodity exporters, such as Indonesia and Malaysia, lower real trade-weighted exchange rates can play an important part in adjusting to weaker terms of trade. More generally, authorities should limit currency market interventions to smoothing volatility, given the importance of maintaining adequate reserves. Where exchange rates are fixed, authorities should typically stabilize currency values in real effective terms, rather than focusing on the nominal bilateral U.S. dollar exchange rate.

Uncertainty also places a premium on deepening structural reforms, through the determined and consistent implementation of ambitious and clearly communicated policies. This will enhance long-term growth prospects. In the short term, it will also boost market confidence, thereby reducing financing constraints and vulnerability, creating additional room for macroeconomic stabilization, and enhancing the effectiveness of any policy response to shocks.

Over the medium term, in China, continued structural reforms will be required to support rapid, sustainable growth. The aim must be to improve the allocation of credit, facilitate resource reallocation from sectors with excess capacity to those with high growth potential, and encourage the expansion of more productive firms. Key policy steps would include strengthening market discipline in the financial sector and allowing inefficient firms, including state-owned enterprises, to exit. In some cases this will require a careful balancing between enhancing market discipline and avoiding disruptions to the labor market. In the long term, ad-hoc administrative measures in the financial sector must be gradually replaced by a market-based mechanism where interest rates clear the credit market and allocate capital.

Elsewhere in developing East Asia, this report identifies three priority areas for medium-term reforms. **First, critical investment needs must be addressed.** In several countries, regulatory reforms are urgently needed to ignite investment. In Indonesia, the recently announced policy package recognizes the need to reduce red tape and regulatory uncertainty. The Philippines also needs to induce more private investment, including FDI, by addressing its weak investment climate and costly business regulations. Relatedly, reforms are required to boost the region's modest level of private infrastructure investment. Public-private partnerships can help fill this gap, provided key obstacles are removed.

Many countries in the region also need to reexamine the use of tax incentives for investment. Several key points stand out. First, tax incentives complement rather than substitute for broader investment-climate reforms. The cost of tax incentives, including the extent to which they subsidize investments that would have occurred in any case, must be carefully considered. Discretionary tax incentives are particularly prone to abuse. And a regional approach, for instance through ASEAN, can help avoid harmful tax competition.

Second, the focus of agricultural policies needs to change. Regional food policy has traditionally centered on "food security," typically defined narrowly in terms of national self-sufficiency and price stability in rice. However, as the region becomes more affluent and urbanized, the structure of food demand and production is seeing significant shifts, including from direct to indirect consumption of cereals, via increased consumption of animal products and, relatedly, increased imports of animal feed. This requires a broader, multisectoral food policy, and a flexible recasting of the concept of food security. In particular, increased interdependence across countries places a premium on trade liberalization, trade facilitation, and logistics. Greater emphasis also needs to be placed on nutritional outcomes, food safety, and environmental risks.

Finally, regional integration needs to be deepened. In December 2015, the ASEAN Economic Community (AEC) will be formally established. The associated regional integration process has already had several important beneficial effects: ASEAN tariffs have been significantly reduced, regional trade has been facilitated, trade in services has been liberalized, and FDI has been boosted. There are large potential gains from fully implementing and extending the AEC integration program. However, realizing these gains will require ASEAN to address several new challenges, including reversing the rising use of nontariff measures, accelerating services integration, and promoting regulatory cooperation.

Part I. Recent Developments and Outlook

I.A. Recent Developments

The global economy has proved more fragile than previously projected. The period since the previous, April 2015, East Asia and Pacific Economic Update *has been characterized by subdued recovery in the high-income economies, a widespread slowdown in developing economies, persistently low commodity prices, and slowing international trade. All this interacted with the prospect of monetary tightening in the United States and concerns about China's growth outlook to generate financial volatility and raise external financing costs in recent months. Overall, growth in developing East Asia and Pacific eased over the first half of the year. China's GDP grew by 7 percent. Growth varied across the larger developing Association of Southeast Asian Nation (ASEAN) economies, and remained generally solid in the rest of developing East Asia.*

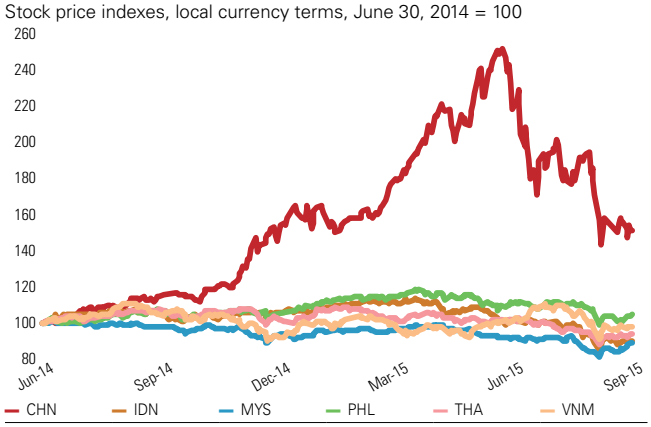
The global economy has proved to be more fragile than projected in the previous *East Asia and Pacific Economic Update*. The pace of recovery in high-income economies remained uneven in the second quarter of the year; growth eased in the Euro Area and Japan, offsetting a pickup in the United States (Box I.A.1). The widespread slowdown in developing economies intensified, particularly in commodity producers, which were affected by weakening commodity prices; output in Brazil and Russia contracted. The first half of the year also saw the slowest growth in global trade since 2009, driven by lower import demand in emerging markets, and again especially in commodity producers. Muted economic activity and low commodity prices have been reflected in weak inflation pressures, both globally and across much of developing East Asia and Pacific, despite some significant currency depreciations.

Financial markets were volatile and currencies depreciated against the U.S. dollar, though adjustment remains generally moderate in real trade-weighted terms

Chinese stock prices, after more than doubling over the previous year, began to reverse sharply in June 2015. Overall, Chinese stock markets fell approximately 30 percent from June through August (Figure I.A.1), despite increasingly determined measures by the authorities to limit potential risks to confidence and financial stability. This turbulent period for stocks included an 8.5 percent daily decline for the Shanghai Composite on August 24, dubbed "Black Monday" by official Chinese media. The stock market decline, likely triggered by tighter rules on margin finance, reduced overstretched valuations after the rally that took off in November 2014.

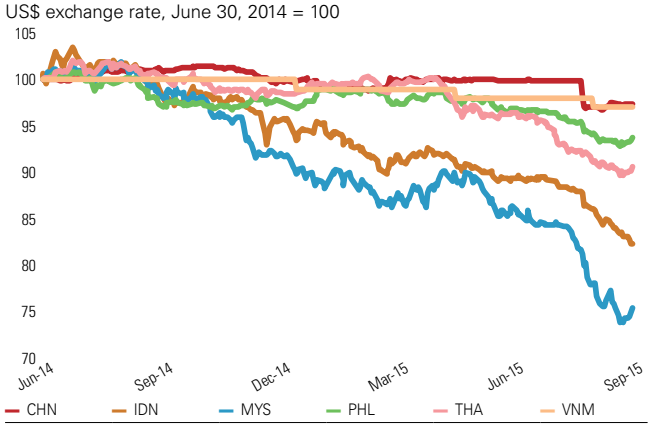
The turbulence in Chinese stock markets spilled over into other equity markets in the region and globally. Prices on regional stock markets, as elsewhere, fell sharply in mid-August amidst volatility, followed in most cases by a rebound (Figure I.A.1). For instance, the Jakarta Composite Index was down by 5.4 percent in the week through August 21, and 4.0 percent on August 17 alone, and subsequently regained much of this ground, leaving it down 4.5 percent from mid-August to September 18. The Malaysian benchmark share index more than recouped its losses over this time. Nevertheless, these equity markets, and those in the Philippines and Thailand, have all fallen substantially thus far in 2015, although by less than some other major regional equity markets (Singapore and Taiwan, China) and in other emerging market economies (for instance, Brazil).

Figure I.A.1. Stocks across the region fell, following a reversal in Chinese stocks that began in June 2015



Sources: CEIC.
Note: Benchmark stock indexes (China: Shanghai Composite). Data through September 18, 2015.

Figure I.A.2. EAP currencies weakened against the U.S. dollar, sharply so in August 2015



Sources: CEIC.
Note: Data through September 18, 2015.

On August 11, 2015, the People's Bank of China changed its system of exchange rate fixing, resulting in a depreciation of the renminbi against the U.S. dollar of 1.8 percent. This was the biggest one-day change in over two decades and surprised financial markets, where the move was widely interpreted as an attempt to stimulate the economy. The PBOC explained the move as a step toward adopting a more market-based approach to determine the reference exchange rate, basing it on the previous day's closing level and other market factors. Subsequently, China's exchange rate against the U.S. dollar moved little, for a cumulative year-to-date depreciation through September 18, 2015, of 2.5 percent (Figure I.A.2).

Regional currencies, after already tending to depreciate against the U.S. dollar during the course of 2015, experienced a sharp selloff in August (Figure I.A.2). In Indonesia and Malaysia, the exchange rate fell below symbolically significant thresholds against the U.S. dollar (14,000 Indonesian rupiah, and 4 Malaysian ringgit, per U.S. dollar). Vietnam's central bank, after devaluing the dong in January and May, did so again in August, for a cumulative devaluation of 3 percent. It also widened (again, in August) the trading band from +/-1 percent to +/-3 percent, citing the need to promote foreign exchange market stability and preserve external competitiveness.

However, the real, trade-weighted changes in major regional currencies since the start of 2015 have proved relatively moderate. The U.S. dollar has experienced a historically strong and broad-based appreciation since June 2014, leaving it higher by 16.6 percent in August on a global, trade-weighted basis, half of which occurred during 2015.[1] This reflected in large part the pricing-in of diverging monetary policy, as the prospect of the U.S. Federal Reserve raising policy rates contrasted with continued aggressive quantitative easing in the Euro Area and Japan. As a result, across the region, depreciation against the U.S. dollar has been much more pronounced than against the euro and yen. In trade-weighted terms, and adjusting for inflation, depreciations have therefore proved relatively moderate, with the exception of Malaysia (Figure I.A.3). Adopting a longer-term standpoint, exchange rates in China and the Philippines lie above their 10-year real trade-weighted trend value; in Indonesia, Thailand, and in particular Malaysia they lie below trend (Figure I.A.4).

1 Measurement basis: Bank for International Settlements (BIS) Nominal Effective Exchange Rate.

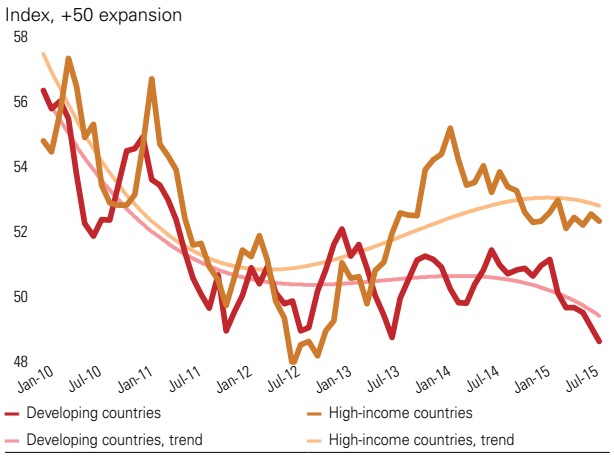
Box I.A.1. Recent Global Developments

Global growth remained weak in the first half of the year. In the first quarter, weak activity in the United States and China, output contraction in Russia and Brazil, and weakness across other major commodity exporters, offset improvements in the Euro Area, India, and Japan. During the second quarter, growth picked up in the United States, but eased in the Euro Area and turned negative in Japan, while remaining weak or decelerating further across emerging and developing countries. The first half of 2015 also saw the slowest growth in global trade since 2009. Weak trade was driven by a significant contraction in import demand from emerging markets, especially commodity exporters, reflecting weak domestic demand combined with weaker currencies. Global inflation also remained low, reflecting the continued dampening effect of low commodity prices, relatively weak wage growth in advanced economies, and overcapacity in China.

A moderate recovery in high-income countries is ongoing. Following a temporary setback in Q1, the U.S. economy grew by a robust 3.7 percent in Q2 (quarter-on-quarter seasonally adjusted annualized rate [qoq SAAR]) and showed further signs of improvements since then. Labor market conditions continue to tighten, with the unemployment rate at 5.1 percent in August—the lowest rate since April 2008—and employment gains averaging 231,000 since May. Euro Area growth eased to 1.6 percent (qoq SAAR) in Q2, following a 2.2 percent expansion in Q1. Growth has been supported by the European Central Bank's quantitative easing program, which helped improve credit conditions, weaken the euro, and shelter peripheral economies from contagion risks from Greece.

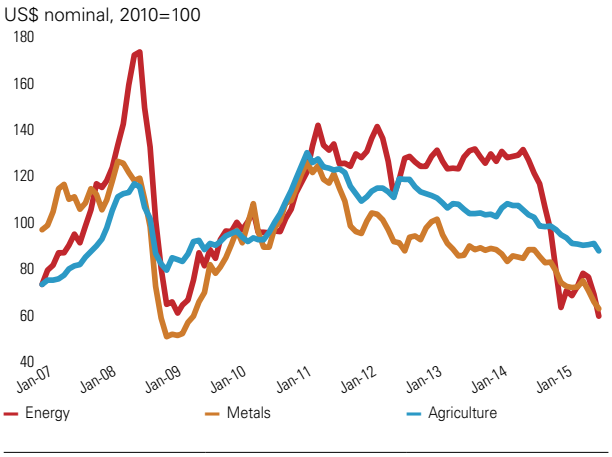
The growth slowdown is under way in major developing countries. High-frequency indicators suggest that weak growth in Q1 among major emerging markets (Angola, Brazil, Nigeria, Russia, and South Africa) has extended into Q2. The recovery in India appears to remain robust, although growth slowed somewhat from an exceptionally strong Q1. Industrial production growth in several countries has either struggled to gather momentum (Mexico, South Africa) or slowed (Brazil, Russia, and Thailand) (Figure I.A.1.1). A number of oil exporters (Colombia, Kazakhstan, Malaysia, Nigeria, Russia) are under acute pressure from deteriorating terms of trade, while countries reliant on export revenues from metal and other nonenergy commodities (Argentina, Chile, Indonesia, Peru, South Africa, Zambia) also face significant headwinds. Despite weaker activity, significant currency depreciations fueled inflation in a number of large emerging markets during the first half of 2015 (Brazil, Russia, South Africa, and Turkey).

Figure I.A.1.1. Manufacturing PMI



Sources: World Bank; Haver Analytics.
Note: PMI = Purchasing Managers' Index.

Figure I.A.1.2. International commodity prices



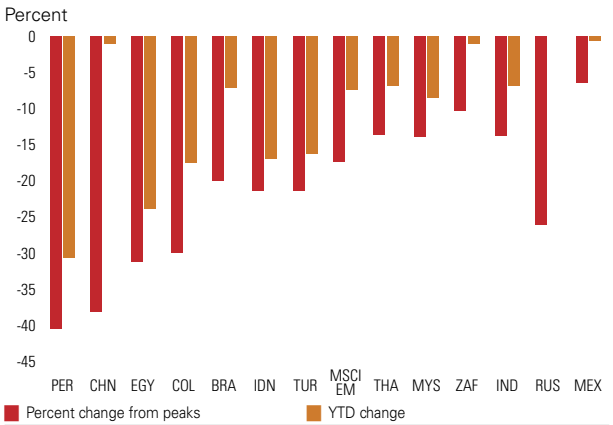
Source: Bloomberg.

Box I.A.1. continued

Commodity prices have been experiencing downward pressures. The weakness in energy prices continued into the third quarter of 2015 (Figure I.A.1.2). Oil prices fell below US$46 per barrel in August, to their lowest level since the 2008. The decline has been driven by an oversupplied global market, partly reflecting the resilience of U.S. shale oil production to date despite large reductions in investment and drilling. OPEC production continues to climb, with Saudi Arabia and Iraq recently reaching record levels. In addition, the agreement with Iran over its nuclear program could, if ratified, increase Iranian oil exports by 0.5 million to 0.7 million barrels per day by 2016. Increasing concerns about slowing growth in China—the world's second-largest oil consumer—also contributed to the recent drop in crude oil prices. Similar concerns contributed to a continued slump in metal prices, which reached their lowest levels in more than six years. The strengthening U.S. dollar has also played a role, as depreciating currencies of commodity producers tend to delay closure of higher-cost capacity. Grain and oilseed prices declined as well in August, down 8 percent and 7 percent, respectively, in response to well-supplied markets and despite El Niño concerns. The broad weakness in commodity prices is expected to persist for the rest of 2015, before a modest recovery in 2016.

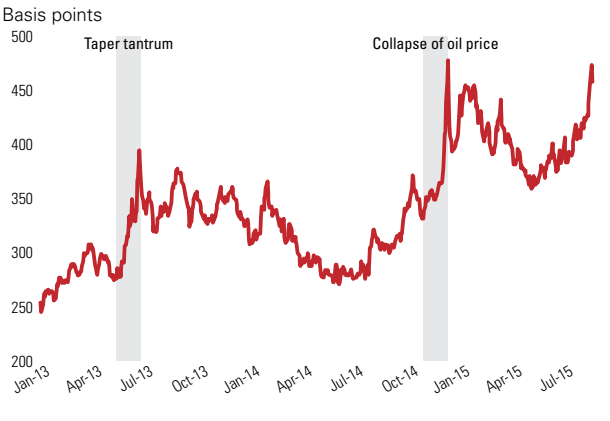
Emerging markets have been under significant financing and exchange pressures. The sharp decline of Chinese stock prices and unexpected depreciation of the renminbi, the renewed strength of the U.S dollar and uncertainty about the timing of a U.S. Federal Reserve rate increase, and lingering weakness of commodity prices sparked a sharp selloff in emerging market currencies and equities in August. Half of the 20 largest stock markets among emerging and frontier economies have fallen 20 percent or more from their peaks, with China leading the decline with a 40 percent drop (Figure I.A.1.3). The currencies of key commodity exporters, including the Brazilian real, the Indonesian rupiah, the Malaysian ringgit, the Russian ruble, and the South African rand, fell to multiyear lows against the U.S. dollar. Although the market rout in August was mostly concentrated in equity and currency markets, emerging market borrowing costs also rose in line with a broader increase in risk aversion, with the Emerging Market Bond Index spread rising 23 basis points since end-July (Figure I.A.1.4). Outflows from emerging market equity funds were significant in August, but bond outflows were more measured, and preliminary data suggest that international debt issuance by emerging markets remains steady.

Figure I.A.1.3. Emerging market stock market indexes (in local currency)



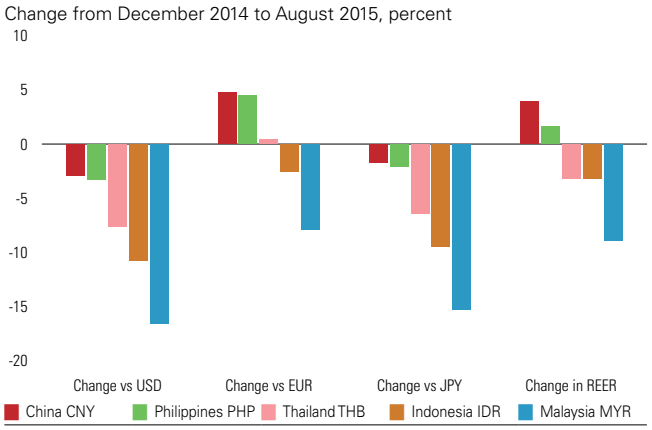
Source: World Bank.

Figure I.A.1.4. Emerging market sovereign bond spreads



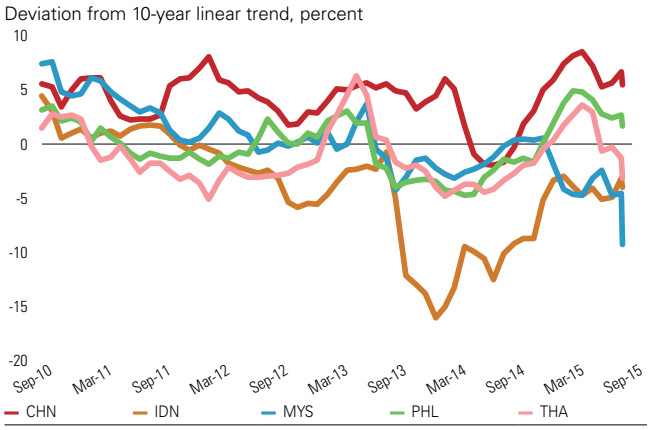
Source: Bloomberg.

Figure I.A.3. Major EAP currencies fell sharply against the U.S. dollar, but adjusted more moderately in real trade-weighted terms



Sources: BIS; CEIC; World Bank staff estimates.
Note: Increase indicates appreciation. REER = Real Effective Exchange Rate.

Figure I.A.4. In real trade-weighted terms, exchange rates in Indonesia, Thailand, and in particular Malaysia are below their long-term (10-year) trends



Sources: BIS; World Bank staff estimates.
Note: Increase indicates strengthening vs. trend.

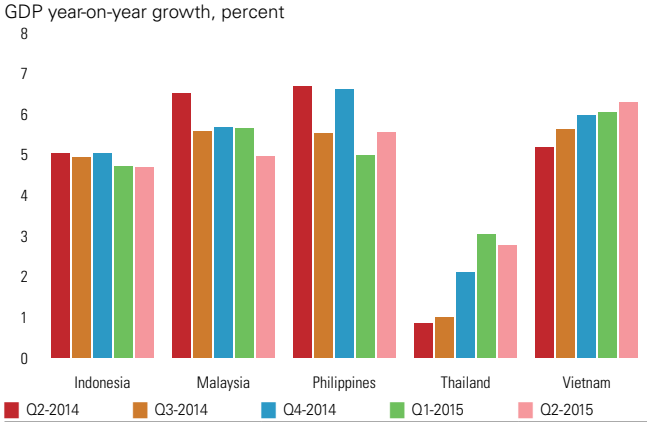
Growth in EAP eased during the first half of the year

Growth in the major developing economies of developing East Asia and Pacific (EAP) eased over the first half of the year to 6.2 percent year-on-year (yoy), down from an average of 6.5 percent in 2014 (Figure I.A.5). This mostly reflected slower growth in China. Aggregate growth in the ASEAN-5 economies (Indonesia, Malaysia, the Philippines, Thailand, and Vietnam) stood at 4.7 percent yoy, similar to the pace in 2014. In the context of a slow global recovery (Box I.A.1), the region accounted for almost two-fifths of global growth, more than twice the combined contribution of all other developing regions, and higher than its share in 2014.

Figure I.A.5. Growth in the major economies of developing EAP eased through the middle of 2015

Source: Haver Analytics; World Bank staff estimates.
Note: GDP-weighted average of Indonesia, Malaysia, the Philippines, Thailand, and Vietnam.

Figure I.A.6. Growth in Malaysia cooled in Q2 2015, while in the Philippines and Vietnam, it picked up



Source: Haver Analytics.

China's GDP grew by 7 percent yoy in both the first and second quarter of the year. The real estate sector saw an orderly correction, reflecting policy efforts to reduce oversupply and tighten nonbank credit. The adjustment in credit conditions, a buildup of excess capacity, and decelerating exports all affected industrial activity. Partly offsetting this, growth in services was robust, supported by growth in banking and insurance services, in part owing to the equity market bubble during the first half of the year.

Growth conditions varied across the larger developing ASEAN economies during the first half of the year. In Malaysia, growth slowed in the second quarter due to cooling domestic demand and weak exports, factors which also continued to weigh on growth in Indonesia (Figure I.A.6). In Thailand, growth in the first and second quarters was significantly higher than in 2014, but remained far below regional norms, as weak exports and subdued investment continued to dampen activity. In the Philippines, growth picked up in the second quarter, on the back of robust investment; however, the increase was less than expected, and growth was below 2014 levels. In contrast, Vietnam enjoyed buoyant growth, driven by domestic demand.

In the rest of developing East Asia, growth remained generally solid. Economic activity in Cambodia, Lao People's Democratic Republic, and Myanmar was strong. However, Mongolia's economy slowed, reflecting weak investment and a plunge in export growth, amidst a significant fiscal adjustment.

Poverty declined sharply in EAP in the decade to 2012 (the latest available comprehensive data)

Poverty in developing East Asia has continued to decline rapidly in recent years, including as measured using a new global poverty line based on updated purchasing power parity (PPP) adjustments. Extreme poverty in the EAP region, as measured using new 2011 PPP prices and a revised global extreme poverty line of US$1.90 PPP a day (Box I.A.2), has decreased sharply, from 29.1 percent in 2002 to 7.2 percent in 2012, with projections indicating the poverty rate fell further to 4.8 percent in 2014 (Figure I.A.7). The new estimates indicate that the number of people in developing East Asia living on less than US$1.90 PPP a day decreased from 551 million in 2002, to 147 million in 2012, and to an estimated 97 million by 2014. Even excluding China, poverty declined rapidly from 21.1 percent in 2002 to 8.9 percent in 2012, the latest year with actual data for China.[2] Nevertheless, using the global moderate poverty line (now updated to US$3.10 a day in 2011 PPP prices), an estimated 379 million people lived in poverty in 2014, and were vulnerable to falling back into extreme poverty.

2 World Bank poverty estimates for China are preliminary and are subject to revision following the release by the National Bureau of Statistics of China of latest estimates based on a new integrated survey, expected later in 2015.

Box I.A.2. Why does the World Bank calculate purchasing power parity (PPP) poverty estimates and why have they been revised?

The World Bank uses PPP poverty estimates primarily to generate measures of global poverty or to aggregate poverty in a region. The PPP estimates enable putting each country's income and consumption data into globally comparable terms that are aggregated into regional and global estimates. Market exchange rates do not accurately capture differences in costs of living across countries; therefore, PPP exchange rates are used instead to compare household consumption and income with a common global poverty line expressed in PPP-adjusted U.S. dollars. They are computed on the basis of detailed cost-of-living data from around the world, conducted under the auspices of the International Comparison Program (ICP), an independent statistical program hosted by the World Bank.

PPP has been used in the World Bank's poverty monitoring since *World Development Report 1990*, which used the 1985 ICP benchmark results. Subsequent ICP benchmark rounds took place in 1993, 2005, and 2011. In order to aggregate the estimates across different regions, they must be based on an international poverty line, which is then converted into local currency. The poverty headcount for a given international poverty line is given by the percentage of the population with consumption (or income levels in some cases) below the international poverty line expressed in local currency. The consumption (or income) data are drawn from household surveys that are carried out periodically in almost all countries.

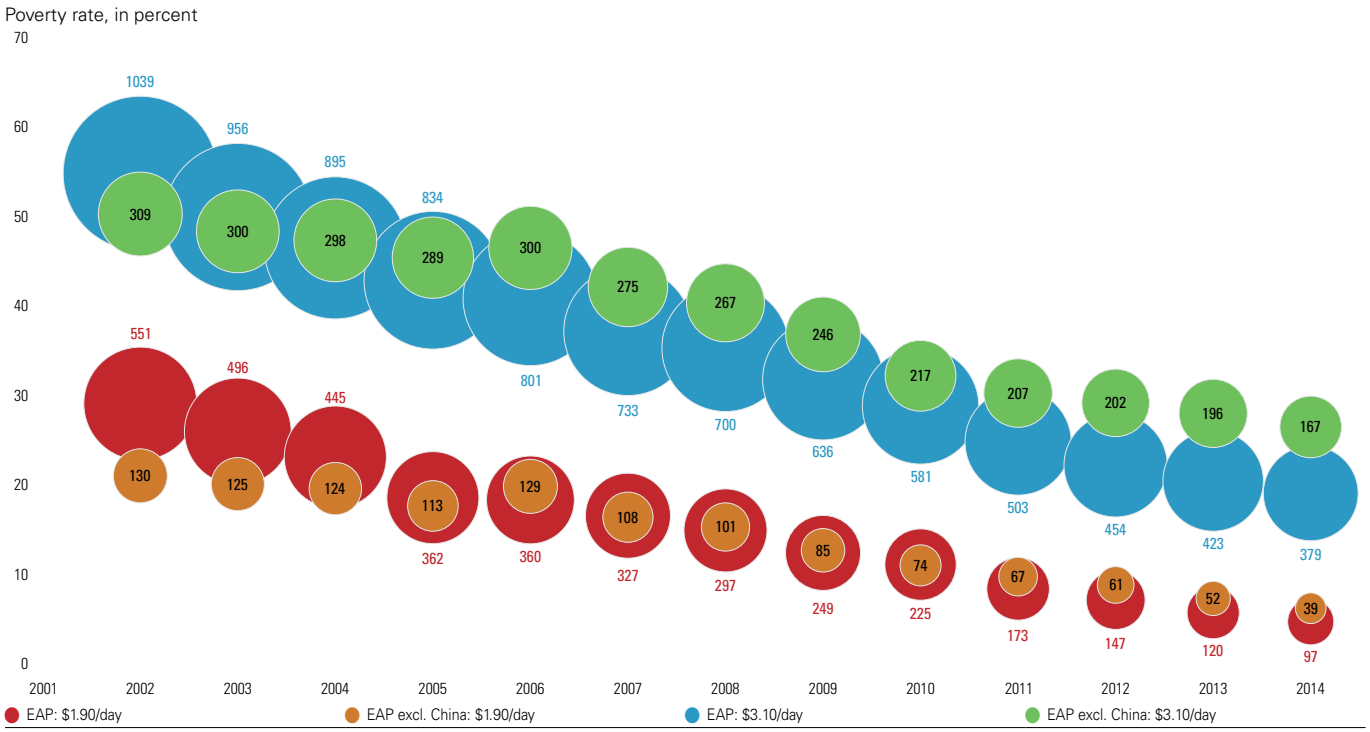
Revision to global poverty estimates

As differences in the cost of living across the world evolve, the global poverty line has to be periodically updated using new PPP price data to reflect these changes. The last change was in 2008, when the World Bank adopted US$1.25 a day as the global poverty line, using 2005 PPP conversion factors. When the PPP exchange rates change, estimates of the relative cost of living across countries change, which also affects the level and composition of global poverty. Consequently, global poverty estimates have now been revised based on the latest PPP exchange rates for 2011, which became available in 2014. On the basis of these new PPP exchange rates, **the global poverty line has risen in nominal terms from US$1.25 to US$1.90 a day**, which ensures that it is in constant real terms.

While the global extreme poverty rate may not be dramatically different after the adoption of the new PPP and poverty line, some regional and country rates may fluctuate considerably. Note that the global poverty line is used primarily to track global extreme poverty, and to measure progress on global goals set by the World Bank, the United Nations, and other development partners. A country's national poverty line remains most appropriate for country-specific analysis, underpinning policy dialogue or targeting programs to reach the poorest. The global poverty line and PPP establishes comparability across countries and is used to monitor progress on a global scale.

In addition, many other nonmonetary indicators—including on education, health, sanitation, water, and electricity—are important for understanding the many dimensions of poverty that people experience. These are a key complement to monetary measures of poverty and are crucial to inform the work of governments and regional and country stakeholders, to effectively improve the lives of the poorest.

Figure I.A.7. Poverty has declined substantially in the EAP region over the last decade



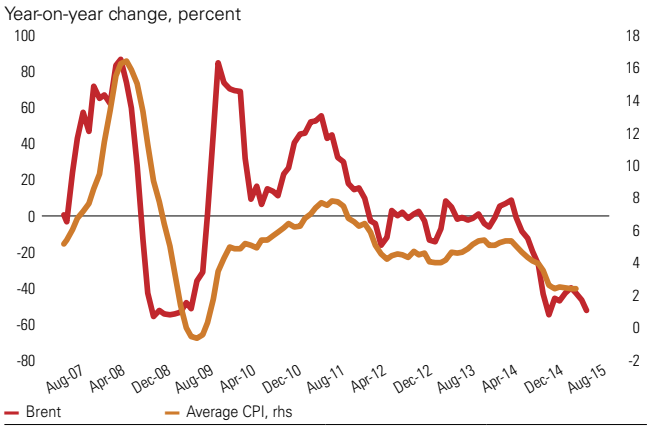
Source: World Bank.

Note: Bubble sizes and number labels indicate number of people, millions. Estimates for 2013–14 are based on per capita GDP growth and historical estimates of the growth elasticity of poverty. Regional poverty estimates are a population-weighted average of country-specific estimates.

The region continued to feel the impact of lower world prices for oil and other commodities

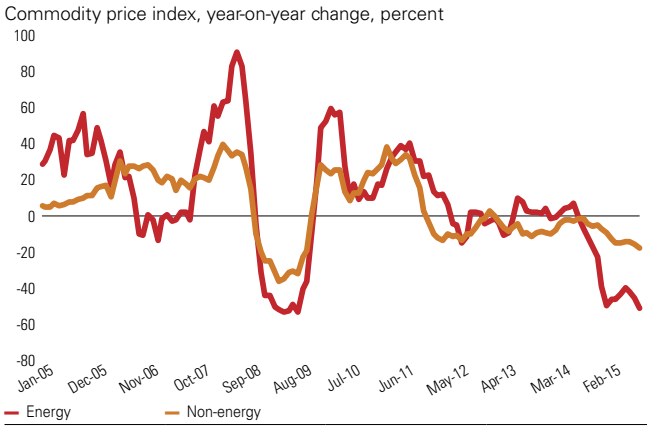
The economic effects of the fall since mid-2014 in global oil prices, and commodity prices more widely, continued to play out in the region. Global oil prices fell by 44 percent over the second half of 2014 in U.S. dollar terms. Some of this fall reflected the rapid appreciation of the U.S. dollar over the period. Nevertheless, lower fuel prices caused a significant disinflationary impulse across the region (Figure I.A.8), increasing the scope for authorities in some countries to ease monetary policy. Growth, the balance of payments, and fiscal positions were affected depending on the extent to which countries were net importers or exporters of oil and related products, including natural gas. Effects on output were clearly negative for Malaysia (through the impact on investment activity and exports), and positive for the Philippines and Vietnam (through lower import spending and higher real income).

Figure I.A.8. Lower oil prices contributed to lower inflation in EAP over H1 2015



Source: Haver Analytics.
Note: Simple average CPI for developing East Asian economies (excluding Myanmar).

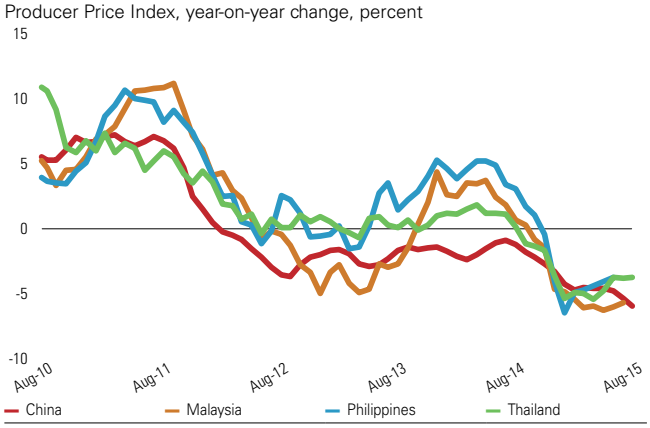
Figure I.A.9. Global commodity prices continued to decline



Source: World Bank.

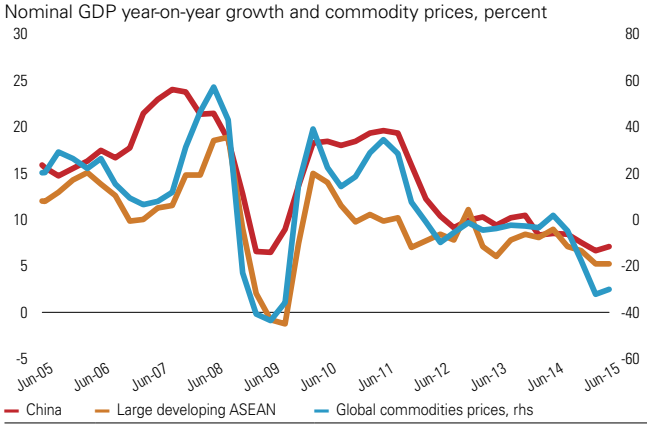
Downward pressures on both oil and other commodity prices continued through September 2015. Oil prices fell below US$46 per barrel in August, to their lowest level since 2008. In 2015 through August, energy commodity prices as a whole fell 24 percent, and nonenergy commodity prices fell by 12.4 percent (Figure I.A.9).[3] The continued broad-based decline in commodity prices has largely offset the boost to the terms of trade of Indonesia, a major net oil importer.

Figure I.A.10. Producer prices, after contracting steeply in H2 2014, generally stabilized, but kept falling in China



Source: Haver Analytics.

Figure I.A.11. Lower commodity prices have been associated with slowing nominal GDP growth in the major developing Asia economies



Source: Haver Analytics.
Note: "Large developing ASEAN" denotes the unweighted average for Indonesia, Malaysia, the Philippines, and Thailand.

Lower global commodity prices fed into wholesale prices, which fell sharply in China, Malaysia, the Philippines, and Thailand, and in the first half (H1) of 2015 reinforced the trend toward lower nominal GDP growth. The pattern since 2011 of subdued producer price increases (Philippines), or outright producer price contraction (most notably in China), was reinforced in H1 2015 (Figure I.A.10). The decline in producer

3 World Bank commodity price indexes through end-August 2015.

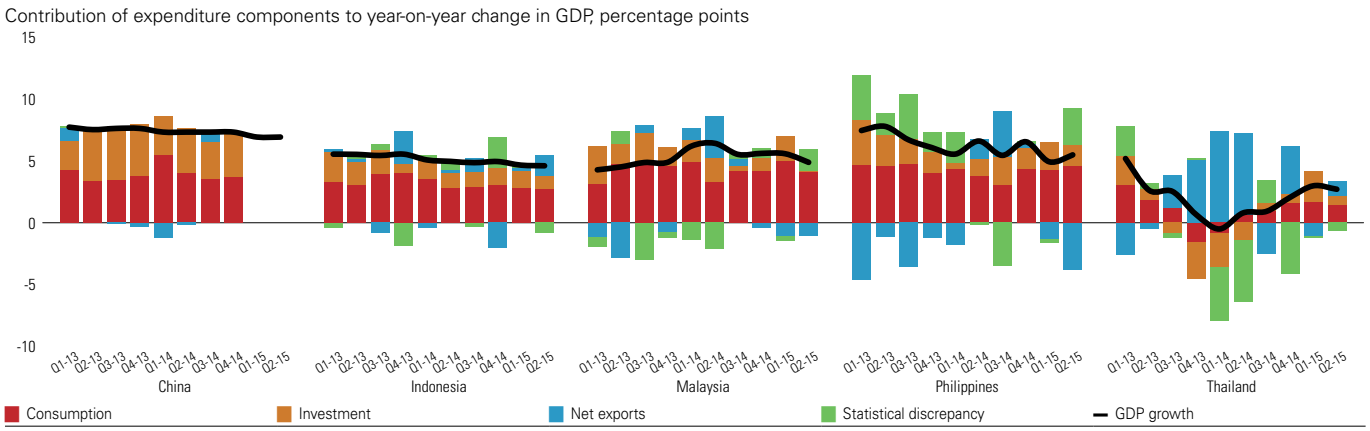
prices is consistent with the broad-based decline in global commodity prices over this period, including the sharp plunge in oil prices in the second half (H2) of 2014 and, relatedly, the impact of excess industrial capacity in China. There was also a marked deceleration in nominal GDP in the first half of the year across the major regional economies (Figure I.A.11). While broadly consistent with drops in commodity input prices, the disinflationary trend was widespread across sectors, and may therefore also indicate downward demand pressures in some economies and sectors (such as the export sectors of commodity-producing Indonesia and Malaysia, and China's industrial sector).

Domestic demand broadly slowed in the larger economies, except the Philippines

Real consumption continued to underpin growth in the large developing ASEAN economies, but softened in the first two quarters of the year in Indonesia and Malaysia (Figure I.A.12). In Indonesia, private consumption, the engine of the economy, decelerated, reflecting headwinds from weaker commodity-related income growth and tighter credit. In Malaysia, the temporary spike in retail spending ahead of the introduction of the General Sales Tax in April faded. Private consumption also remained subdued in Thailand. In contrast, consumption growth picked up in the Philippines, where it accounted for the bulk of output growth, and in Vietnam.

Fixed investment made a generally modest contribution to growth in the larger economies. In Indonesia, lower investment growth continued to drive the overall GDP slowdown, accounting for only 1.3 percentage points of yoy growth in the first half of the year, less than half the 2010–12 average. In both Malaysia and Thailand, investment got off to a strong start in Q1, only to weaken sharply in Q2. In the Philippines, investment contributed an average of 2 percentage points to year-on-year GDP growth in the four quarters through the second quarter; however, implementation of the public investment budget has lagged significantly behind expectations.

Figure I.A.12. Consumption has continued to drive growth, but weakened in Indonesia and Malaysia in the second quarter, and remained tepid in Thailand



Sources: Haver Analytics; World Bank staff estimates.

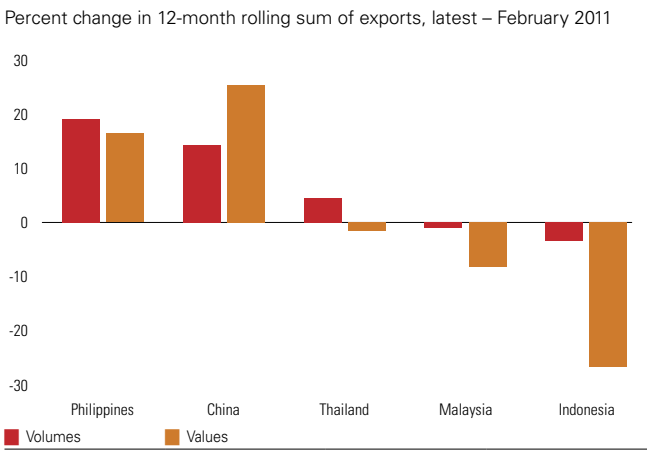
Trade flows in the region were sluggish, but exports still grew faster than the global average, and there were variations in performance across countries

Underlying trade performance, as measured by volume, has been stronger than suggested by headline U.S. dollar import and export values, owing to the magnitude of recent price and currency effects. Export values in the region excluding China contracted in the first half of the year compared with their year-ago levels. This reflected large commodity price declines, and the nominal weakening of several major regional currencies (Figure I.A.13). Since February 2011, when global commodity prices peaked, export revenues have fallen sharply for Indonesia and, to a lesser degree, Malaysia—the region's two major commodity exporters. In contrast, export volumes for these two economies have contracted only slightly during the same period (Figure I.A.14).

Figure I.A.13. In developing Asia excluding China, export volumes have declined much less than values

Source: World Bank.

Figure I.A.14. Reflecting large falls in export values, but not volumes, in commodity exporters, especially Indonesia, since the 2011 peak in global commodity prices



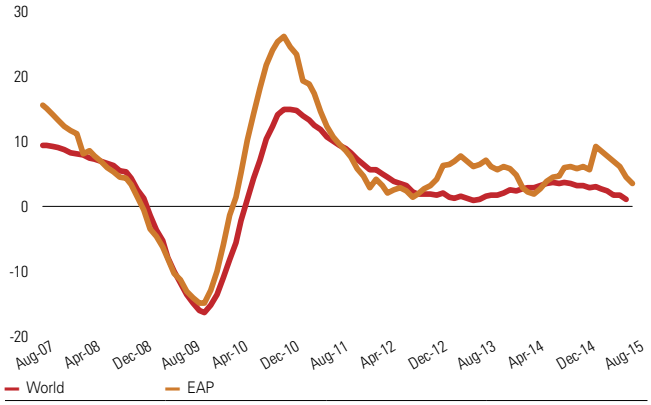
Source: World Bank.

Export volume growth in EAP trended down in the first half of the year, but export growth was still above the global average. Export volumes from developing Asia were up 4.6 percent yoy in July on a 12-month rolling basis—the slowest rate since August 2014, and about half of the post-global financial crisis average. Export volumes from China grew by 5.6 percent on a 12-month rolling basis in July, outperforming the rest of the region. Regional trade growth, while sluggish, was still stronger than the global average, of only 1.1 percent growth during the 12 months to July 2015 (Figure I.A.15). The general weakness in both global and EAP trade in H1 2015 extended the pattern of subdued global trade in the post-crisis period.[4]

4 World Bank *Global Economic Prospects*, January 2015 and June 2015.

Figure I.A.15. EAP export growth has been sluggish and dipped in H1 2015, but still outpaced global trade

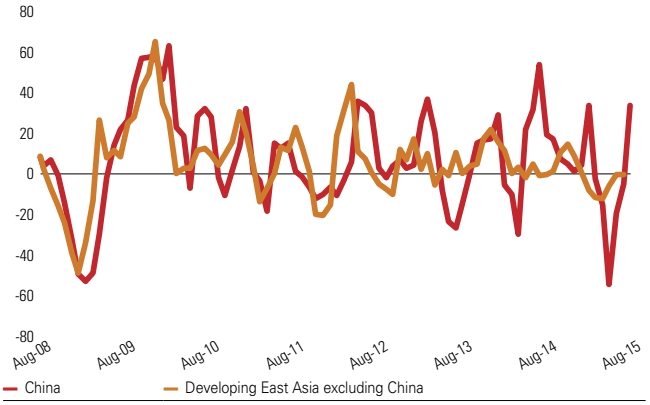
Export volumes, year-on-year change in 12-month moving average, percent



Source: World Bank.

Figure I.A.16. There are tentative signs of a stabilization in developing Asia's exports

Export volumes, 3m/3m change at a seasonally adjusted annualized rate, percent

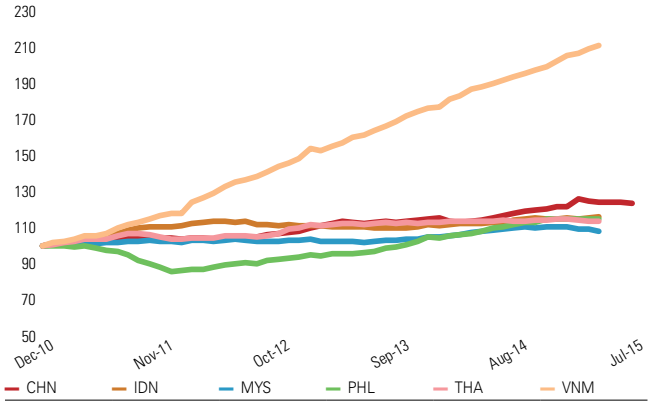


Source: World Bank.

Trade growth appears to be stabilizing, but only to around the very weak post-crisis average. The dip in trade growth over the first half of the year appears to be bottoming out. High-frequency trade data, while noisy, point to export growth through end-August rebounding in China, and stabilizing in the rest of developing Asia, after several months of contraction (Figure I.A.16).[5]

Figure I.A.17. Among the larger EAP economies, Vietnam's export growth in recent years stands out

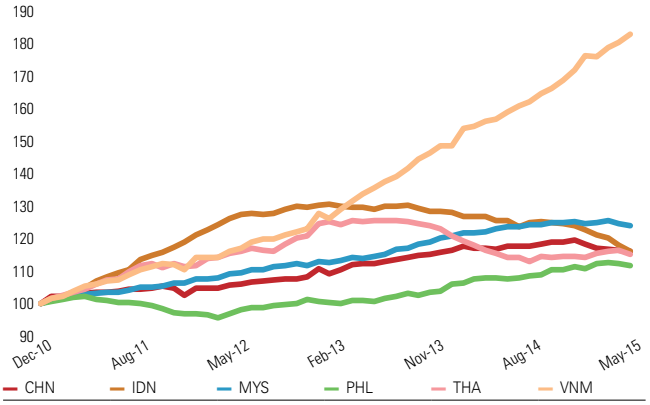
Export volumes, index of 12-month moving sum, December 2010 = 100



Source: World Bank.
Note: Volumes from customs trade data, seasonally adjusted.

Figure I.A.18. Vietnamese import volumes have also grown strongly in recent years, in contrast to slumps in Indonesia and Thailand

Import volumes, index of 12-month moving sum, December 2010 = 100



Source: World Bank.
Note: Volumes from customs trade data, seasonally adjusted.

Adopting a longer perspective, Vietnam and to a lesser degree, the Philippines and China, stand out among the larger developing EAP economies for their trade performance. Vietnam's export volumes have approximately doubled since 2010 (Figure I.A.17), with imports not far behind (Figure I.A.18). Export volumes from China and the Philippines, have also increased significantly since 2010. Among the smaller economies, export volumes in Cambodia and Lao PDR have also approximately doubled since 2010 (not shown

5 The warehouse explosions at the Port of Tianjin on August 12, 2015, despite their significant human toll, are not expected to have a major impact on China's trade.

in figures). Import volumes declined in Indonesia and Thailand over the last two years, consistent with more subdued domestic demand growth, and export headwinds facing these economies (which reduced demand for intermediate imports).

Vietnam's strong trade performance is at least partly associated with China's progression from low-skill, labor-intensive exports toward more sophisticated products. This has entailed increased domestic value added and a reduced import content of exports. Most recently, the sharp appreciation of the renminbi has accelerated the shift of labor-intensive production from China to lower-income Asia, including Bangladesh, Cambodia, and Vietnam.[6,7] Vietnam's merchandise trade performance has, in particular, benefited from dynamism in the foreign-invested manufacturing sector, as leading international manufacturers have expanded production of electronics, mobile phones, and associated goods (Box 1.B.3).

Supply-side developments in the smaller developing Asia economies

Among the small ASEAN economies, agricultural output growth was weak, being negatively affected by poor weather in Cambodia and Lao PDR. In Myanmar, preliminary indications are that the main rice crop will have been significantly dented by severe floods that occurred in late July.

Construction, and investment activity, remained generally robust. Construction sector activity remained buoyant in Cambodia. Myanmar, where both consumer and investor confidence have been supported by reform progress, saw more investments in light manufacturing, particularly garments. However, in Mongolia investment activity remained subdued in the first part of the year, after contracting sharply in 2014 as the boom in mining and other investment projects ended.

Mineral and energy output was supported in several countries by specific project developments. Mongolia's mining output grew by a robust 16.5 percent in the first half of the year, on the back of new copper production. Growth in Lao PDR received a larger-than-expected boost from copper and gold output as higher-grade ore was reached and processed at the country's two big mines; growth also benefited from continued investments in the energy sector, where a block of a major new power plant (Hongsa) came online. However, Papua New Guinea's mining output was hit by the suspension of production at its gold and copper Ok Tedi mine. In Timor-Leste, weaker global oil prices since mid-2014 have weighed on the oil sector, and on growth overall, given the central importance of the sector to output and public revenues.

Tourism is a key service sector in a number of economies. In Lao PDR, the expansion of the customer base to China and the Republic of Korea has increased tourist numbers; tourism is now one of the biggest sources of foreign exchange, in addition to supporting employment and growth. In contrast, Cambodia's large tourist sector underperformed, with tourist arrivals during the first six months of the year growing by only 4.6 percent yoy, relatively low compared to recent years.

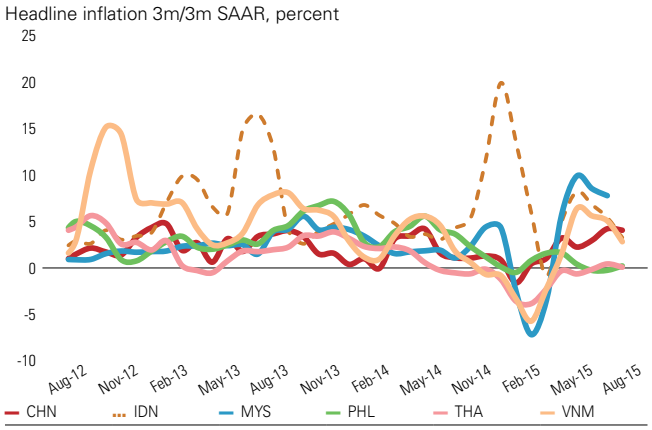
6 Some labor-intensive production has shifted to inland China, where labor also remains relatively cheap (*East Asia and Pacific Economic Update*, April 2015).

7 "China. Article IV," International Monetary Fund, Washington, DC, July 2015; and G. Gottlieb, G. Hong, S. Jung, K. Mathai, J. Schmittmann, and J. Yu, "China and the CLMV: Integration, Evolution, and Implications," IMF Occasional Paper, International Monetary Fund, Washington, DC, forthcoming.

Inflation pressures remain contained at the consumer price level in key economies

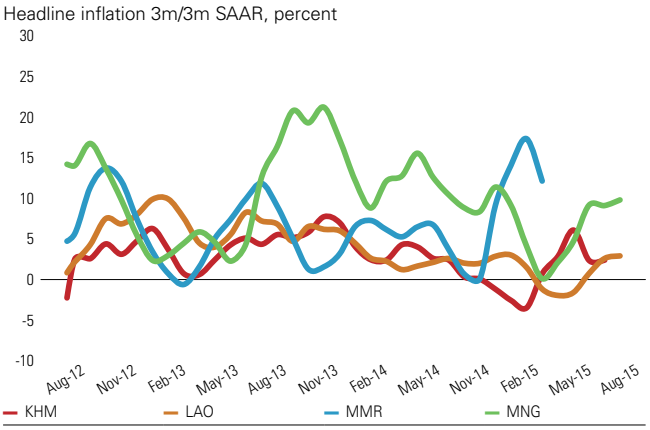
Consumer price inflation was contained across the region over the first half of the year, benefiting from the reduction in global fuel prices since 2014. In Indonesia, reforms increased fuel prices in late 2014 and pushed up CPI inflation, but this effect proved temporary, fading in the first quarter of the year. In Malaysia, retail prices rose following the introduction of the General Sales Tax in April, an effect that continued to impact consumer prices over subsequent months. Looking through such policy-induced factors, however, inflation pressures remained contained, and notably low in the Philippines and Thailand (Figure I.A.19). Among the smaller economies, policy tightening and slowing domestic demand amid weak FDI in Mongolia curtailed inflation momentum (Figure I.A.20).

Figure I.A.19. In the larger EAP economies, inflation momentum slowed in the early part of 2015, helped by lower fuel prices



Source: Haver Analytics.
Note: SAAR = Seasonally Adjusted Annual Rate.

Figure I.A.20. In Mongolia, policy tightening helped to rein in inflation

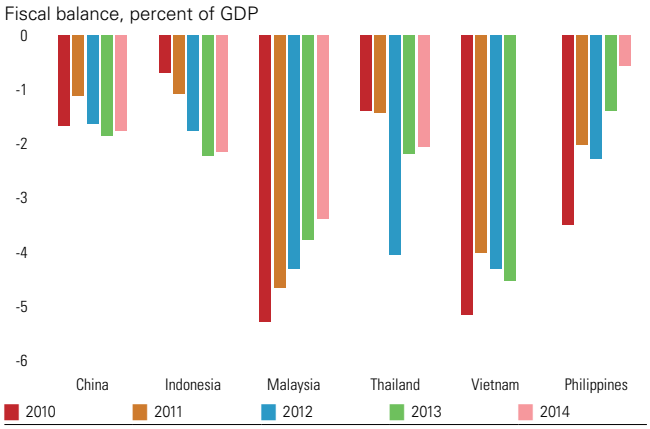


Source: Haver Analytics.
Note: SAAR = Seasonally Adjusted Annual Rate.

Lower commodity prices have posed a major fiscal challenge for commodity producers; fuel subsidy reforms are helping to meet it

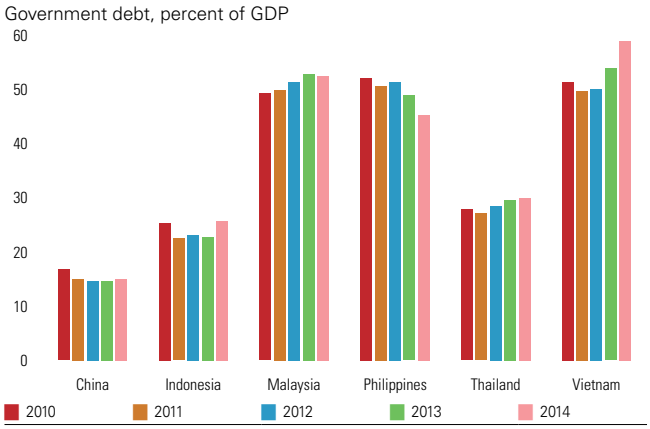
As global energy prices fell, Indonesia and Malaysia faced a negative shock to oil- and gas-related public revenues, but also seized the opportunity to sharply reduce fuel subsidies; Vietnam also reformed fuel pricing. In Malaysia, where hydrocarbon-linked revenues are approximately 30 percent of the total, the government abolished gasoline and diesel subsidies at the end of 2014, yielding budgeted savings for 2015 of Rm 10.7 billion (approximately US$2.6 billion). In Indonesia, where oil- and gas-related revenues have accounted for 20 percent or more of government revenues in recent years, explicit gasoline subsidies were eliminated and diesel subsidies were capped at a relatively low Rp 1,000 per liter, cutting budgeted fuel subsidy costs for 2015 to 0.6 percent of GDP, down from the 2.4 percent of GDP outturn in 2014. Vietnam also moved to increase fuel prices, tripling its environmental tax on fuel consumption (effective May 2015), and raising tariffs on fuel imports from 18 percent (in May 2013) to 27 percent (in December 2014) and 35 percent (in January 2015).

Figure I.A.21. Fiscal deficits have narrowed significantly in Malaysia and the Philippines



Source: Staff estimates.
Note: China, Indonesia, the Philippines: central government fiscal balance; Malaysia: federal government fiscal balance; Thailand: cash balance of central government before financing.

Figure I.A.22. Government debt remains moderate in Thailand, but is rising rapidly in Vietnam



Source: Staff estimates.
Note: Central/national/federal government debt; Vietnam: includes government-guaranteed debt.

More broadly, fiscal policy in Malaysia and Indonesia has adapted to weaker global prices for energy and other commodities. Malaysia revised down its oil price budget assumption to US$55 per barrel (from US$100 per barrel in the original budget), and lifted the 2015 deficit target slightly, to 3.2 percent of GDP. Revenues were bolstered by the introduction of the new GST in April. This follows a strong track record of fiscal consolidation since 2009 (Figure I.A.21). As a result, its government debt has stabilized as a share of GDP, although at a relatively high level (Figure I.A.22). In Indonesia, the revised 2015 budget also slashed the originally budgeted oil price for 2015, and projected oil- and gas-related revenues to fall sharply. This was planned to be offset by large increases in nonoil and gas tax revenues, lifting the budgeted 2015 tax-to-GDP ratio by 1.4 percentage points from 2014. This has proved overly ambitious in the face of lower GDP growth, though the deficit impact of weaker revenues has been offset by very low capital expenditure disbursement so far in 2015. Overall, the limit of a general government deficit of 3 percent of GDP continues to bind, and government debt remains moderate.

Fiscal deficits have narrowed significantly in the Philippines, from 2.7 percent of GDP in 2009 to just 0.6 percent in 2014, helped by sound revenue and debt management in the context of a robust macroeconomic backdrop and falling borrowing costs. This has strengthened national debt solvency metrics; government debt fell to 45 percent of GDP in 2014, and the debt risk profile improved, with debt servicing approximately halving as a share of government revenues in the three years to 2014, to 27 percent. The pace of deficit reduction has, however, also been flattered by weak budget execution, reflecting ongoing institutional and capacity constraints.

Public debt remains moderate in Thailand, but is rising rapidly in Vietnam. In Thailand, the fiscal deficit was little changed in 2014, at just over 2 percent of GDP. Public debt has gradually increased since the global financial crisis, reflecting stimulus spending in 2009; reconstruction spending in response to the devastating floods of 2011; and slow growth since early 2013, as manufacturing output fell, exports weakened, and tourist arrivals slowed. However, public debt levels remain moderate, at 30.1 percent of GDP (2014). In Vietnam, the fiscal deficit stands at an elevated 5.3 percent of GDP, reflecting poor revenue collections and high recurrent spending. Public debt increased to 59 percent of GDP in 2014, from 47 percent in 2009, with short-term domestic debt rising particularly rapidly.

Smaller economies dependent on extractive industries faced revenue pressures. In Mongolia, revenue fell significantly short of budgeted levels (-15 percent in the first seven months of the year). The government responded with tight payment controls and cut budget execution. In Papua New Guinea, budgeted revenues for 2015 were reduced sharply on the back of weaker mining and petroleum tax revenue and dividends, placing pressure on the originally budgeted 2015 fiscal deficit of 4.4 percent of GDP. Timor-Leste faces a continued challenge to secure fiscal sustainability; the 2015 budget deficit was 20 percent higher than the ceiling of US$1.3 billion consistent with a sustainable fiscal path.

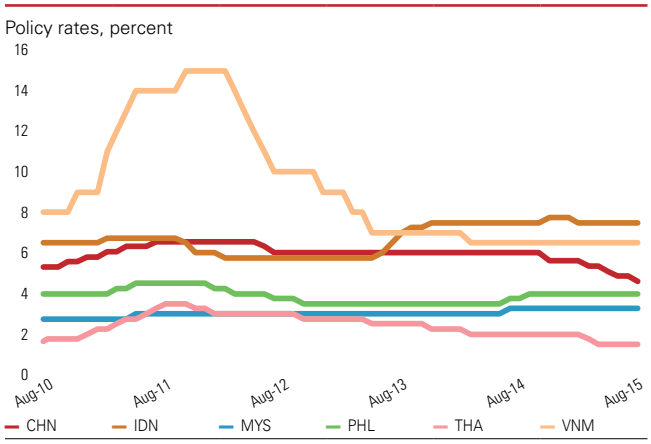
In the small developing ASEAN economies, fiscal pressures remained contained. Cambodia has lifted public revenues markedly, to 17 percent of GDP in 2014, while expenditure was kept at 20 percent of GDP. Lao PDR appears on track to meet its current-year deficit target of 4.1 percent of GDP; growth in the value-added tax and excise taxes is offsetting weaker mining revenues, and the public wage bill is restrained. Public debt levels, however, remain significant, with external debt above 50 percent of GDP. In Myanmar, revenues were bolstered by newly issued telecom licenses, but reforms are also starting to provide more sustained support for tax collections.

Growth concerns have stayed in focus for the majority of regional central banks

Central banks either eased or held policy rates constant in 2015 through August (Figure I.A.23). In February, Bank Indonesia reversed the 25-basis-point reference rate increase it had made in November 2014 to cap inflation expectations following a sizable regulated fuel price increase. The Bank of Thailand cut its benchmark interest rate by 25 basis points in March and again in April 2015, to support growth.

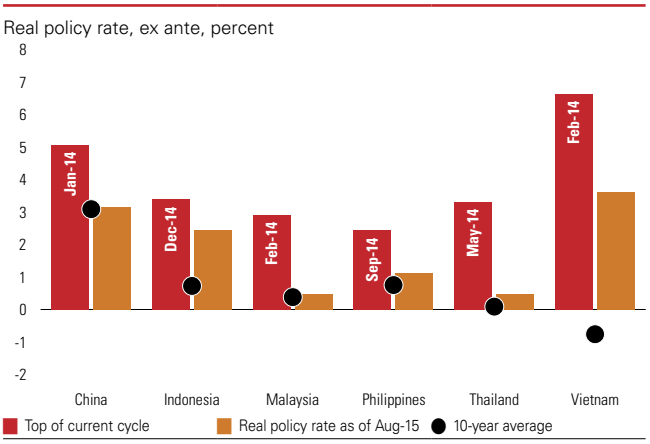
The People's Bank of China eased monetary policy. The benchmark rate, held at 6 percent since July 2012, was reduced in November 2014, March 2015, May 2015, June 2015, and August 2015 by a cumulative 1.4 percentage points. The required reserve ratio was reduced by 50 basis points in both February and August,

Figure I.A.23. Nominal policy rates were flat or trended lower in 2015 until August, led by China



Source: Haver Analytics.

Figure I.A.24. Real policy rates have fallen since their recent (2014) highs, but remain generally close to or above long-term averages



Sources: Haver Analytics; CEIC; staff estimates.

Note: Estimates are based on staff CPI projections; the 10-year average is for realized ex-ante rates (through August 2014); the top of current cycle refers to the most recent high, as dated.

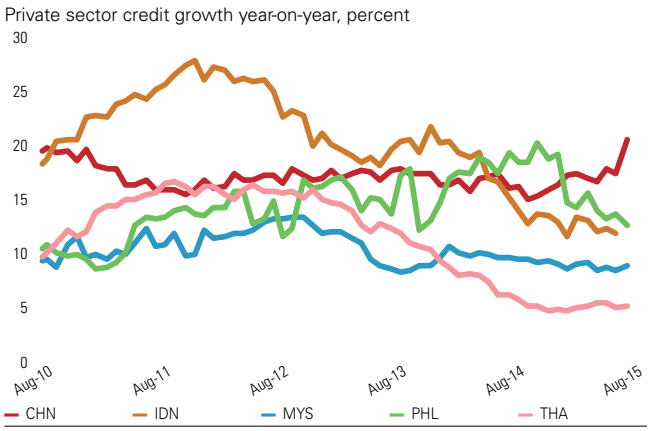
following more narrowly targeted reserve requirement reductions in 2014 to support credit extension to small and rural businesses.

In real terms, policy rates are estimated to have fallen during the course of 2015 in most major regional economies, but generally remain close to or higher than their levels in recent years. Real (ex-ante) interest rates have declined significantly in all the major developing EAP economies, and most notably China, Malaysia, and Thailand, since peaking in 2014 (Figure I.A.24). Despite these declines, real interest rates still remain close to or above their long-term (10-year) averages, as nominal policy rate reductions have taken place against the backdrop of particularly subdued inflation. By this gauge, monetary policy in the major developing EAP economies has eased significantly since 2014, but does not appear strongly accommodative.[8]

Credit conditions diverged over the first half of the year, following a region-wide deceleration in 2014

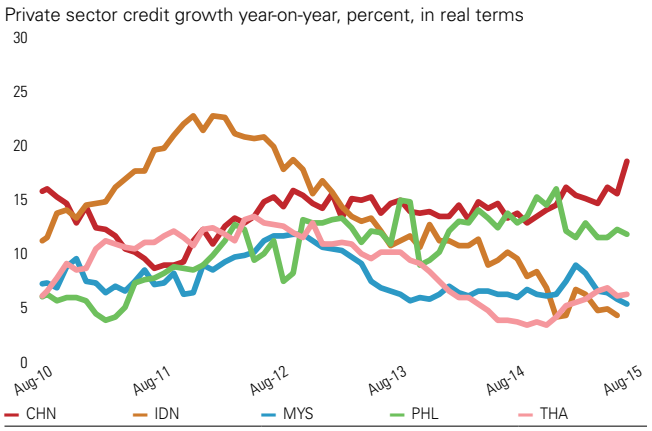
Private sector credit conditions were mixed among the larger EAP economies. Private sector credit growth slowed in Indonesia and the Philippines, was broadly stable in Malaysia and Thailand, and rose sharply in China in July, consistent with its monetary stimulus (Figure I.A.25). In real terms, the pace of credit growth has approximately halved since peaking in 2012 in Malaysia and Thailand, and fallen by four-fifths in Indonesia (Figure I.A.26). With credit growth in Indonesia below its target levels, the central bank shifted its macroprudential stance over the first half of the year to support more lending, by cutting loan-to-deposit ratio ceilings, especially for small business lending, increasing mortgage loan-to-value limits, and cutting minimum down payments for vehicle loans. Vietnam also implemented macroprudential measures to loosen credit conditions, including relaxation of limits on short-term deposits and risk weights for certain lending activities; credit growth responded to the policy loosening and by midyear closed in on the central bank's target range for the whole year, rising 7.9 percent yoy in June.

Figure I.A.25. Credit conditions were mixed across the larger EAP economies, in nominal terms



Source: Haver Analytics.

Figure I.A.26. Real credit growth was particularly subdued in Indonesia



Sources: Haver Analytics; World Bank staff estimates.
Note: Deflated by contemporaneous CPI.

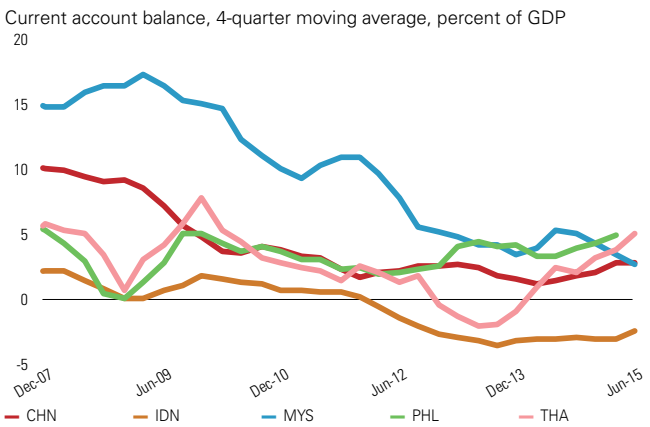
8 However, real policy rates are an incomplete guide as to the overall monetary policy stance, and their current levels are inherently uncertain since they depend on future inflation.

Bank lending conditions were also mixed in the smaller economies. In Cambodia, private sector credit accelerated further, reaching 28 percent yoy over the first half of the year, well ahead of the growth of private deposits. In Myanmar, credit to the private sector also continued to grow rapidly, albeit from a relatively low base. In contrast, in Lao PDR, controls on public spending and tightening balance sheet constraints among some banks contributed to a halving of credit growth, to about 14 percent yoy in March 2015. In Mongolia, bank credit growth, including securitized mortgages, slowed to 5.5 percent in July, with the phasing-out of some quasi-fiscal loans and subdued loan demand.

Current account balances generally increased, but owing to import compression rather than export growth

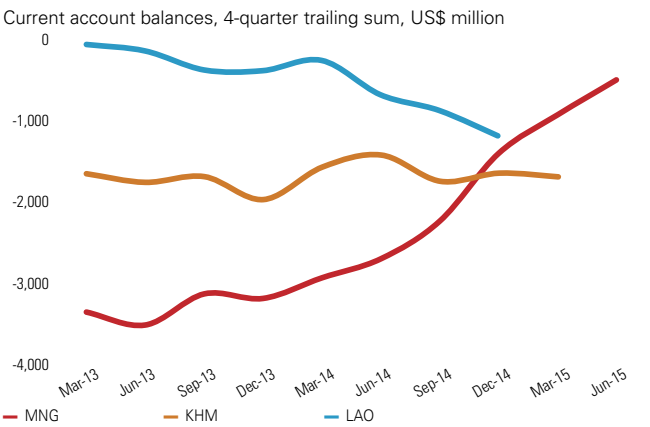
The current account balances of most large EAP economies improved over the first half of the year, despite sluggish export revenues, as slower domestic demand growth and lower commodity prices compressed imports. The current account balances of Indonesia and Malaysia, the two major commodity producers among the larger economies, have been eroded by the decline in global commodity prices and demand since 2011 (Figure I.A.27). Indonesia's current account balance moved into deficit in late 2011 and remains negative. However, the deficit narrowed significantly through Q2 2015 on a broad-based decline in imports, including of oil, of which Indonesia is a net importer. Malaysia's current account surplus has narrowed dramatically in recent years, and continued to fall in the second quarter of 2015; imports compressed, in line with a moderation in domestic demand, but export revenues, including of hydrocarbons, weakened even further. China, the Philippines, and Thailand, all net oil importers, recorded larger current account surpluses, benefiting from lower global energy costs. In Thailand, however, import weakness was broad-based, consistent with low domestic demand growth.

Figure I.A.27. Current account balances rose in the major EAP economies, except in Malaysia



Sources: Haver Analytics; World Bank.

Figure I.A.28. Mongolia's current account deficit narrowed rapidly, as imports fell



Sources: CEIC; World Bank.

Cambodia, Lao PDR, Myanmar, and Mongolia all continued to run large current account deficits, and faced headwinds from weaker export demand and prices. Mongolia's exports fell 6.2 percent over the first seven months of the year, reflecting weak prices for coal and copper, but the current account deficit still

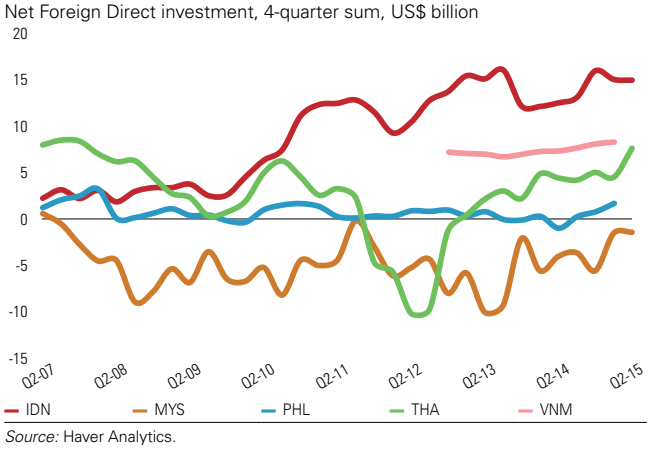
narrowed, reflecting a plunge in imports (Figure I.A.28). Exports from Cambodia and Lao PDR slowed, partly offset in the latter by increased electricity exports from new power plants. In Myanmar, strong demand for investment-related capital imports caused the current account deficit to widen in 2014/15 to over 6 percent of GDP. Papua New Guinea's current account has been supported by the coming on stream since 2014 of liquefied natural gas exports. In Timor-Leste, a weak coffee harvest weighed on exports, while import demand accelerated owing to a growing public works program.

Foreign direct investment (FDI) remained robust while portfolio flows were volatile

FDI inflows to developing EAP increased by 10 percent in 2014, despite a 16 percent decline in global FDI.[9] Developing EAP accounted for 56 percent of all FDI to developing regions, up from 41 percent in 2008. In particular, China became the world's largest single recipient of FDI. Indonesia saw its highest FDI inflows since at least 1990, both in dollar terms (US$23 billion) and relative to GDP (3 percent).

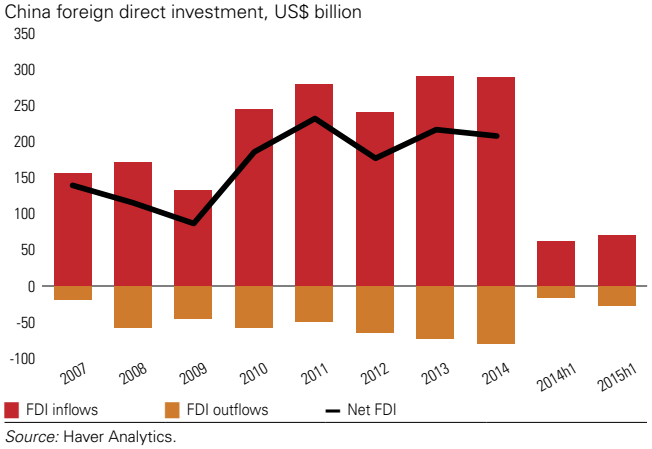
FDI inflows to the larger EAP economies remained generally robust in the first half of the year, rising in all large countries except the Philippines in year-on-year terms. In Thailand, FDI inflows recovered above the level of the pre-crisis period. In the Philippines, FDI has lagged behind, partly owing to regulatory restrictions. Inflows to Vietnam remained buoyant, and were mostly directed at labor-intensive manufacturing. Similar trends were apparent with respect to net FDI flows (Figure I.A.29).

Figure I.A.29. FDI levels have recently remained solid



Source: Haver Analytics.

Figure I.A.30. Outbound FDI from China has increased rapidly in recent years



Source: Haver Analytics.

FDI trends in the smaller economies in the region have also remained generally positive. Over 2009–14, Cambodia doubled annual FDI inflows, mainly in construction, garment manufacturing, and tourism. There has been strong growth in new projects in Myanmar, albeit from a low base; the country attracted US$4.5 billion for 94 new projects in 2014, up from US$0.6 billion for 12 projects in 2011, mostly in the light manufacturing

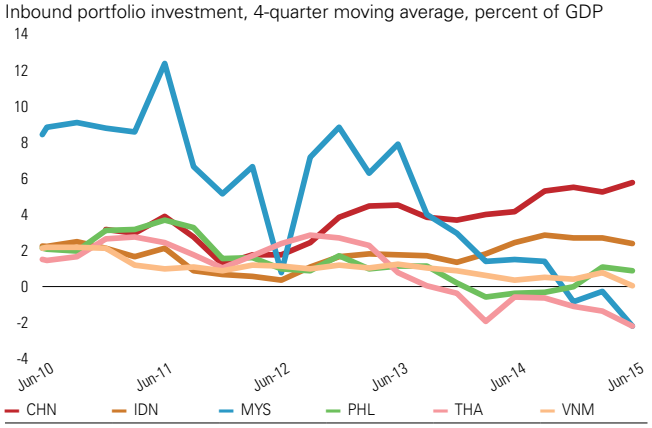
9 All FDI statistics in this section are from the UN *World Investment Report 2015*, CEIC, and Haver Analytics.

and oil and gas sectors. Mongolia enjoyed FDI inflows averaging 40 percent of GDP in 2011–12. However, sharp declines in FDI over the last two years have weighed heavily on growth and the balance of payments.

Outward FDI increased significantly from China, which in 2014 became the world's second-largest source of direct investment, behind only the United States. In H1 2015, FDI outflows from China increased to US$53 billion, compared with US$31 billion in 1H 2014 (Figure I.A.30).

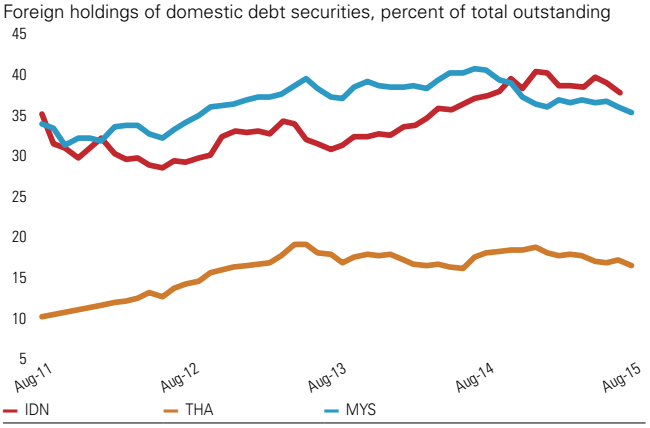
External financing through portfolio investment was volatile. Portfolio investment slowed during the first half of the year in most major economies, albeit in the case of Indonesia from historically high levels in 2014 (Figure I.A.31). Nonresident investors have been sellers of Thai portfolio assets on a sustained basis since mid-2013, and became net sellers of Malaysian securities as well in 2015, extending a prolonged period of declining nonresident portfolio investment. In August, when global risk aversion increased, there was net foreign selling of domestic government debt securities in Indonesia, Malaysia, and Thailand (for which data on high-frequency holdings are available; Figure I.A.32). Nonresident investors remain key players in the local currency bond markets of Indonesia and Malaysia, holding 38 and 35 percent of domestic government bonds outstanding, respectively.

Figure I.A.31. Portfolio inflows softened in H1 2015, notably in Malaysia and Thailand



Sources: Haver Analytics; World Bank staff estimates.

Figure I.A.32. Nonresident holdings of domestic debt securities were flat to declining in 2015, dipping in the August turbulence

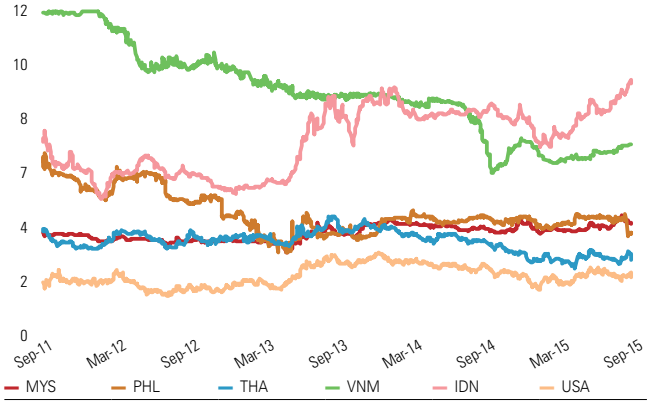


Source: CEIC; World Bank staff estimates.

Government financing costs rose. Local currency funding costs for those governments that issue domestic currency bonds were little-changed in 2015 through August, as gauged by longer-term benchmark yields, and despite the net foreign selling pressures described above in Malaysia and Thailand. The exception was Indonesia, where longer-term yields rose on the order of 130 basis points (Figure I.A.33), as net foreign purchases of domestic bonds slowed, and inflation stayed stickier than had been widely expected. External financing conditions tightened markedly for countries across the region from May onward, as measured by spreads over U.S. Treasury yields for the U.S. dollar bonds of the major EAP issuers (Figure I.A.34).

Figure I.A.33. Local currency government bond yields rose in Indonesia

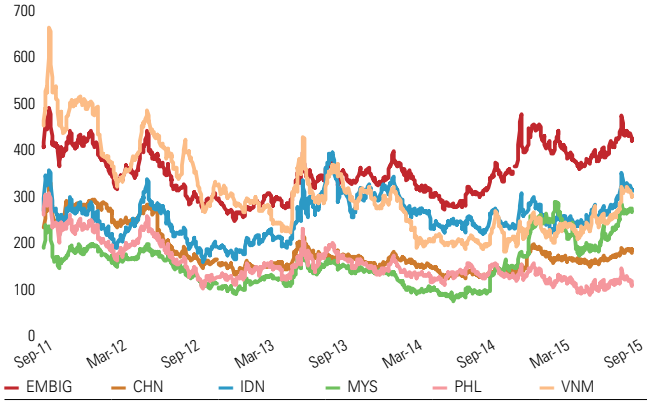
10-year benchmark yields for local currency government bonds, percent



Sources: Haver Analytics; CEIC; JP Morgan.
Note: Data through September 18, 2015.

Figure I.A.34. External sovereign borrowing costs for the region generally rose after May

Spreads over U.S. Treasury rates for country EMBIG subindexes, basis points



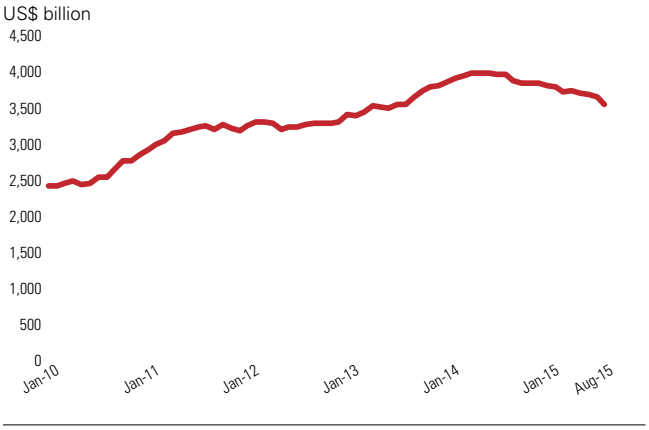
Source: JP Morgan.
Note: The EMBIG (Emerging Market Bond Index Global) is an overall index for emerging market economy sovereign bonds. Data through September 18, 2015.

Reserves fell in the major economies, but coverage ratios remained adequate

International reserves in dollar terms broadly decreased across the region during 2015 through August. In absolute terms, the largest drop in reserves was in China, where foreign currency reserves peaked at close to US$4 trillion in June 2014, and subsequently recorded sustained declines, cumulating to US$436 billion as of August 2015 (Figure I.A.35). Reserves in Indonesia also declined significantly (Figure I.A.36). In percentage terms, however, the largest recent fall in reserves was in Malaysia, down by 19 percent over 2015 as of August. In contrast, reserves fell only slightly in Thailand, and were stable in the Philippines. The general decline in gross reserves in developing Asia's large economies was attributable mainly to active intervention by central banks to lean against currency depreciation or to smooth day-to-day volatility, but also reflected negative valuation effects, as non-U.S. dollar holdings depreciated in U.S. dollar terms.

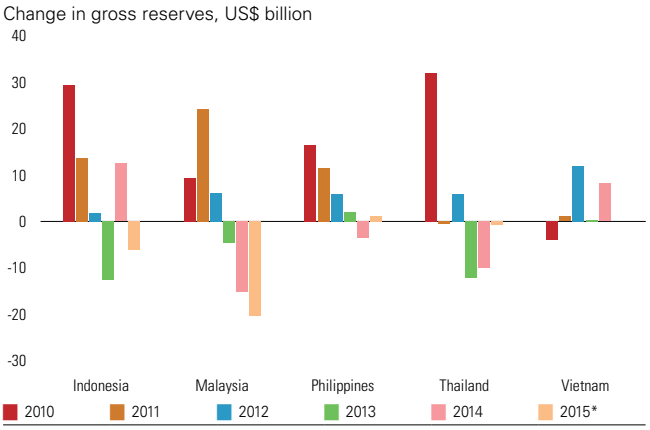
Reserves of the major economies in the region generally remain adequate. Foreign currency reserve coverage relative to domestic broad money has been broadly stable, or declined only modestly, since mid-2014 in Indonesia, the Philippines, and Thailand (Figure I.A.37). Coverage is lower and has declined on a more sustained basis in China and Malaysia, but remains above standard adequacy levels; in addition, China's vulnerabilities are reduced by its large domestic monetary base and capital account restrictions. Among the internationally financially integrated ASEAN economies, reserve adequacy relative to near-term external debt financing requirements has in recent years been substantially reduced only in Malaysia (Figure I.A.38). However, over the first half of the year, Malaysia's reserve adequacy relative to external debt stabilized.

Figure I.A.35. China's foreign currency reserves peaked in June 2014



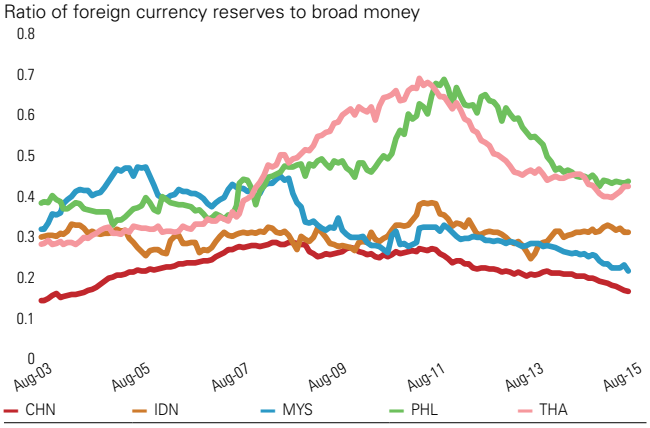
Source: Haver Analytics.

Figure I.A.36. Among the large developing ASEAN economies, international reserves fell in 2015 through August, especially in Malaysia



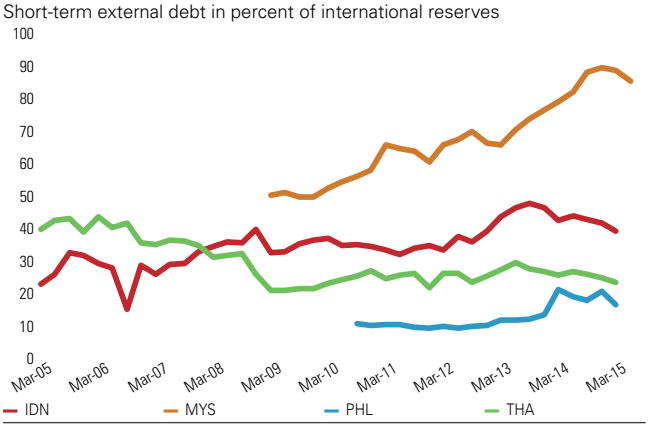
Source: Haver Analytics.
Notes: *2015 year to end-August. Data for 2015 not available for Vietnam.

Figure I.A.37. Reserves of the major developing Asia economies remain ample relative to domestic money supplies



Sources: Haver Analytics; World Bank staff estimates.
Note: Broad money is M2.

Figure I.A.38. Among the largest ASEAN economies, reserves are also ample compared to external debt refinancing needs, except in Malaysia



Sources: Haver Analytics; World Bank staff estimates.

Recent developments in the Pacific Island Countries

Most Pacific Island Countries (PICs)[10] recorded moderate growth over the last year. In several cases, this was driven mainly by the construction of donor-financed infrastructure projects. Growth in tourism, an important sector for foreign exchange and employment in several countries, was generally solid, being supported in Palau by new air links with Hong Kong SAR, China, which helped push up tourist arrivals by 40 percent yoy in H1 2015. Growth in Fiji also benefited from strong visitor numbers, and an improvement in investor confidence and private spending, following elections in September 2014.

10 Comprising the Federated States of Micronesia, Fiji, Kiribati, Palau, the Republic of Marshall Islands, Samoa, the Solomon Islands, Tonga, Tuvalu, and Vanuatu.

Besides inflicting tragic human costs and destruction in Vanuatu and Tuvalu this year, natural disasters remain an important driver of the economic cycle in other countries, including through reconstruction-related investment activity. Samoa's economy continues to recover from the effects of Tropical Cyclone Evan in 2012. The Solomon Islands experienced flash flooding in April 2014, resulting in the premature closure of the country's only operating mine, Gold Ridge (accounting for an estimated 20 percent of net exports and 6 percent of government revenue), as well as income losses in nonmineral sectors. Reconstruction on the Hapai'i islands group following Hurricane Ian in 2014 contributed significantly to growth in Tonga. In March 2015, Tropical Cyclone Pam battered Tuvalu (particularly its outer islands) and Vanuatu. In Vanuatu, 188,000 people (two-thirds of the population) were affected, 75,000 of whom needed emergency shelter, and 11 lives were lost, while damage and losses were estimated to be equivalent to almost two-thirds of GDP.

Lower global commodity prices generally reduced inflationary pressures and supported the external positions of PIC economies, including by reducing fuel import costs. Current account positions were also helped in some cases by strong fishing-related revenues (exports and licensing fees), but in most small PICs, official development assistance remains a key component of external financing.

I.B. Outlook and Risks

Growth in developing East Asia and Pacific is expected to ease. China's economy will shift to a more balanced and sustainable growth path. In the rest of the region, growth conditions will depend on the exposure of countries to accelerating demand in high-income economies, gradually tightening external financing conditions, and still-subdued international commodity prices. Although the outlook for growth and poverty reduction remains fundamentally positive, two key downside risks have increased: a steeper-than-expected downturn in China, reducing growth in the wider region; and real economy spillovers from volatile financial markets, particularly against the backdrop of the normalization of monetary policy in the United States.

Regional growth will moderate as China rebalances, despite an improved global growth outlook

Growth in developing East Asia and Pacific is expected to ease from 6.8 percent in 2014 to 6.5 percent in 2015, and an average of 6.3 percent over 2016–17 (Table I.B.1). This decrease, more pronounced than previously projected, mainly reflects a moderate slowdown in China. Aggregate growth in the ASEAN economies will be roughly stable at 4.3 percent in 2015, rising to 4.9 percent by 2017, with increasing support from global growth and export demand, particularly from high-income economies. However, the outlook differs markedly across countries, and growth risks for the region are significant.

Global growth in output and trade is expected to rise, as high-income economies accelerate (Box I.B.1). Global growth is projected to rise in 2016–17, after repeatedly disappointing in 2012–14. In particular, growth is projected to strengthen in the Euro Area and Japan, closing the gap with the United States. Global trade activity will rise, but at a pace still significantly below the average before the global financial crisis. This reflects both a maturing of global supply chains, and a shift in the sources of global growth from trade-intensive investment toward government and private consumption (Constantinescu, Mattoo, and Ruta 2015).

In China, growth will be about 7 percent in 2015, moderating to 6.7 percent in 2016 and 6.5 percent in 2017. Continued reforms will support a further rebalancing of domestic demand. Investment will decelerate, owing to tighter credit and more subdued property sector conditions (Figure I.B.1). The labor market will remain robust, supporting private consumption growth. The shift from capital- and resource-intensive manufacturing to services will continue, facilitated by policies to reduce excess industrial capacity and ease business regulations in the services sector.

Table I.B.1. East Asia and Pacific: GDP growth projections

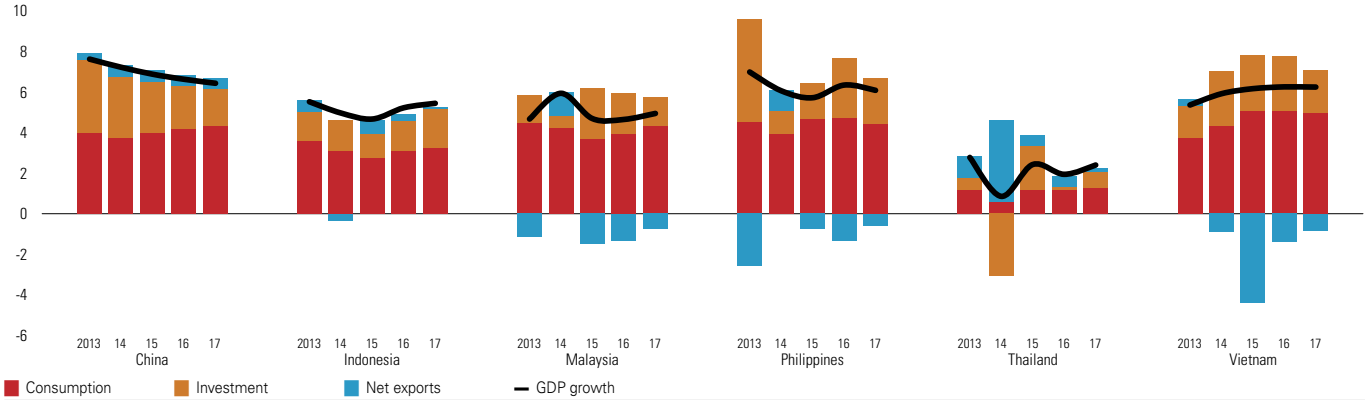
Percent change from a year earlier, unless otherwise noted

			Forecast	Forecast	Forecast	Changes from Apr-15* (in percentage points)		
	2013	2014	2015	2016	2017	2015	2016	2017
East Asia and Pacific**	6.3	6.1	5.7	5.8	5.8	-0.3	-0.2	-0.2
Developing East Asia and Pacific	7.1	6.8	6.5	6.4	6.3	-0.2	-0.3	-0.3
China	7.7	7.3	6.9	6.7	6.5	-0.2	-0.3	-0.4
Indonesia	5.6	5.0	4.7	5.3	5.5	-0.5	-0.2	0.0
Malaysia	4.7	6.0	4.7	4.7	5.0	0.0	-0.3	-0.1
Philippines	7.1	6.1	5.8	6.4	6.2	-0.7	-0.1	-0.1
Thailand	2.8	0.9	2.5	2.0	2.4	-1.0	-2.0	-1.6
Vietnam	5.4	6.0	6.2	6.3	6.3	0.2	0.1	-0.2
Cambodia	7.4	7.1	6.9	6.9	6.8	0.0	0.0	0.0
Lao PDR	8.5	7.5	6.4	7.0	6.9	0.0	0.0	-0.1
Myanmar	8.5	8.5	6.5	7.8	8.5	-2.0	-0.4	0.5
Mongolia	11.6	7.8	3.3	4.1	4.0	-1.1	-0.1	0.1
Fiji	4.6	4.0	3.4	3.1	3.0	1.9	0.7	0.4
Papua New Guinea	5.5	8.5	8.7	3.3	4.0	-7.3	-1.7	1.6
Solomon Islands	3.0	1.5	3.3	3.0	3.5	-0.2	-0.5	0.0
Timor-Leste***	2.8	7.0	6.8	6.9	7.0	0.0	0.0	0.0
Memo: Developing East Asia excl. China	5.2	4.6	4.6	4.9	5.1	-0.5	-0.5	-0.3
Memo: ASEAN	5.0	4.4	4.3	4.7	4.9	-0.6	-0.4	-0.3
Working assumptions about the external environment:								
World	2.4	2.6	2.5	3.0	3.1	-0.4	-0.2	-0.1
High-income countries	1.2	1.7	1.7	2.1	2.1	-0.4	-0.3	-0.1
Developing countries****	5.2	4.9	4.3	5.0	5.3	-0.4	-0.4	-0.2
Energy commodities (2010 = 100)	127.4	118.3	68.1	68.7	72.4	-0.9	-5.0	-6.1
Crude oil (average, spot, US$/bbl)	104.1	96.2	53.4	53.5	56.6	0.2	-3.7	-4.5
Nonenergy commodities (2010 = 100)	101.7	97.0	84.1	85.5	86.7	-3.0	-2.6	-2.4
Food (2010 = 100)	115.6	107.4	92.6	93.9	95.2	-4.3	-3.8	-3.3

Source: World Bank data and staff estimates.
* World Bank, "East Asia and Pacific Economic Update: Adjusting to a Changing World," April 2015.
** Developing East Asia + NIEs + Korea.
*** Nonoil GDP.
**** Developing countries have been regrouped in line with the World Bank methodology.

Figure I.B.1. Domestic consumption is projected to continue underpinning GDP growth

Contribution of expenditure components to year-on-year change in GDP, percentage points



Source: Staff estimates.
Note: Excludes statistical discrepancies and changes in inventories.

Box I.B.1. Global outlook and risks

Having repeatedly disappointed in 2012–14, global growth is likely to rise to 3.1 percent on average in 2016–17 (Figure I.B.1.1). Growth in high-income countries is expected to accelerate from 1.4 percent in 2012–14 to 2.0 percent on average in 2015–17. Divergences across major economies will narrow in 2015–17 as growth plateaus in the United States and strengthens in the Euro Area and Japan.

In the **United States**, driven predominantly by private consumption, growth should strengthen modestly to 2.7 percent on average in 2015–16, before slowing toward potential growth in 2017. The unemployment rate, which is around 5.1 percent, is expected to fall further by end-2015, below the level at the start of the previous monetary tightening cycle in 2004. Overall, policy in the United States is expected to remain accommodative. But as the economy closes in toward the employment and inflation objectives of the Federal Reserve's dual mandate later in 2015, a very gradual monetary tightening cycle is expected to begin.

Euro Area growth is now projected to reach 1.5 percent this year, increasing to 1.6 percent in 2016–17. Additional easing by the European Central Bank in 2014–15, including the launch in March 2015 of a quantitative easing program, brought long-term interest rates to record lows in both core and periphery countries. It also contributed to a 10 percent depreciation of the euro in trade-weighted terms since mid-2013, which should support activity and gradually lift headline and core inflation from currently very low levels. Private investment should gradually pick up, but elevated corporate leverage, persistent financial fragmentation, significant slack in the labor markets of periphery countries, lingering supply-side impediments, and weak demand continue to weigh on prospects for a swift recovery.

Activity in **Japan** started picking up in late 2014 and was robust in the first quarter of 2015, but disappointed in the second quarter. Growth is predicted to be around 1 percent this year, before accelerating to 1.4 percent on average in 2016–17, supported by expansionary policies. Following persistent economic weakness during 2014 and bolstered by a victory in general elections in December 2014, the government implemented a series of fiscal stimulus measures, and postponed to April 2017 a second sales tax increase originally scheduled for October 2015. This stimulus, combined with policy accommodation by the Bank of Japan, lower costs for firms and households due to declining energy prices, announced product and labor market reforms, and the prospect of higher earnings following spring wage negotiations, should boost activity and confidence throughout 2015. Inflation is likely to remain below the target 2 percent through 2017.

Growth in developing countries is expected to slow to 4.3 percent in 2015, before recovering somewhat by 2017, to slightly above 5 percent. As a result of developments in major economies and in global commodity markets, developing countries face two transitions: to tightening financial conditions, which will be associated with moderating capital flows, gradually rising financing costs, and heightened risks of further currency depreciation, and to persistently low commodity prices. Some emerging economies that rely heavily on foreign capital inflows could be negatively affected by rising borrowing costs as the U.S. Federal Reserve raises policy rates. Commodity-exporting countries, which account for about one-third of developing-country GDP, will continue to struggle to adjust to low commodity prices. Their slowdowns dampen activity in other countries with close trade, finance, and remittance links, and offset benefits from low energy prices. This outlook is set against the backdrop of weak global trade, and a trend slowdown in developing-country growth related to structural issues, including slowing growth in working-age populations, productivity, and investment.

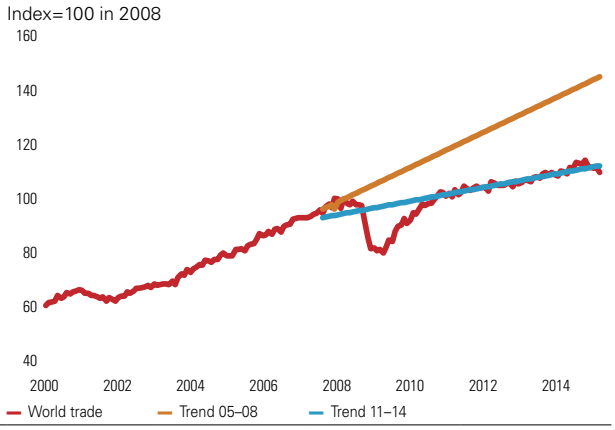
Growth in the **BRICS** (Brazil, Russia, India, China, and South Africa) will remain soft and will increasingly diverge. Falling oil prices and geopolitical sanctions are expected to result in a contraction in the Russian Federation in 2015. Fragile confidence, increases in administered prices, and low commodity prices are expected to contribute to a recession in Brazil in 2015 with a modest recovery in 2016–17. In contrast, growth is gradually resuming in South Africa, but is held back by energy shortages, weak investor sentiment amid policy uncertainty, and by the anticipated tightening of monetary and fiscal policies. In India, activity is buoyed

Box I.B.1. continued

by stronger confidence as a reform-minded government implements its agenda and lower oil prices help contain vulnerabilities.

Figure I.B.1.1. Global GDP growth forecast

Figure I.B.1.2. Global trade volumes



Sources: World Bank; Bloomberg; Haver Analytics.
Note: Working assumptions.

Easy, but gradually tightening, financing conditions. On balance, global financial conditions are expected to tighten modestly, and tilt capital flows toward developing countries with sound prospects and low vulnerabilities. In light of the sizable impact of U.S. monetary policy decisions on global financial markets, global borrowing costs are expected to rise with the launch of the tightening cycle. As world financing conditions tighten, investors are likely to increasingly discriminate based on country prospects and vulnerabilities. Many countries will also face an added debt service burden through the rise of the U.S. dollar and borrowing costs.

Low and volatile commodity prices. The broad weakness in commodity prices is expected to persist for the rest of 2015, before a modest recovery in 2016. Oil prices are expected to remain well below their 2013 levels during the next decade. Second-round effects of low oil prices on other commodities, together with robust supplies and soft demand, are expected to keep prices low for most other commodities in the medium term. Downside risks to the energy forecast include higher-than-expected non-OPEC production (supported by falling costs) and continuing gains in OPEC output, notably from Iraq, Saudi Arabia, and Iran (especially in view of the recent agreement on its nuclear program). Upside risks include earlier-than-expected closure of high-cost operations, supply restraint by major producers, and unexpected disruptions in supply stemming from geopolitical risks.

Subdued and shifting global trade. At around 3.6 percent in 2014, global trade remains substantially weaker than its pre-crisis average of about 7 percent (Figure I.B.1.2). Some recovery in global trade is projected over the next two years, but at a pace still significantly below pre-crisis averages, both in absolute terms and in relation to global GDP growth. This reflects both a maturing of global supply chains, and a shift in the sources of global growth from trade-intensive investment toward government and private consumption (World Bank 2015a). However, global trade may receive a small boost from the decline in oil prices as a result of reduced freight costs.

The balance of risks remains tilted to the downside. Some preexisting risks, especially of deflation in the Euro Area, have receded somewhat but new financial stability and growth risks have emerged. Deteriorating prospects in some developing economies, especially commodity-exporting ones, are eroding their resilience.

Box I.B.1. continued

This, together with the possibility of volatility around U.S. monetary policy normalization, is increasing the risk of financial stress. In addition, the broad-based dollar appreciation could slow the U.S. economy more than expected. The recent turmoil in global financial markets adds to these downside risks. If all the downside risks were to materialize at the same time, the disruptions to developing-country financial markets and economies could be substantial. On the upside, the benefits from lower oil and nonoil commodity prices could prove larger than currently anticipated.

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_____. 2015b. "Global Economic Prospects: Global Economy in Transition." World Bank, Washington, DC, January.

Among the large developing ASEAN economies, growth conditions are expected to be most buoyant in the Philippines and Vietnam. In the Philippines, lagging implementation of the public investment budget has caused growth projections to be marked down since the previous *EAP Economic Update* in April. However, a pickup in government disbursements over the second part of 2015, accelerated implementation of the existing pipeline of public-private partnership projects, and spending related to the May 2016 presidential election are expected to boost activity. The country also continues to benefit from relatively diversified export markets and from lower global commodity prices. Growth is therefore projected to rise in 2016 to 6.4 percent, once more outperforming all other large ASEAN economies. In Vietnam, a mix of investment and consumption demand growth, amidst strong export sector performance, is expected to sustain the economic expansion.

In both Indonesia and Malaysia, the outlook for household incomes and business profits is clouded by weak global commodity market conditions; in Thailand, by uncertainty and economic vulnerabilities. GDP growth in Indonesia is expected to edge higher to 5.3 percent in 2016 but, with domestic demand still facing headwinds, this will be critically dependent on the success of government reforms. In particular, accelerating implementation of the ambitious public investment program, and creating a more conducive environment for private sector investments, will be needed to boost investment and growth. The reform package announced by the government on September 9, 2015, would include potentially decisive measures to cut regulatory red tape and reduce costs and uncertainty for private investments, and de-bottleneck public investments. Follow-through on this ambitious program will be key. In Malaysia, growth will stabilize at around 4.5 to 5 percent, slower than in recent years, as the commodity downturn and its impact on public revenues and the currency constrain investment. In Thailand, growth will remain weak, at 2 to 2.5 percent over 2015–17. Political uncertainty is likely to weigh on private investment; high levels of household debt will affect private consumption, and export growth will remain subdued.

For most of the smaller economies, growth will be stable or slower in 2015, before picking up again over the remainder of the forecast horizon (to 2017). Mongolia's adjustment to the end of the mining boom is expected to continue, with only moderate economic recovery on the back of weakening mineral exports and fiscal consolidation, although the underground Oyu Tolgoi mine project will boost investment. Weak agricultural output will weigh on GDP growth in Cambodia and especially Myanmar, following the severe monsoonal floods in July 2015. Growth in Lao PDR will remain buoyant, helped by new power projects, though trade and investment activity may be adversely affected by subdued economic conditions in neighboring Thailand.

Poverty will continue to decline, but at a slower rate than in recent years

Projections through 2017 suggest poverty in developing EAP will continue to decline, albeit at a slower rate. Extreme poverty, based on the US$1.90 a day poverty line (in 2011 PPP prices), is projected to decline further from an estimated 4.8 percent in 2014 to 3.1 percent by 2017. This corresponds to around 63 million people in extreme poverty. Poverty, excluding China, is projected to reach 4.1 percent by 2017 under the US$1.90 a day PPP line. Under the higher poverty line of US$3.10 a day PPP, the developing EAP region will still be home to more than 300 million poor people by 2017.

Table I.B.2. Poverty is projected to continue falling

US$1.90 PPP per capita per day poverty: Estimates and Projections (Preliminary)				
Developing EAP				
	2014	**2015**	**2016**	**2017**
Poverty rate (%)	4.8	4.2	3.6	3.1
Number of poor (millions)	97	84	72	63
Developing EAP excluding China				
	2014	**2015**	**2016**	**2017**
Poverty rate (%)	6.2	5.5	4.7	4.1
Number of poor (millions)	39	35	30	26
US$3.10 PPP per-capita per-day poverty: Estimates and Projections (Preliminary)				
Developing EAP				
	2014	**2015**	**2016**	**2017**
Poverty rate (%)	19.0	17.8	16.6	15.6
Number of poor (millions)	379	357	337	317
Developing EAP excluding China				
	2014	**2015**	**2016**	**2017**
Poverty rate (%)	26.5	25.5	24.6	23.7
Number of poor (millions)	167	163	159	155

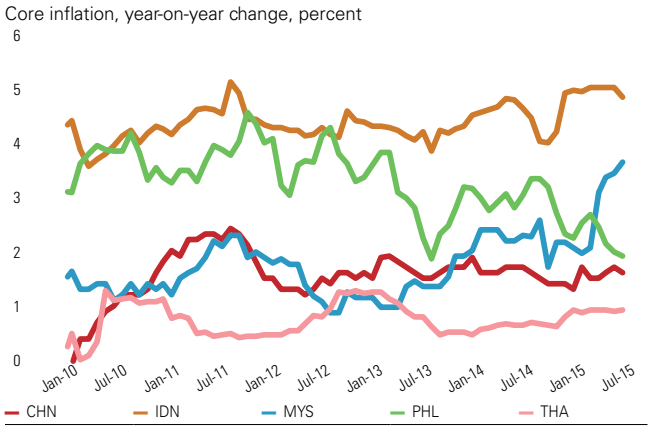
Source: World Bank East Asia and Pacific Poverty Portal.

Note: Projections for 2015–17 are based on projected per capita GDP growth and historical estimates of the growth elasticity of poverty. Regional poverty projections are a population-weighted average of country-specific projections.

Inflation will remain contained

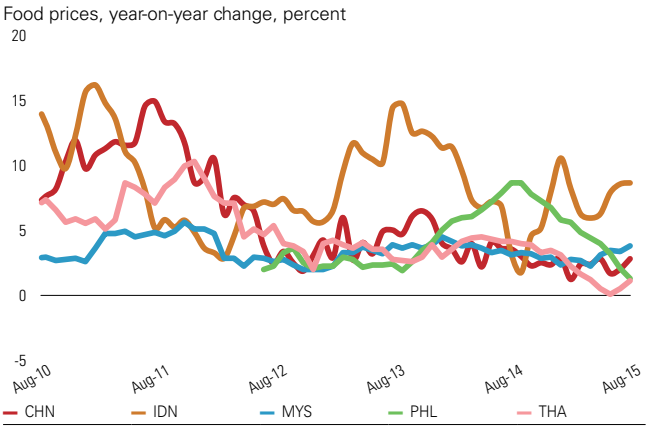
The strong deflationary impulse from the decline in oil prices since mid-2014 has largely faded, but underlying inflation momentum remains weak in the major regional economies. Core consumer price inflation has increased only in Malaysia, and this reflected the introduction in April of the general sales tax, the impact of which is expected to dissipate further over time (Figure I.B.2). Core inflation remains relatively high but stable in Indonesia. In general, there does not appear to be a risk of rising inflation expectations. Weak growth or outright declines in producer prices (Part I.A.) also suggest no incipient inflationary pressures. The further falls in recent months in key global commodity prices may exert an additional deflationary impact, by reducing prices for intermediate goods, as well as retail fuel.

Figure I.B.2. Core inflation has remained stable, except in Malaysia (reflecting the April 2015 GST)



Source: Haver Analytics.

Figure I.B.3. Food price inflation in the larger EAP economies was subdued, except in Indonesia



Source: Haver Analytics.

Uncertainty around growth projections is relatively high, with risks skewed to the downside

The baseline scenario for regional growth is subject to a greater-than-usual degree of uncertainty, and risks are weighted to the downside. In particular, uncertainty surrounds the trajectory of, and spillovers from, China's economic rebalancing and the expected normalization of U.S. policy interest rates. These are ultimately necessary conditions for a strong and sustainable global economy over the long term. However, over the short term, these factors could affect global and regional growth. They could also lead to large moves in key asset and commodity prices, exchange rates, and investment flows, and to bouts of extreme financial volatility. Although the region has broadly weathered the immediate impact of the mid-August volatility and uncertainty (as well as the previous, 2013 "taper tantrum"), future developments could generate financial stress. In addition, the U.S. dollar appreciation could slow the U.S. economy more than expected. Should these risks materialize simultaneously, they would magnify one another's impact.

The potential for disruption is particularly large in the context of a still fragile global economy. Growth prospects have weakened, above all in emerging markets; international trade has slowed; and commodity prices are persistently low. Should the downside risks materialize, this delicate environment would again magnify the subsequent impact. On the upside, some preexisting risks, especially of deflation in the Euro Area, have diminished. Also, the benefits from lower oil and nonoil commodity prices could prove larger than currently anticipated, although the impact would differ across countries.

The balance of inflation risks in the region is tilted toward inflation being lower than expected in the base case, reflecting the negative skew to regional growth risks. Any inflation risks from the broad-based regional depreciations against the U.S. dollar appear contained, since currencies have depreciated far more modestly (and, in some cases, appreciated) in trade-weighted terms. Likewise, risks from volatile food prices, a large component of regional consumer price indexes, at present appear limited. Among the major economies,

food prices have been rising sharply only in Indonesia (Figure I.B.3).[1] And El Niño is not expected to affect world food prices significantly, since global agricultural markets are presently well supplied; that said, it may have localized effects, and the forecasts are still subject to considerable uncertainty (Box I.B.2).

A faster-than-expected downturn in China would lower growth in the wider region

The baseline projections for China's economy in 2016 and beyond are subject to considerable uncertainty. The pace of the slowdown will depend on both global developments and domestic structural trends. Continued reforms are expected to enable further economic restructuring and rebalancing of domestic demand but, as also discussed in previous *EAP Economic Updates*, accumulated imbalances do continue to pose a risk of disorderly adjustments.[2]

There is a risk that real and financial vulnerabilities in the Chinese economy cause a sharper-than-expected slowdown in spending, especially investment, a significant tightening of credit conditions, and increased capital outflows. A persistent, deepening correction in asset prices could spill over into confidence and real sector spending. There is also a risk of mounting financial pressures in sectors operating at low capacity utilization, increasing nonperforming loan costs for financial intermediaries and other investors. A consequent weakening of the capital bases of lending institutions could lead to a more general tightening of credit. Finally, if confidence in China's growth prospects wanes and growth in high-income economies strengthens, private capital outflows might accelerate, prompting authorities to tighten domestic financing conditions.

China has sufficient policy buffers to address these risks and prevent a sharp slowdown. There is fiscal space to apply limited stimulus in the event of a sharper-than-expected slowdown. Government debt is moderate (41 percent of GDP at end-2014),[3] and it is predominantly held domestically by a small group of institutions, reducing exchange rate and refinancing risks. Regulations restrict savings instruments outside the banking system, and the financial system is still predominantly state owned. Capital controls on portfolio investment and bank lending can limit surges in capital outflows. Finally, if reduced confidence in the financial system translated into attempts to convert local currency deposits into foreign currency, these could be met using the ample international reserves, which still amount to over US$3 trillion.

If China's growth were to slow more than expected, the effects would be felt in the rest of the region, especially in countries linked to China through trade, investment and tourism. The key trade effects would be mediated through developments in commodity prices, exports of non-commodity merchandise to China, and receipts from Chinese tourists. Financial spillovers would arise through a decline in outward FDI from China. Also, any abrupt downturn would likely result in a more generalized investor pull-back from the region and significant financial volatility.

1 Overall food price inflation reached 9.3 percent in August. In particular, rice prices spiked in February, affected by uncertainty over stocks and the degree to which imports would be allowed.

2 See, for example, Part 1.B of the October 2014 *East Asia and Pacific Economic Update*.

3 General gross government debt (2014; Source: IMF), including central government debt of approximately 15 percent of GDP as of 2014 (Figure I.A.22).

Box I.B.2. The Impact of El Niño on East Asia and Pacific [1]

The current El Niño weather pattern is expected to have a significant impact on economic activity and welfare in the East Asia and the Pacific region. The impact will depend on its actual strength, timing, and duration, and will vary across countries. Nevertheless, evidence from past El Niño episodes, forecasts that the current El Niño will prove stronger than the historical average, and the already available indicators all point to large effects on agriculture (and especially subsistence agriculture), industry, water resources, public health, and disaster risk. As a benchmark, the strongest recent El Niño cycle in 1997–98 led to an estimated 15 percent increase in global poverty rates, and caused East Asia and Pacific around US$45 billion in damage (NOAA 2015).

El Niño has significant implications for temperatures and precipitation over much of the world, and East Asia and Pacific, in particular. El Niño causes the winds of the equatorial Pacific to slow or reverse direction, raising the temperature of waters over a vast sea area. These higher temperatures cause below- or above-normal precipitation in many regions. The impact is most noticeable in East Asia, South Asia, Australia, and South America; the effects on the Northern Hemisphere are muted. The current El Niño is likely to prove the strongest of the past 20 years, and possibly of the last half-century, and turn 2015 into the warmest year ever recorded (WMO 2015). It is expected to peak in the last quarter of 2015 and continue well into next year, before gradually weakening into the middle of 2016.

Agriculture

The most immediate regional and global effects will be felt in the agricultural sector through several mechanisms:

- Droughts or excessive rains directly affect rain-fed agriculture. In addition, they affect river levels, which can reduce water availability for irrigation, cause floods, and disrupt river transport.
- Dry weather affects palm oil production in Indonesia, the world's largest palm oil producer and exporter. Historically, palm oil prices have been the most sensitive to El Niño.
- Drought in Australia causes major damage to its wheat crop. Australia is the world's fifth-largest wheat exporter.
- Higher-than-normal precipitation increases soybean and wheat yields in North America.
- Higher temperature in Brazil reduces the likelihood of frost for coffee.
- Reduced monsoon rains in India decrease rice and sugar crops. However, this effect is largely localized, since India trades little rice or sugar.

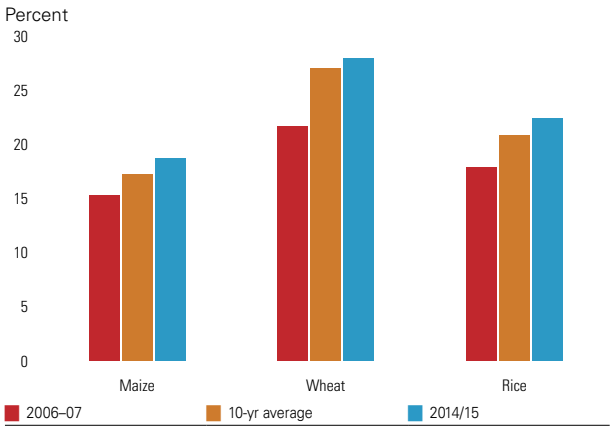
The estimated historical global impacts of El Niño range widely, but in general, agricultural yields decrease and prices increase. Maize, rice, and wheat yields on average decrease (by up to 4.3 percent). One exception is global soybean yields, which on average increase (by 2.1 percent to 5.4 percent) (Iizumi et al. 2014). Consistent with this, a one-standard deviation weather shock during El Niño raises real commodity prices by 3.5 to 4 percentage points (Brunner 2002). Relatedly, adverse weather shocks during 1980–2012 had a negative and significant impact on world wheat prices (Algieri 2014; Ubilava 2014). Also, El Niño accounted for nearly 20 percent of changes in commodity-price inflation during 1963–98 (Brunner 2002).

1 Prepared by John Baffes, Yann Kerblat, Zuzana Stanton-Geddes, and Jolanta Kryspin-Watson.

Box I.B.2. continued

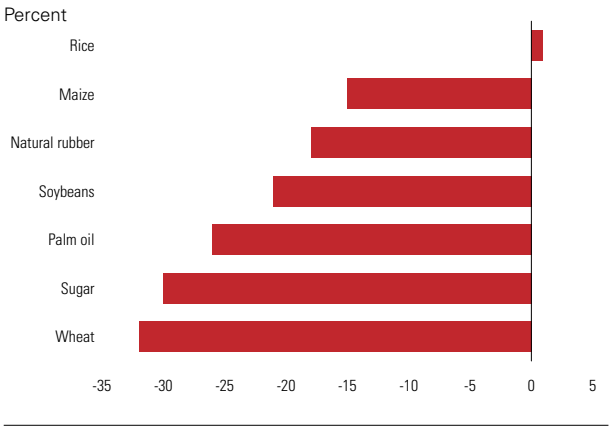
The current El Niño will have a limited impact on global agricultural markets, since these are presently well supplied. Stock-to-use ratios (a measure of the abundance of supply) for maize, wheat, and rice are well above their 10-year averages, and much higher than in 2006–07, when the last spike in food commodity prices began (Figure I.B.2.1). Further, the prices of commodities that are likely to be impacted by El Niño have been declining. For instance, the prices of seven key commodities during April–August 2015 were on average much lower than during the corresponding period in 2014 (Figure I.B.2.2). El Niño is likely to at most offset this declining trend. Reflecting this, the U.S. Department of Agriculture, which releases a monthly global update for most grain and oilseed commodities, maintained its comfortable outlook for the 2015–16 crop year in its August update.

Figure I.B.2.1. Stock-to-use ratios



Source: World Bank.

Figure I.B.2.2. Price changes from May–August 2014 to May–August 2015



Source: World Bank.

However, at the regional level, El Niño will affect agricultural output in several countries, and reduce food security for a large number of vulnerable communities. In Indonesia and Papua New Guinea, El Niño leads to marked rainfall deficits extending throughout the year. One result is a significant decrease in Indonesian rice production.[2] In Indonesia, moderate projections show a potential decline by 1 million to 2.1 million tons, equivalent to 1.5 to 3 percent. Further, reduced wet-season rainfall has a particularly strong impact on subsistence agriculture, which plays a significant role in Fiji, Papua New Guinea, the Solomon Islands, and Vanuatu. In the Pacific Island Countries, agricultural lands are rendered unproductive by seawater inundation stemming from surges associated with tropical cyclones. To varying degrees, agriculture will also be affected in Cambodia, Lao PDR, Myanmar, the Philippines, and Vietnam. Relatedly, El Niño events have led in the past to sudden increases in agricultural insurance claims owing to a higher probability of increased weather and catastrophic insurance and reinsurance losses.

Regional agriculture is already being affected, including by severe heatwaves and droughts, and the impact is likely to spread during the second half of 2015. There was low rainfall during the summer in Northeastern China and Southeast Asia, including Indonesia, which is suffering from severe drought, and Papua New Guinea. In Cambodia, Lao PDR, Thailand, and Vietnam, farmers are already leaving fields and rice paddies unplanted, owing to a severe lack of rainfall and excessive heat. Given their dependence on

2 Sea surface temperature anomalies explain about two-thirds of the interannual variance in rice plantings and 40 percent of the interannual variance in rice production during the main season in Java (Naylor et al. 2001).

Box I.B.2. continued

agriculture, the impact on their livelihoods could be significant. In the Philippines, 8 provinces are under a state of calamity for drought reasons, and farmers indicate that 40 percent of their crops have been affected (*Nation* 2015).

An eventual impact on local or (less likely) global agricultural prices would affect regional inflation rates. Food constitutes 30 to 40 percent of the consumer price index in Indonesia, the Philippines, and Thailand. On average, El Niño increases their inflation rate by 0.5 to 0.9 percentage points (Cashin, Mohaddes, and Raissi 2015).

Industry

El Niño will also affect industrial activity, through several channels:

- Drought reduces hydroelectric power generation. Cambodia, Indonesia, Lao PDR, Myanmar, the Philippines, and Vietnam would all be affected, although to varying degrees.
- El Niño affects wind strength, often lowering electricity production from wind turbines.
- Industrial activities that rely heavily on electricity, and in particular on hydropower (such as mining), are at risk (Cashin, Mohaddes, and Raissi 2015).
- Shortfalls in electricity generation lead to higher demand for both coal and crude oil.
- Localized excessive rain can cause mines to flood (for instance, in Australia, Chile, and Indonesia), tightening metal supplies.

Regional industry is already being affected. Low rainfall has reduced hydroelectric power generation and, hence, nickel production, in Indonesia, the world's top producer. Relatedly, loss of hydroelectric power is boosting domestic coal demand in countries such as Vietnam. As a result, buyers of Vietnamese coal, such as China, can expect more uncertainty in shipment volumes (Reuters 2015).

Water supplies and public health

El Niño will affect water supplies and resource management across the region, with major consequences particularly for the Pacific Island Countries. In Indonesia, severe drought is already increasing the risk of forest fire, including by accelerating deforestation activities; all this both complicates water resource management, and results in higher urban air pollution. In Indonesia, as of July 2015, 16 provinces witnessed droughts and 5 of 16 major dams noted water deficits. At the same time, fires and haze are already at critical levels in Sumatra, with over 880 hotspots detected in September 2015. Small islands with relatively low mean rainfall, such as the Cook Islands, Niue, and Tonga, are especially dependent on freshwater lenses (thin layers of fresh groundwater, overlying seawater) for their supply of freshwater. These lenses are threatened both by decreased rainfall, and by seawater intrusion from high sea levels or storm surges caused by tropical cyclones, which may also increase in frequency. It can take months or years for freshwater lenses to recover from drought and seawater intrusion, since they can only be recharged by significant rainfalls. For instance, recovery from such shocks in the Cook Islands took three years (UNESCAP 2014).

El Niño's impact on water supplies can have serious consequences for public health. Water shortages lead to decreased hygiene, and floods create exposure to contaminated water. Both result in outbreaks of diseases, such as diarrhea and typhoid. Further, the risk of vector-borne diseases, including dengue, Chikungunya, and Zika, rises since the mosquito population increases, and greater temperatures enhance viral

Box I.B.2. continued

reproduction and transmission. In Fiji, dengue associated with the 1997–98 El Niño affected 24,000 people, claimed 13 lives, and cost approximately US$6 million in medical care and other direct costs. During drought years, Tonga reports dengue outbreaks, and in Papua New Guinea the incidence of malaria increases, as people living in mountain areas are forced to move to the lowlands, becoming more exposed to mosquito-borne diseases (UNOCHA 2015).

Disaster risk

El Niño is raising the risk of weather-related disasters, particularly in the Pacific. It has already increased the likelihoods of cyclones and severe storms by almost 30 percent in 2015. Five super typhoons (Category 5) have been reported for the year through early September, making the current season one of the most active in terms of frequency and intensity of tropical cyclones (UNOCHA 2015). In Myanmar, torrential monsoon rains from a cyclone in August triggered severe floods, flash floods, and landslides. By some estimates, more than 1.5 million people have been displaced, 21,221 houses destroyed, and 1.4 million acres of farmland inundated at some point during the disaster (NNDMC 2015).

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Slower than expected growth in China would exacerbate downward pressures on many commodity prices, with a negative impact on major commodity exporters. China's growth moderation and rebalancing to date have already exerted a significant negative impact on international commodity prices, and hence on the terms of trade, exports, and growth in major commodity producers such as Indonesia, Malaysia, and Mongolia. Even under the baseline scenario, most commodity prices are projected to remain broadly flat in real terms through end-2016. Additional reductions in Chinese demand would likely further reduce commodity prices. In turn, lower prices for crude oil would dampen activity in Malaysia and Timor-Leste; for natural gas, in Indonesia, Malaysia, Myanmar, and Papua New Guinea; for coal, in Indonesia and Mongolia; for rubber, in Indonesia and Malaysia; and for copper, in Lao PDR and Mongolia.[4] Conversely, the direct impact of lower commodity prices would be positive for net commodity importers, such as the Philippines.

Spillovers would be relatively significant for economies that trade intensively with China. Malaysia, Thailand, and the Philippines are particularly exposed, as measured by the share of their total output accounted for by final demand for (non-commodity) merchandise from the Chinese market (Box I.B.3, Figure I.B.3.1). Conversely, Cambodia and Vietnam would be less affected through the trade channel.

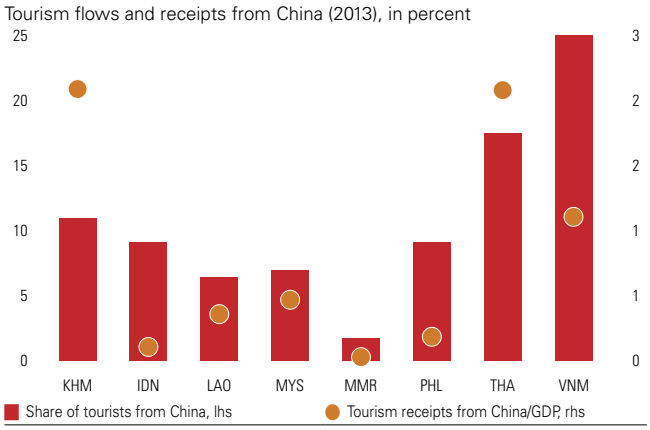
Some economies would experience a significant impact through tourism. Tourism from China to the region has expanded substantially in recent years. A sharp downturn could reduce both tourist numbers and average expenditure per trip. Among the developing Asian economies, Chinese tourists are particularly important for Cambodia, Malaysia, Thailand, and Vietnam, both as a share of total tourist arrivals and in terms of tourism receipts relative to GDP (Figure I.B.4). For instance, China accounts for 18 percent of all tourists visiting Thailand, and over 2 percent of GDP in tourism revenues.

The region would be affected by a fall in FDI from China. In recent years, China has emerged as a major source of direct investment. Retrenchment of existing Chinese investment stakes in the region, notably in mining and real estate, appears unlikely. However, a weaker Chinese financing capacity could pose risks to new projects in countries and sectors where Chinese investors have been heavily involved, including Lao PDR (where China is one of the largest investors in power projects), Cambodia (where China accounted for 74 percent of all project approvals in H1 2015), Mongolia, and Myanmar (Figure I.B.5).

A sharper-than-expected slowdown in China could affect the region through financial contagion effects, raising the costs and constraining the availability of external financing. There could be a sharp reduction or even reversal of capital flows to emerging markets, including in particular developing EAP. In turn, this would exert considerable pressure on countries with vulnerable external positions. It would also increase the pressure for depreciation against the U.S. dollar, raising the cost of servicing U.S.-dollar-denominated debt. Specific vulnerabilities are broadly analogous to those stemming from U.S. monetary policy normalization (see below). However, the impact may be more focused on those economies that are closely linked to China through the above trade and FDI channels.

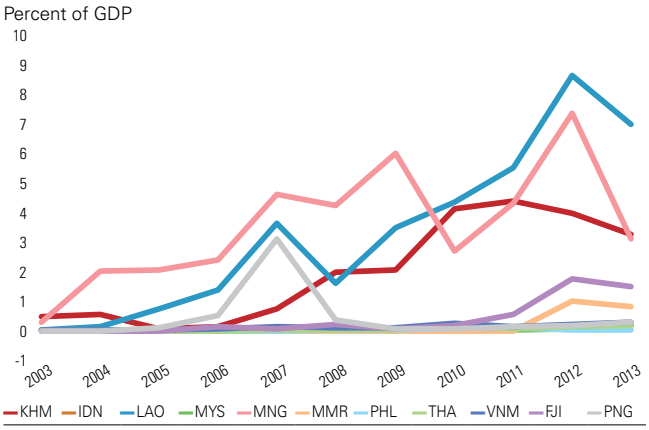
4 For instance, should copper and coal revenues fall in 2016 by 10 percent more than projected in the baseline, Mongolia's current account deficit would be estimated to widen by another 3 percentage points of GDP, and its GDP growth in 2016 to fall by about 1 percentage point.

Figure I.B.4. For many countries in the region, Chinese tourism is important for growth, jobs, and foreign exchange



Source: World Bank staff estimates, based on CEIC and World Development Indicators.

Figure I.B.5. FDI inflows from China have risen in recent years



Source: World Bank staff estimates, based on CEIC and World Development Indicators.

U.S. monetary policy normalization adds to external financing risks

Baseline projections are predicated on a gradual, smooth tightening of external financing conditions, with an orderly normalization of monetary policy in the United States. This smooth scenario reflects several factors. First, the shift in U.S. monetary policy has long been anticipated. Second, it is likely to occur gradually, and only if the U.S. economy remains robust, which would partially offset the impact on economic activity in developing countries. Third, U.S. term spreads are likely to remain narrow, based on evidence from previous tightening episodes. Finally, other major central banks are expected to continue pursuing exceptionally accommodative policies, helping to maintain low global interest rates (Arteta et al. 2015).

However, there is a risk that the U.S. policy rate "lift-off" will instead trigger abrupt market reactions, causing currencies to depreciate sharply, bond spreads to rise steeply, capital inflows to fall sharply, and liquidity to tighten, as occurred during the 2013 "taper tantrum." Several factors heighten the risk of such financial volatility, which would have adverse implications for real activity. Uncertainty about the underlying strength of the U.S. economy creates ambiguity about the pace and extent of future shifts in U.S. monetary policy; U.S. term premia are well below their historical average and could revert abruptly. Monetary policy continues to diverge among advanced economies. Liquidity conditions are fragile in some key asset markets. And, as discussed, should a sharp lift-off occur concurrently with a sharp slowdown in China, it could significantly exacerbate the pull-back from emerging markets.

A sharp tightening in external financing conditions would have different impacts across the region. The countries most at risk are those that rely on portfolio flows and short-term borrowing to finance current account deficits or debt rollovers, such as Indonesia; have a large external debt load, such as Malaysia and Mongolia; have a significant share of local currency debt held abroad, such as Malaysia and Indonesia; or have high levels of household debts, such as Malaysia and Thailand (see also Box I.B.4). Under an adverse scenario, corporate balance sheets and cash flows would be stressed. This, together with the necessary domestic policy adjustments, would push growth down significantly.

Box I.B.3. Reassessing East Asia's trade performance through the lens of global value chains [1]

The last quarter-century has seen a rapid expansion of cross-border global value chains (GVCs), an important contributor to development. Since the 1990s, global production processes have become increasingly fragmented, with firms locating different stages and tasks in different countries, operating networks of affiliates and independent suppliers, and generating mounting trade in intermediates (parts and components) across national boundaries. As part of this process, developing economies have been able to participate in the production of increasingly sophisticated products (Taglioni and Winkler, forthcoming). Manufacturing functions, especially final assembly, were among the first to be externally sourced, but services and even some aspects of research and development followed. Key drivers of this phenomenon included falling transport costs, a general reduction in global tariffs, the proliferation of bilateral and regional trade and investment agreements, the information and communications technology (ICT) revolution, the transition of China to a market economy, and new management techniques including just-in-time delivery and manufacturers outsourcing "noncore" business functions. This new pattern of production has allowed developing countries to increase their competitiveness through access to world-class technology, inputs, and know-how, and to insert themselves into dynamic export sectors, specializing in specific tasks within a value chain without having to build the entire supply chain domestically (Baldwin 2006).

East Asian economies, in particular, have rapidly increased their participation in GVCs, as part of a broad pattern of export-led growth. The region has increasingly become a full-fledged participant in international manufacturing networks. All developing EAP countries for which data are available rank higher on formal indexes of participation in GVCs than the global average, and participation rates have almost universally increased over time (*East Asia and Pacific Economic Update*, October 2014, Box 4, pp. 21–25). For instance, during 1995–2013, the region's trade in intermediates grew by a factor of 6, even higher than the fourfold increase in final-goods trade.

Assessing trade performance in a world of GVCs requires the use of new datasets. Where exports consist primarily of imported components, economies can record high export volumes but add little value domestically. And conventional trade data record trade flows on a gross output (sales) basis, without separating domestic and foreign value added. New datasets measuring trade flows on a value-added basis instead capture the fragmented geography of international production, shedding light on the roles played by different economies within GVCs, and on whether involvement in GVCs is leading to higher economic growth.[2] This box represents one of the first attempts to analyze the June 2015 update of the OECD/WTO trade in value-added (TiVA) database, covering the period through 2011, to shed further light on some key aspects of East Asia's trade performance.[3]

China's regional and global influence continues to increase

China itself is an increasingly important source of final demand for the rest of the region; as a corollary, developments in China are likely to exert an increasingly important regional influence. China has long been viewed as a regional assembly hub, importing semifinished goods from other regional economies, and re-exporting finished products to high-income economies. However, the new data indicate that a large and rapidly growing share of the rest of the region's value added is accounted for by exports used to meet final

1 Prepared by Daria Taglioni and Fitria Fitriani.

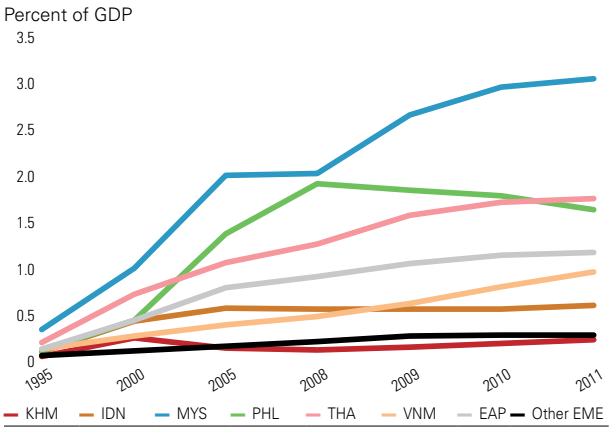
2 In particular, these data can trace the contribution of inputs from abroad to a country's gross exports, generating estimates of exports in value-added terms—that is, the value of the economy's goods and services that are embodied in its exports, after accounting for the use of imported intermediate goods and service inputs.

3 The OECD/WTO TiVA database covers the six largest East Asian developing economies (China, Indonesia, Malaysia, the Philippines, Thailand, and Vietnam), and Cambodia.

Box I.B.3. continued

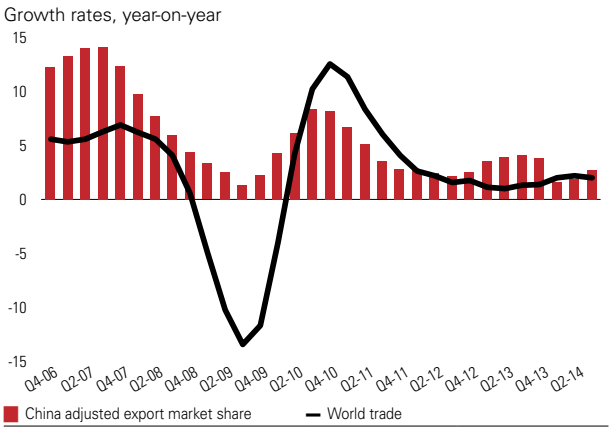
demand from Chinese consumers. Much of this reflects trade in commodities, whose global price is strongly influenced by developments in the Chinese economy (Part I.B). But the same holds true for noncommodity trade. Malaysia is particularly dependent on final demand from China for noncommodity merchandise (accounting for over 3 percent of its GDP; Figure I.B.3.1). Thailand and Vietnam are also increasingly exposed to the Chinese market. In contrast, the Philippines is growing less dependent on China, as its exports become increasingly diversified.

Figure I.B.3.1. Domestic value added accounted for by final demand from China for manufacturing merchandise has risen



Source: OECD/WTO TiVA database.

Figure I.B.3.2. Developments in China are now exerting a dominant influence on world trade growth



Source: Gaulier et al. 2015.

Note: "Adjusted" market share refers to China's global market share, after controlling for the impact on trade values of export-market orientation and product-mix specialization. This may be viewed as a proxy for China's export competitiveness. Data are based on monthly bilateral gross trade flows at the 5-digit Standard International Trade Classification level.

More broadly, developments in China now exert a dominant impact on global trade as a whole. Supply-side shocks affecting Chinese exports are a key driver of world trade, from both a short-term cyclical standpoint, and a long-term structural perspective (Figure I.B.3.2).

The region's trade performance has been remarkable, but there are significant differences across countries

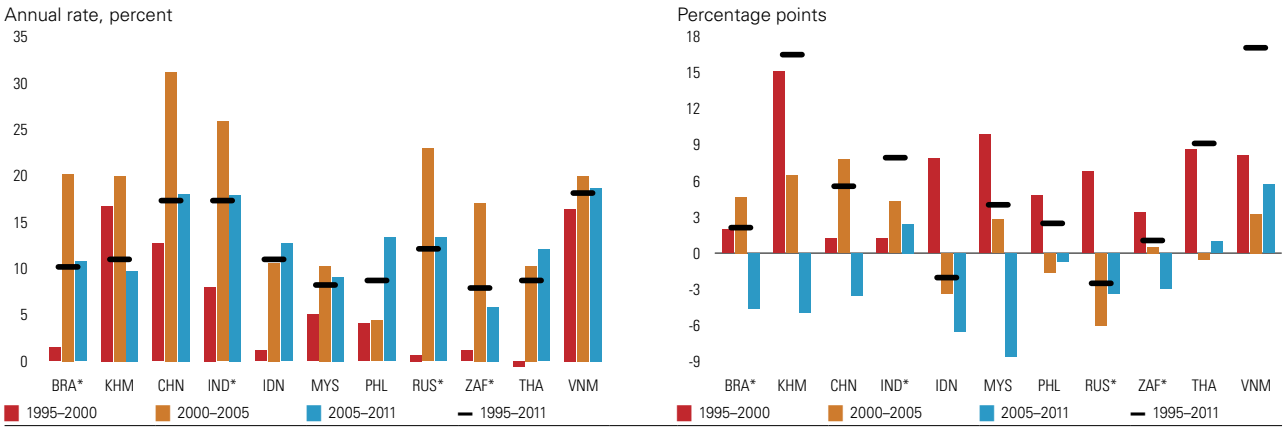
The region has seen rapid growth in the domestic value added embodied in manufacturing exports; the performance of Vietnam, China, and to a lesser extent Cambodia, stands out. Total domestic value added in exports has increased sharply both in absolute terms (Figure I.B.3.3, panel A), and as a share of GDP (Figure I.B.3.3, panel B). The trend is evident over both the last two decades and selected subperiods.

Focusing on the more recent period, the region continued outperforming the rest of the world in trade in every manufacturing subsector. During 2005–11, in every subsector, regional domestic value-added embodied in exports increased as a share of global value added exported. In absolute terms, most of this increase reflected growth in China (Figure I.B.3.4, panel A). For instance, China's shares of the total value added in world exports of textiles, clothing, and footwear, and of electrical equipment, increased by 13 percentage points. In relative terms, Vietnam enjoyed particularly significant increases in its share of the total value added in world exports of agribusiness; textiles, clothing, and footwear; and other machinery (Figure I.B.3.4, panel B)

Box I.B.3. continued

Figure I.B.3.3. Regional domestic value added embodied in manufacturing exports has increased rapidly

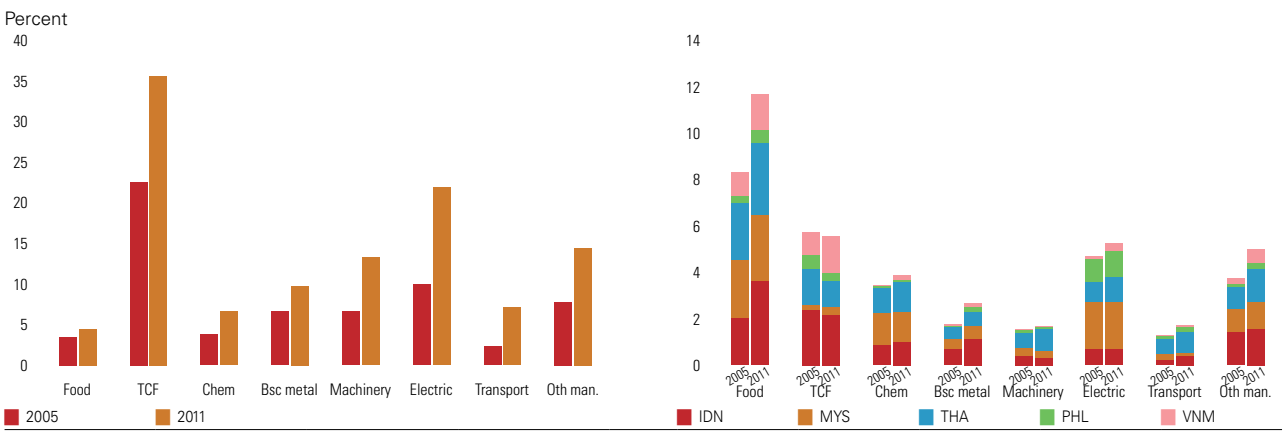
Domestic value added in manufacturing exports, for selected EAP economies and comparator countries (current US dollars)



Sources: OECD-WTO TiVA database; World Bank staff estimates.
Note: *Denotes economies that are not part of developing EAP.

Figure I.B.3.4. The region has outperformed the rest of the world in trade in every manufacturing subsector

Domestic value added in manufacturing exports, by manufacturing subsector, as share of global exports of relevant manufacturing subsector



Sources: OECD-WTO TiVA database; World Bank staff estimates.
Note: Bsc metal = basic metals manufacturing; Oth man. = other manufacturing; TCF = textiles, clothing, and footwear.

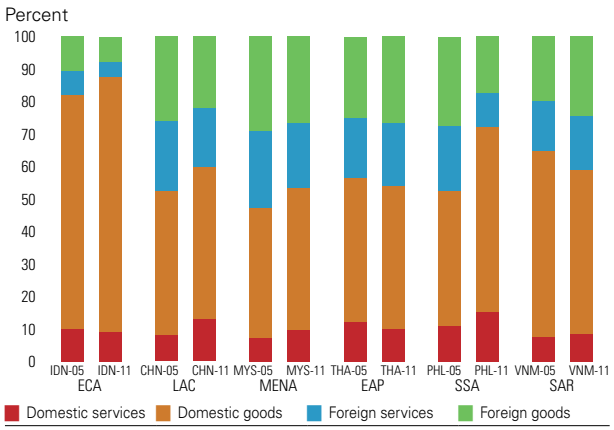
During 2005–11, the share of domestic relative to foreign value added in regional exports generally increased. The share of domestic value added in exports increased in China, Indonesia, Malaysia, and the Philippines, although not in Vietnam (Figure I.B.3.5). This trend affected both goods and services. It did not reflect any shift toward commodity exports, but rather held also for manufacturing exports (Figure I.B.3.6). Within manufacturing, the share of domestic value added in exports also rose within most subsectors. The increase was most pronounced in relatively high value-added categories, such as electrical and electronic

Box I.B.3. continued

goods, with the exception of Indonesia (Figure I.B.3.7). These developments could reflect three trends. First, as transportation costs increased (with oil prices peaking in 2008 and remaining elevated until mid-2014), firms may have chosen to re-centralize ("in-shore") some of their production. Second, countries such as Malaysia and Thailand, where labor costs have been rising, may have shed labor-intensive, low-value-added segments of the value chain. Third, countries may have expanded their participation in higher value-added segments of the value chain.

Figure I.B.3.5. The share of domestic relative to foreign value added generally increased in merchandise exports…

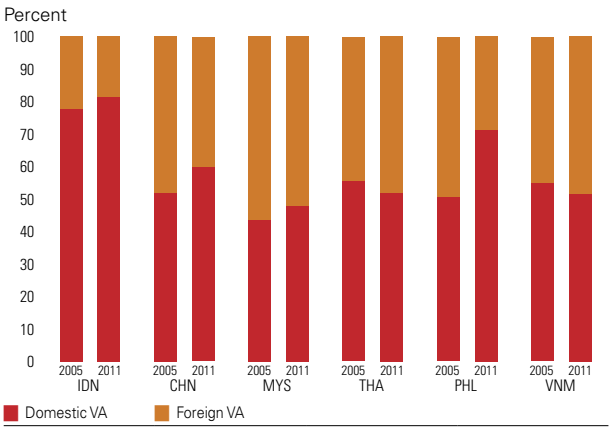
Domestic and foreign value added in total merchandise exports



Sources: OECD/WTO TiVA database; World Bank staff estimates.

Figure I.B.3.6. …and in manufacturing exports

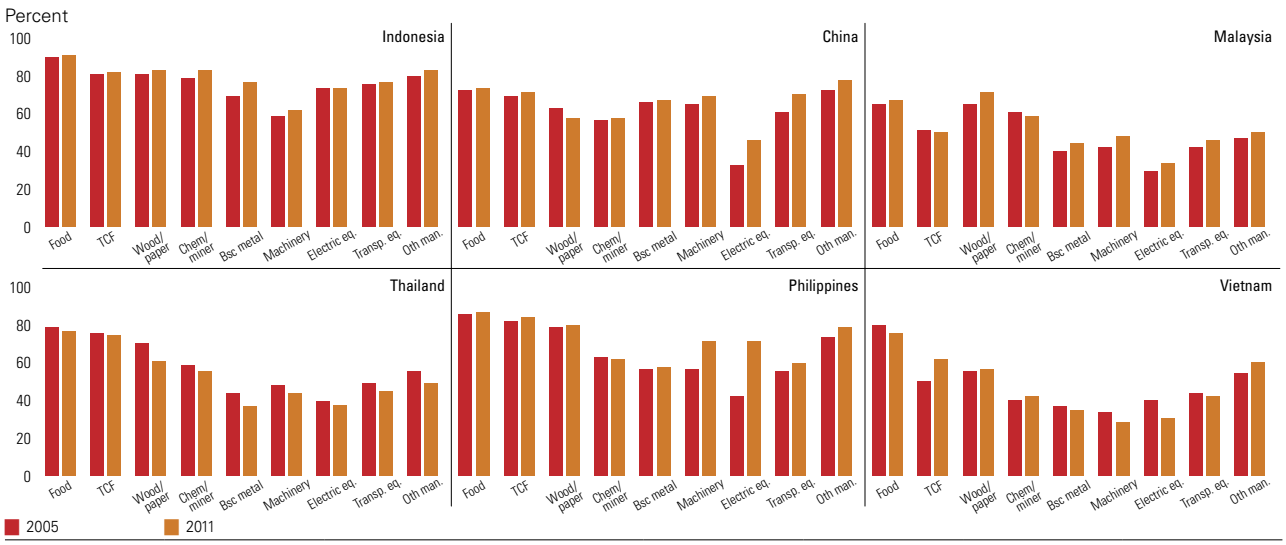
Domestic and foreign value added in total manufacturing exports



Sources: OECD/WTO TiVA database; World Bank staff estimates.

Figure I.B.3.7. … and in the exports of most manufacturing subsectors

Domestic value added in manufacturing exports, by manufacturing subsector, as share of exports of relevant manufacturing subsector



Sources: OECD/WTO TiVA database; World Bank staff estimates.

Box I.B.3. continued

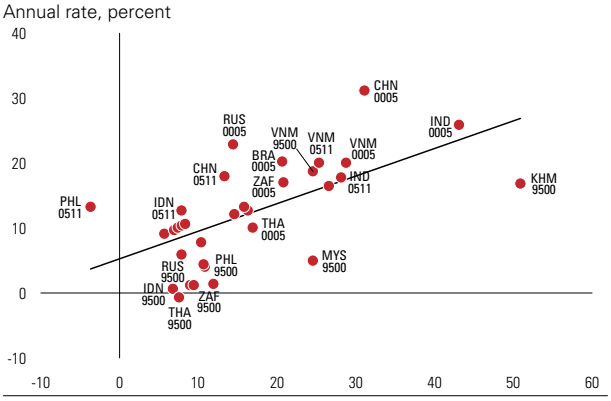
Import Promotion as Export Promotion in a World of Global Value Chains

The ability of countries to participate in GVCs rests critically on their capacity to efficiently import world-class inputs, technology, and know-how. Within a GVC, imports are critical inputs into exports. Therefore, export success hinges on removing barriers to imports of intermediate goods, broadly defined. Taking a long-term, cross-country perspective, growth in domestic value added in exports is robustly associated with growth in intermediate trade (Figure I.B.3.8).[4]

This implies a need to redouble efforts to cut barriers to trade in intermediates and services, boost infrastructure, deepen trade integration, and more generally improve the investment climate. Preliminary results from ongoing World Bank research, analyzing sectoral-level performance in a cross-country context, confirm that growth in value added within GVCs is strongly correlated with trade and investment policy, infrastructure and connectivity,[5] the business climate, and governance.[6] The implied policy prescriptions are not novel, but become even more salient in a world of GVCs. For instance, the distortionary impact of any trade barrier, including tariffs, is amplified when intermediate inputs must cross borders multiple times along the production chain.

Figure I.B.3.8. Growth in domestic value added in exports is robustly associated with growth in intermediate trade

Growth in domestic value added and in foreign value added in manufacturing exports



Sources: OECD/WTO TiVA database; World Bank staff estimates.

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Taglioni, D., and D. Winkler. Forthcoming. *Making Global Value Chains Work for Development*. Washington, DC: World Bank.

4 Indeed, this association is far stronger and more robust than any link between growth in domestic value added and changes in the ratio of domestic to foreign value added in exports.

5 Including customs procedures, logistics, and communication services, which are particularly important in facilitating access to imported inputs.

6 For advanced economies, a relatively important role is also found for financial development, labor market policy, and education and innovation policy.

Any sharp depreciation against the U.S. dollar would raise the cost of servicing U.S.-dollar-denominated debt, amounts of which have grown significantly since the easing of U.S. monetary policy in 2009. Indonesia, Malaysia, Thailand, and Vietnam, in particular, all saw significant increases, with dollar-denominated debt at end-2014 amounting to over 15 percent of GDP in each country (*East Asia and Pacific Economic Update*, April 2015). Conversely, failure to depreciate against the U.S. dollar, if it were to strengthen further against the euro, yen, and renminbi, would lead to real effective appreciation, which in turn would reduce external competitiveness and again increase vulnerability.

Outlook and risks for the Pacific Island Countries

Modest growth prospects…

The medium-term growth prospects for most Pacific Island Countries (PICs) remain modest. In some countries, such as Kiribati, Samoa, and Tonga, the outlook is dependent on the extent to which tapering infrastructure investment is replaced by other sources of growth.

Tropical Cyclone Pam, having severely impacted livelihoods and productive capacity in Tuvalu and Vanuatu, will substantially affect their economic outlook over the next one to two years. The agriculture and tourism sectors will take time to recover to pre-cyclone levels. However, economic activity will be supported by reconstruction. If well executed and targeted at productive sectors, this should also boost longer-term potential growth. Infrastructure investment cycles continue to be an important influence on growth in the other PICs, with the resumption of work on donor-funded projects prompting a possible near-term rebound in growth in the Republic of the Marshall Islands, while tapering construction activity will moderate the medium-term outlook in Kiribati, Samoa, and Tonga. Large investments in infrastructure and telecommunications are expected to support growth in the Solomon Islands over the coming years.

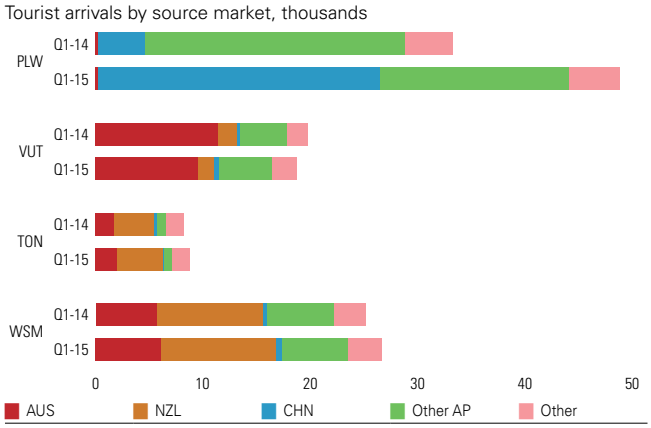
The outlook for inflation in the PICs remains generally benign. Most PICs are heavily dependent on imported food and fuel, and will therefore continue to benefit from low global commodity prices. Some offsetting inflationary pressure is to be expected from weaker local currencies and stronger domestic price pressures from above-trend GDP growth in some economies, such as Fiji.

…but limited risks

Should growth slow further in China, the direct impact on the PICs will be limited, since China accounts for only a relatively small share of exports. The major exceptions are Palau and the Solomon Islands. Among PICs, Palau is the most dependent on tourism (tourist arrivals are almost five times its population), and the number of Chinese tourists has grown rapidly in recent years (Figure I.B.6). The Solomon Islands relies on China for more than half of its export earnings, making it vulnerable to any reduction in Chinese timber imports. An additional risk is that fishing license fees and seamen's remittances could be negatively affected if a slowdown in China results in lower growth throughout the Asia and Pacific region. As for PICs more broadly, one concern is that demand from Australia and New Zealand, including through tourism from these countries, may fall should they be negatively impacted by a sharp slowdown in China.

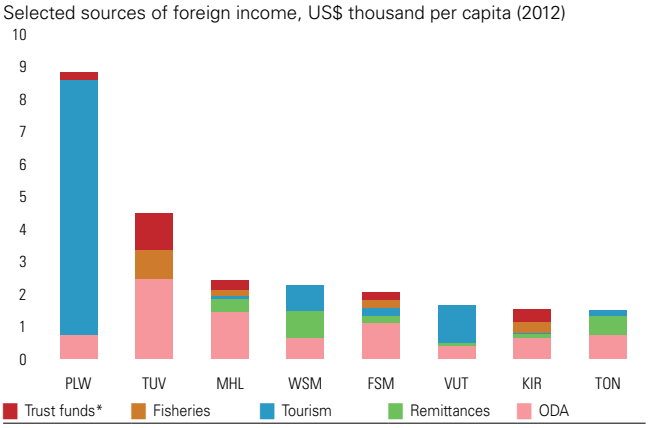
There is relatively little risk to PICs from potential global financial market volatility. Most PICs rely very little on private capital inflows, and hence are not directly exposed to a potential reversal of these flows should global risk appetite deteriorate further. The most important sources of foreign exchange for the small PICs, such as grants and concessional loans from development partners, remittances, and fishing license revenues are not likely to be substantially affected (Figure I.B.7). However, global financial volatility could affect the borrowing costs of Fiji, which plans to refinance a US$250 million global bond before April 2016. Also, many small PICs (the Federated States of Micronesia, Kiribati, Palau, the Republic of Marshall Islands, and Tuvalu) have sizable trust funds, and Timor-Leste has a large Petroleum Fund, all of which are invested in international financial assets. Although their portfolios are diversified, returns on these assets could be adversely affected by turbulence in international financial markets.

Figure I.B.6. Chinese tourists are particularly important for Palau, and tourists from Australia and New Zealand elsewhere in the PICs



Source: South Pacific Tourism Organization.

Figure I.B.7. Tourist earnings are a key foreign earnings source in many PICs



Source: World Bank staff estimates.

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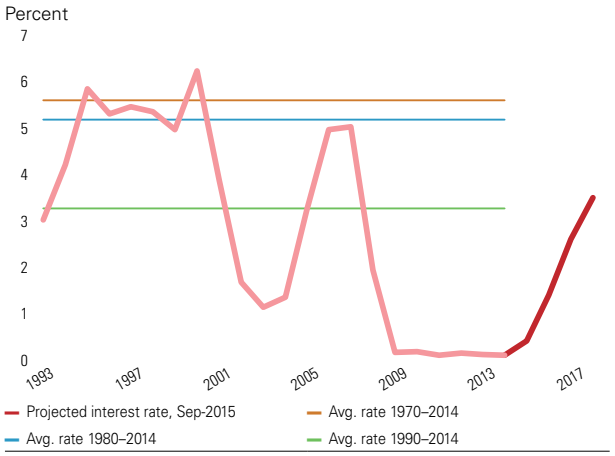
Box I.B.4. "Lift-off": The likely impact of an increase in U.S. policy rates on East Asia and Pacific [1]

The U.S. Federal Reserve Board (the Fed) is likely to soon start increasing its key policy rate, the Federal Funds rate ("lift-off"). Since December 2008, the rate has been held at the zero bound. The pace of future increases is broadly expected to amount to 30 basis points in 2015, about 100 basis points in 2016, and another nearly 120 basis points in 2017. The policy rate is expected to reach 2.6 percent in 2017, and 3.5 percent in the "long run" (Figure I.B.4.1). The long-term interest rate that the Fed expects to attain is comparable to the average rate observed in the last decade and half, though lower than the rate observed over a longer time period. The actual pace of increase would depend on the evolving macroeconomic conditions in the United States, which in turn would be affected by the outlook for the global economy.

Historically, tighter U.S. monetary policy has been associated with reduced global financial liquidity and capital outflows from emerging market economies (EMEs). These have often included disruptive "sudden stops," sometimes culminating in large exchange rate depreciations, elevated sovereign debt servicing burdens, and corporate and banking distress where there was exposure to foreign currency liabilities.

Figure I.B.4.1. Trajectory of the U.S. policy rate (Federal funds rate)

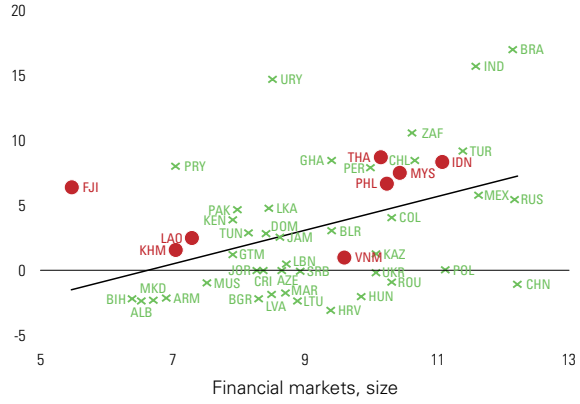
Actual and projected U.S. policy rate



Sources: Interest rate expectations from Federal Reserve Board; long-term rates from Haver Analytics.

Figure I.B.4.2. Exchange rate depreciation during "taper tantrum," April–August 2013

Extent of capital flows/size of the financial markets mattered



Source: Eichengreen and Gupta 2014.

Note: Financial market size is measured by total external private financing—that is, inflows of equity, bonds, and loans during 2010–12 from the IMF *Global Financial Stability Report*, transformed into logs.

The abrupt pricing-in by financial markets of future U.S. monetary policy tightening resulted in a bout of financial market volatility in mid-2013 (the "taper tantrum"). Within EAP, the four most affected countries were Indonesia, Malaysia, the Philippines, and Thailand. These were also the countries that had received larger volumes of capital flows during 2010–12, and had larger and more liquid financial markets (Figure I.B.4.2). In contrast, smaller countries, with little exposure to foreign capital, were relatively insulated.[2] This pattern is

1 Prepared by Poonam Gupta.

2 Smaller countries are empirically likely to experience only second-order effects from global rebalancing events, emanating from their trade or financial exposures to the larger countries in the region. For example, even though exchange rates depreciated in some of the smaller EAP economies such as Myanmar, Mongolia, and Papua New Guinea during the period of the taper tantrum, these effects can be attributed to country-specific factors not directly related to the taper tantrum.

Box I.B.4. continued

consistent with research on EMEs more widely, showing that it is precisely the countries that receive the most capital flows that are at the risk of losing them during a rebalancing of global portfolios, and that for foreign investors it is easier and less costly to redeem from a few large and liquid markets, than from many small markets. Countries with some specific macroeconomic vulnerability indicators, such as real exchange rate appreciation, increases in the current account deficit, and higher inflation (all often a manifestation of large capital inflows) experienced larger impacts from the taper tantrum (Eichengreen and Gupta 2014).

The short-term impact of lift-off on exchange rates and financial conditions is likely to be less dramatic. Lift-off has been widely anticipated and internalized by the financial markets subsequent to the taper tantrum, and the pace of U.S. interest rate increases is expected to be modest and calibrated. In addition, the fundamentals of many countries have strengthened, underpinned by exchange rate deprecation during the taper tantrum and afterward, narrower current account deficits, and smaller inflows of portfolio capital. Many countries in EAP are thus better positioned to comfortably withstand any financial market volatility associated with the initial impact of an incremental lift-off.

However, the medium-term financial and economic impact of a continued tightening of global liquidity will be appreciable. It will be manifested in a higher cost of financing and increased debt servicing burden. Policy makers across EAP economies need to gear up policy responses at three levels: first, to continue to manage any volatility around each bout of incremental policy tightening by the Fed; second, to adjust to the higher cost of financing after years of cheap finance; and third, to manage aptly the international financial integration of their economies to better withstand boom and bust cycles.

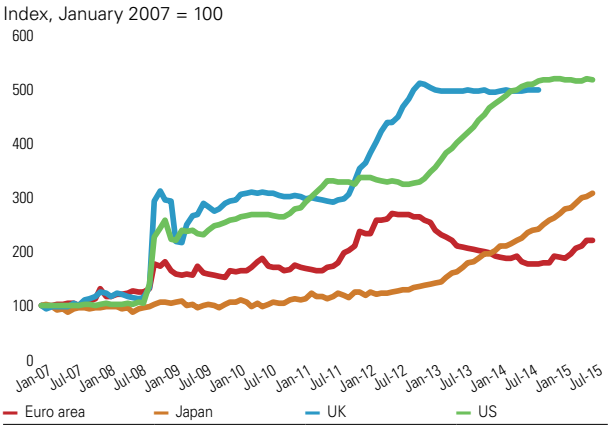
Determinants of impact on EAP

The impact of the increase in the U.S. policy rate on EAP economies will depend on three major factors. First is the combined monetary policy stance of advanced (G-4) economies, that is, how the U.S. tightening will be offset or matched by monetary policy in the Eurozone, the United Kingdom, and Japan. All G-4 countries have resorted to loose monetary policies to counter the impact of the global financial crisis, with their policy rates hovering at lower bounds and their balance sheets vastly expanded (Figure I.B.4.3). While the phase of easy monetary policy seems to be coming to an end in the United States, other advanced economies are expected to maintain their stance, reducing the net impact of U.S. tightening on global liquidity.[3]

Second is the extent to which the pace and timing of tightening are anticipated. Unlike the taper tantrum, the future direction of U.S. policy rates is well anticipated, and is already reflected in

Figure I.B.4.3. Aside from the U.S. Fed, other G-4 central bank balance sheets may continue to increase

Central bank balance sheets have expanded due to unconventional monetary policies



Source: Bank of England; Bank of Japan; European Central Bank; US Federal Reserve; World Bank staff calculations.

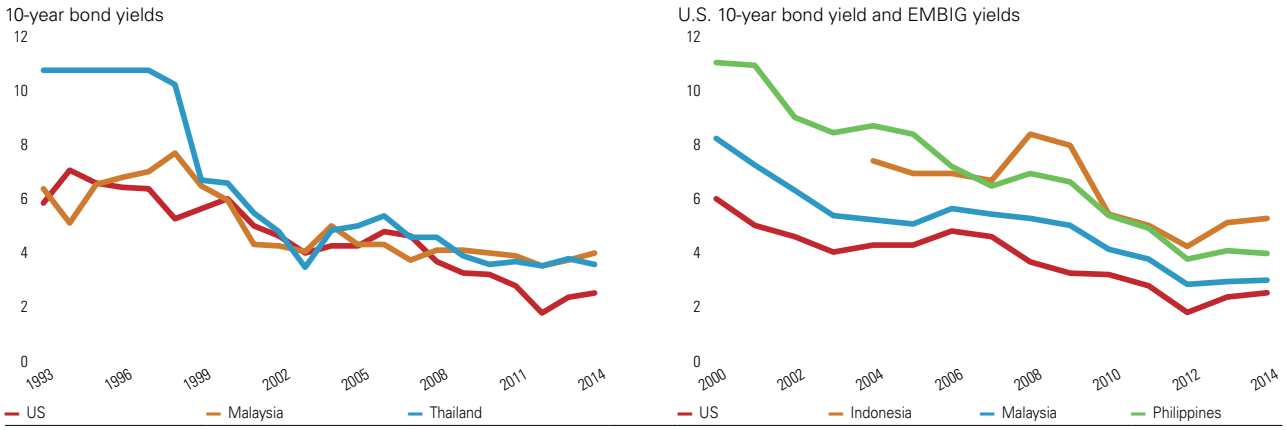
3 Notwithstanding the fact that for many large emerging markets in Asia and Latin America, owing to their stronger financial links with the United States, the U.S. rate has a dominant impact.

Box I.B.4. continued

already hardened U.S. bond yields and appreciation in the U.S. dollar. The actual increase in the U.S. policy rate thus may result in a more modest reallocation of portfolios this time around.[4] However, there remains uncertainty about the pace and extent of future changes.

Third, and critically, is the macroeconomic vulnerabilities of EAP countries, which have generally reduced in the period since the taper tantrum. In Indonesia, since mid-2013, the real effective exchange rate (REER) has been more competitive, official reserves have been significantly rebuilt, and the current account deficit has narrowed. The Philippines is running a current account surplus, and has not attracted fresh net portfolio inflows, although its REER has appreciated and there has been no fresh accumulation of reserves. The Malaysian real exchange rate has depreciated, portfolio liabilities have decreased, and even though hit by the steady decline in oil prices, it continues to run a current account surplus, albeit a smaller one, while the level of reserves has declined.

Figure I.B.4.4. U.S. federal funds rate and interest rates in EAP countries



Source:

For EAP countries, the biggest impact of lift-off is expected to be on the cost of debt financing (Figure I.B.4.4). U.S. bond yields are a key driver of bond yields in EAP, for both sovereign and private bonds, and for both domestic-currency-denominated and foreign-currency-denominated bonds. Empirical estimates suggest that every 100-basis-point increase in the benchmark 10-year U.S. bond yield is associated with a slightly larger, 106-to-144-basis-point increase in yields in EAP countries (Table I.B.4.1). That is, as U.S. interest rates increase, there is also an increase in the spread on EAP bonds.

4 Just as the impact of actual tapering events, when the U.S. Fed scaled back the pace of its securities purchases by US$10 billion each time starting in December 2013, was quite modest across emerging markets.

Box I.B.4. continued

Table I.B.4.1. Correlation between U.S. bond yield and East Asian financing costs

	(1)	(2)	(3)	(4)
	East Asian domestic currency bond yield	East Asian U.S. dollar bond yield	East Asian domestic currency bond yield	East Asian U.S. dollar bond yield
	Annual data		Monthly data	
U.S. bond yield	1.34***	1.44***	1.06***	1.33***
	[10.25]	[10.61]	[16.32]	[29.92]
Observations	86	41	724	507
Number of countries	4	3	4	3
Adj. R-squared	0.54	0.73	0.27	0.64

Note: Columns 1 and 3 show regressions of East Asian domestic-currency-denominated bond yields on U.S. bond yields. The data refer to 10-year government bond yields for the United States, Malaysia, the Philippines, and Thailand, and to 2-year government bond yields for Indonesia. Columns 2 and 4 show regressions of East Asian U.S.-dollar-denominated bond yields on U.S. bond yields. The data refer to the country-specific component of the EMBI Global index for Malaysia, Indonesia, and Thailand, and 10-year government bond yields for the United States. Data are not available for the Philippines. Regressions include country-specific intercepts.

Policy Responses

Countries have deployed a number of tools to respond to abrupt capital flow reversals and to tighter external financing conditions more generally. The response of EAP countries during the 2013 taper tantrum was typical in this regard, including intervening in currency markets to modulate the pace of depreciation, preventing overshooting and providing foreign exchange liquidity; raising interest rates to increase portfolio asset attractiveness to foreign investors and to stem carry trades against their currencies; and lowering cash reserve requirements or using other liquidity measures to ensure adequate local currency liquidity. Indonesia, being the most impacted EAP country, wielded a range of policy responses, which included raising policy rates, using foreign reserves to modulate the effect on exchange rate, and accepting exchange rate depreciation. Other EAP countries, owing to the smaller impact of the taper tantrum, required a milder response, consisting in most cases of using reserves to intervene in the foreign exchange market, and adjusting to some depreciation of their currency. Countries could wield a similar mix of policies in case of volatility emanating from U.S. interest rate increases.

The taper tantrum also prompted many countries to seek additional bilateral swap lines or to extend the coverage of existing ones. The Philippines extended a swap line with the Bank of Japan; Indonesia signed or extended multiple swap lines with China, the Republic of Korea, and Japan; and Malaysia extended a swap line with the Bank of Korea. In recent months, countries have explored and extended further swap lines to act as a backstop against lift-off liquidity problems. Such swap lines, whether bilateral with other central banks, or regional (such as under the Chiang Mai initiative or the proposed BRICS bank), do not offer a panacea from external volatility. Financial markets generally place a premium on scarce U.S. dollar swap lines; in particular, the credibility of some lines are considered uncertain until they are tested, and yet others often come with the rider that there has to be an IMF program in place before they can be drawn upon. Regional swap lines, such as under the Chiang Mai Initiative, have never been activated, and there is no evidence to show that they provide insulation to the signatories from the volatility emanating from international capital flows.

Beyond foreign exchange liquidity management considerations, EAP countries need to gear up to brace for the impact of the Fed lift-off on the cost of financing, both sovereign debt and private sector debt. While priorities differ across countries, this will generally require fiscal consolidation or continued fiscal prudence, as well as limiting further buildup of leverage by banks and corporates, and strengthening interest coverage ratios. Most fundamentally, more competition and productivity-enhancing reforms will be crucial

Box I.B.4. continued

as emerging market economies globally compete to attract scarcer investment funds. Enriching domestic financing sources, through efficiency gains in banking sectors where viable, and financial sector reforms to help channel domestic savings more effectively, can also help cushion the impact of lower global liquidity.

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I.C. Policy Considerations

Risks to global and regional growth, and to the external financing environment, demand a focus on sound macroeconomic management, and on mitigating external and fiscal vulnerabilities. This constrains the scope for countercyclical fiscal and monetary policy, particularly in commodity exporters. Exchange rate flexibility will help buffer shocks, but depreciations may also generate significant balance-sheet risks. Conversely, the economic uncertainties place a premium on deepening structural reforms, through the determined and consistent implementation of ambitious and clearly communicated policies to enhance long-term growth prospects. In the short term, this will also boost market confidence, thereby reducing financing constraints and vulnerability, creating additional room for macroeconomic stabilization, and enhancing the effectiveness of any policy response to shocks. This task is particularly urgent for those economies where domestic demand growth was highly leveraged, or where external demand was temporarily boosted by the commodities boom. In China, the key short-term policy challenge is to strengthen market discipline in the financial sector; over the medium term, the focus must be on continued structural reforms to support economic rebalancing and boost potential output.

Current uncertainties place an increased premium on prudent macroeconomic management, complemented by structural reforms

The financial turbulence in August is a reminder of the need for continued progress in ensuring sound macroeconomic management, shoring up financial vulnerabilities, and addressing persistent domestic impediments to more rapid, sustainable growth. The specific challenges and priorities differ across the heterogeneous economies of the region.

In China, the key short-term policy challenges are to reduce leverage in the economy and to continue rebalancing it toward consumption and services; this will likely decrease short-term growth, but will also reduce risks of an eventual sharp slowdown. Policies should aim to strengthen local government finances, through better alignment of local revenue with expenditure and improved management and oversight of local government borrowing. Reform should also continue to facilitate a reorientation from investment toward consumption, and from manufacturing and construction toward services. Overall, the process of deleveraging and rebalancing will be associated with slower but more sustainable growth than the credit- and investment-intensive boom observed after the global financial crisis. And some priority reforms can boost economic activity and growth even in the short term, including removing barriers to entry in restricted sectors, reducing administrative and regulatory burdens, and improving the allocation of land.

Across much of the region, and particularly although not only in commodity exporters, the room for policy manoeuver has shrunk; countries should prioritize monetary and fiscal policies that reduce vulnerabilities and strengthen policy credibility. In general, there is only limited room to adjust macroeconomic policies to further support growth. Given the expected external demand and financing conditions, fiscal or monetary

expansion could increase vulnerability to global financial tightening and volatility, and unduly reduce the policy buffers available to respond to future abrupt shocks.

The scope for more public spending to boost short-term growth is limited. In some cases, such as Indonesia, this reflects the already narrow revenue base and modest share of the fiscal sector in total spending. In others, such as Malaysia, government financing needs are already significant. More generally, a key fiscal challenge lies in increasing the ability to execute a high-quality capital expenditure program.

Policy rate reductions are also unlikely to prove beneficial, unless inflation prospects decrease even further. Monetary loosening could prove counterproductive if it led to capital outflows, the likelihood of which will grow once U.S. policy rates increase and interest rate differentials with the United States narrow.

Exchange rate flexibility will help buffer shocks, but depreciations may also generate significant balance-sheet risks. Some of the larger economies face significant unhedged foreign currency exposure. Meanwhile, a key benefit of depreciation—the anticipated export response—may continue to be hampered by supply constraints.

These constraints on macroeconomic policy, together with the current global and regional economic uncertainties, place a premium on deepening structural reforms, boosting confidence in overall economic management, and reducing political uncertainty. Determined and consistent implementation of an ambitious and clearly communicated structural reform agenda will enhance private investment and long-term growth prospects. In the short term, it will also boost market confidence, thereby reducing financing constraints and vulnerability, creating additional room for macroeconomic stabilization, and enhancing the effectiveness of any policy response to shocks.

Scope for fiscal expansion is generally limited, especially if market conditions were to deteriorate

The current risks demand prudent fiscal management, based on realistic assumptions and targets. Budgets for 2016 and beyond should rest on conservative assumptions regarding the outlook for growth compared with that in recent years. In cases where public revenues depend on natural resources, fiscal management should recognize that prices, although uncertain, do not appear likely to rebound substantially in the near term toward their previous highs. Adopting a prudent approach will help preserve fiscal space in the event that authorities need to act to cushion the social impact of severe external shocks, which remains a material risk (part I.B).

The scope for fiscal expansion to offset negative output shocks varies across countries; assuming relatively adverse circumstances, current fiscal settings would already place debt on a rising trajectory across most of the region, and particularly in Mongolia and Indonesia. Analyses of fiscal sustainability are inevitably tentative, reflecting their sensitivity to uncertain assumptions about growth and financial markets. Nevertheless, and assuming conditions comparable to the historical average, such analyses suggest that, in China and the Philippines, the structural fiscal stance has been consistently debt-reducing, after the normalization that followed the response to the 2008–09 global financial crisis (Figure I.C.1). Thailand's fiscal stance, having been broadly debt-reducing since 2010, has more recently moved toward being debt-neutral.

Indonesia's fiscal settings have gradually trended toward being somewhat debt-increasing, particularly since 2012. Fiscal settings in Vietnam and Mongolia deteriorated over 2010–12, placing public debt on a sharply rising trajectory, but this trend has more recently stabilized. Given the uncertain environment, fiscal sustainability also needs to be analyzed assuming relatively adverse circumstances, characterized by significant economic and financial stress. Under such conditions, current fiscal settings would increase debt to a high degree in Mongolia, to a significant degree in Indonesia, and to a lesser degree in all the other large regional economies (Figure I.C.2). Only in China is the current fiscal stance not significantly debt-increasing under stress conditions, indicating greater scope for a fiscal response to a sharp slowdown. That said, the analysis abstracts from factors that would warrant some caution, including local government debt dynamics.

Figure I.C.1. Estimated fiscal sustainability gaps under historical conditions vary

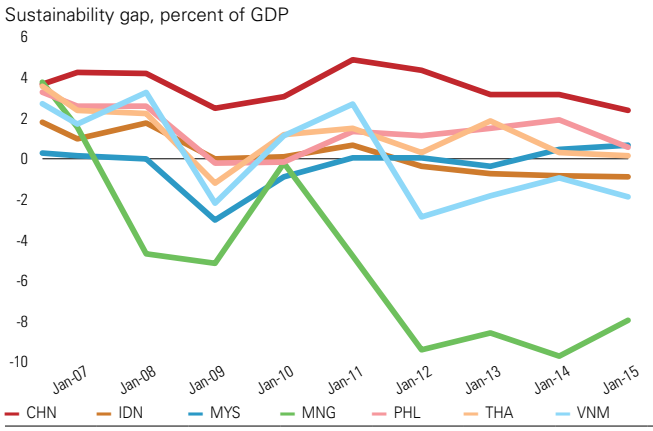
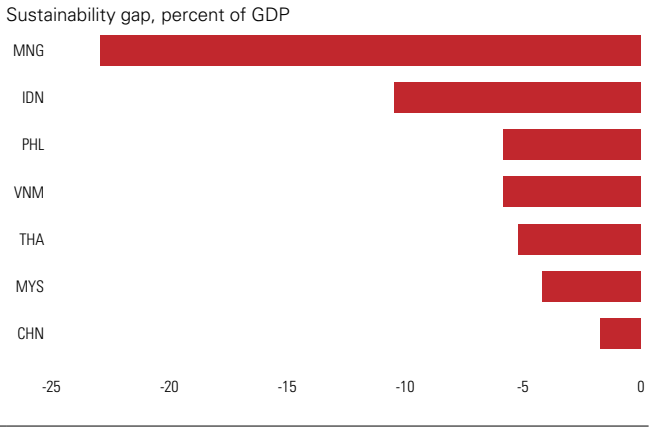


Figure I.C.2. Under stress conditions, the estimated fiscal sustainability gap is smallest in China



Source: World Bank.

Note: The sustainability gap is the difference between the primary balance and the estimated debt-stabilizing primary balance for central government debt; it reflects assumptions about country-specific growth rates and interest rates. "Historical conditions" denote country-specific averages during 1980–2014. "Stress conditions" set nominal GDP growth at the country-specific average during 1998–2014 minus 1 country-specific standard deviation, and the nominal interest rate at the country-specific average plus 1 standard deviation. A negative value indicates that the primary balance is central government debt-increasing, a value of zero that the balance holds debt constant, and a positive value that the balance is debt-reducing.

The recent deceleration in nominal GDP in some countries also suggests limited scope for discretionary fiscal expansion. Weak growth in nominal GDP (part I.A) makes it more challenging to achieve current fiscal deficit targets, even in the absence of additional, discretionary stimulus. For important revenue sources like the value-added tax (VAT), the tax base adjusts quickly in line with nominal GDP.[1] In contrast, expenditures can often only be adjusted with significant lags.

Taking steps to strengthen public revenues on a sustainable basis remains the major underlying fiscal challenge across much of the region. Weaker global commodity prices since 2011–12, especially for energy, have exposed the narrowness of Indonesia's revenue base. Well sequenced and coordinated tax policy and administrative measures are urgently needed to expand its tax and nontax public revenues. Malaysia remains heavily dependent on fiscal revenues from the oil and gas sectors, although the introduction of a general sales tax in April has helped diversify the revenue mix. Both countries, along with others, also need to build on recent progress in reforming energy-pricing policies, including untargeted fuel subsidies (see below). This will both enhance fiscal sustainability and create space for increased development spending and well-targeted social

1 For instance, in China, domestic VAT receipts in August fell by 4.7 percent yoy; in Indonesia, cumulative VAT receipts for the year through August fell by 3.2 percent yoy.

assistance. In the Philippines, reforms to boost tax revenues will support priority expenditure, including on infrastructure.

A number of the smaller regional economies require fiscal consolidation. Mongolia and Papua New Guinea, commodity exporters adjusting to a less favorable external environment, need to further strengthen public financial management to improve the efficiency of spending and their service delivery, and to secure public finances over the medium term. In Vietnam, implementation of fiscal consolidation plans, including shoring up state-owned enterprises and the finances of state-owned banks, remains essential in light of the previous buildup of fiscal and financial imbalances. In Cambodia and Lao PDR, the focus must be on continued fiscal prudence, and in particular on limiting growth in public consumption.

Countries should build on recent momentum to reform energy-pricing policies and their implementation

East Asia and Pacific (EAP) countries have already started tackling untargeted fuel price subsidies; continued low world fuel prices provide an opportunity to sustain the reform momentum with minimal impact on retail prices. Several countries have seized the opportunity to reform fuel subsidies, which weigh on the budget and external balances, distort resource allocation, and reduce space for spending on basic education, health, and infrastructure. At the end of 2014, Indonesia and Malaysia announced the decision to eliminate gasoline subsidies, and reduce (Indonesia) or eliminate (Malaysia) diesel subsidies.

There is scope for Indonesia to solidify these reforms. The Indonesian government has remained publicly committed to lower fuel subsidy spending, but the monthly adjustment of retail gasoline and diesel prices envisaged in the implementing regulations has not taken place. This risks undermining the credibility of the reform, and in particular raises concerns that fuel subsidies could reemerge over time. Consequently, Indonesia would benefit from improved implementation of the new retail gasoline- and diesel-pricing system, including through regular and transparent price adjustments. Indonesia could also strengthen its fiscal position by further reducing diesel subsidies, which are still significant (budgeted at 0.3 percent of GDP in 2015).

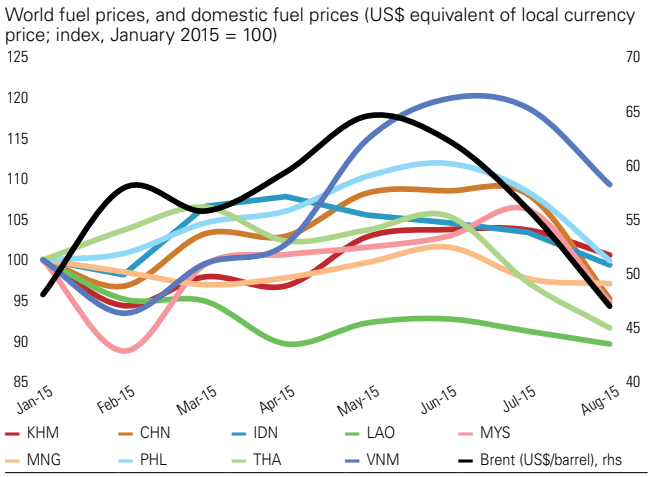
Liquefied petroleum gas (LPG) subsidies remain high in several countries in the region, and should be redirected. Indonesia subsidizes smaller (3 kilogram) LPG canisters at a cost of approximately 0.3 percent of GDP, an amount that, depending on price developments, may continue rising alongside volumetric demand. Thailand has raised LPG prices, except for supplies to poor households. In general, it is desirable to shift from price subsidies, which introduce market distortions and provide powerful incentives for commercial malpractice, toward social assistance targeted to the vulnerable.

Several countries have increased fuel taxes, and others where fuel taxes are currently low should also consider doing so. China increased consumption taxes on oil products in three rounds from November 2014 to January 2015. Mongolia increased customs taxes on petrol and diesel imports from 1 percent to 5 percent in January and lifted excise taxes to their legal limit, thus keeping retail prices broadly stable so far in 2015. Vietnam raised environmental taxes on fuels in May. Tonga, as part of its FY2016 budget, announced a sizable 12 percent increase in petroleum excise duties, the first for many years. Others could benefit from taking similar steps as part of a wider program to strengthen their revenue bases. So far, however, most fuel importers

are simply allowing lower world fuel prices to feed through into domestic fuel prices (Figure I.C.3). Indeed, in the Philippines, the fuel excise tax has been fixed in nominal terms since 1997.

Lower global energy prices also make this an opportune time to move toward greater cost recovery in electricity in some countries. Indonesia has in recent years moved to more market-based electricity pricing, but its subsidies still amount to approximately 0.6 percent of GDP. Electricity subsidies are also a significant drain on public revenues elsewhere in the region, reflecting both subsidies to utilities (Thailand, Timor Leste, and some of the smaller Pacific Island Countries) and the accumulation of contingent liabilities from public utilities (Vietnam).

Figure I.C.3. Most fuel importers are allowing lower world fuel prices to feed through into domestic fuel prices



Sources: CEIC; Haver Analytics; national sources.

Note: Data refer to the retail prices of gasoline in Cambodia, gasoline 93 in China, RON88 gasoline in Indonesia, gasoline/petrol in Lao PDR, RON95 gasoline in Malaysia, Ai-92,93 in Mongolia, RON95 Premium Gasoline in the Philippines, Gasohol 95 E20 in Thailand, and Gasoline A92 in Vietnam.

Monetary policy should remain moderately accommodative across much of the region, but scope for further easing is constrained

Monetary authorities in the major regional economies may appropriately maintain their current, moderately accommodative stance. Inflation pressures remain contained and the balance of inflation risks is tilted to the downside. Also, real policy rate estimates broadly indicate that the current monetary stance in the larger economies is only moderately loose (part I.A). But should adverse food-price shocks transpire from El Niño (Box I.B.2), the authorities will need to evaluate whether any tightening is required to mitigate the risk of persistent effects.

Scope for further monetary easing is in many cases constrained by the need to safeguard financial stability. Risks from any renewed buildup of corporate and household leverage (in particular, in Malaysia and Thailand) must be minimized. Should the risks to external financing materialize, especially in the context of the normalization of U.S. monetary policy, interest rates may need to increase to reduce currency depreciation pressures. This will hold particularly in countries where there is significant foreign portfolio investment in domestic interest-bearing assets, and there are concerns about the balance-sheet effects of sizable depreciations (see below). The effectiveness of any such measures will, however, depend on the credibility of monetary policy.

Among the smaller economies, monetary policy in Papua New Guinea needs to tighten and absorb excess liquidity. Expansionary fiscal policy is already supporting output; and monetary contraction will help reduce exchange rate pressures.

Exchange rate flexibility will help buffer shocks, but currency mismatches may cause balance-sheet strains

For commodity exporters, such as Indonesia and Malaysia, lower real trade-weighted exchange rates can play an important part in adjusting to weaker terms of trade. The depreciations of the Indonesian rupiah and Malaysian ringgit against the U.S. dollar have reduced the drop in exporter revenues, corporate profits, and household incomes in local currency terms—a valuable shock-absorbing effect. The rise in the local currency cost of U.S.-dollar-denominated imports can play a continued, constructive role in facilitating adjustments to weaker terms of trade, by encouraging consumers to substitute toward domestic products. More generally, authorities should limit currency market interventions to smoothing volatility, given the importance of maintaining adequate reserve buffers. Other interventions may also prove costly if they impede currency market liquidity and price discovery, reducing financial market confidence in timely international convertibility.

Where exchange rates are fixed, authorities should in general stabilize currency values in real effective terms, rather than focusing on the nominal bilateral U.S. dollar exchange rate. U.S. dollar strength since mid-2014 has been global in nature, and floating currencies in EAP have tended to fall against the U.S. dollar but not against other global reserve currencies, notably the yen and euro, or relative to peer economies in the region or other emerging market economies (part I.A). These shifts raise the risk of fixed exchange rates against the U.S. dollar causing real overvaluations and a buildup of economic imbalances. In Lao PDR, the kip has appreciated in real effective terms, and reserve coverage is low by most metrics. In Myanmar, the kyat had earlier appreciated sharply on a trade-weighted basis. This has been accompanied by a growing current account deficit, low capital inflows, and low reserves in terms of import cover, while administrative measures to control foreign exchange transactions had fueled market concerns. In Papua New Guinea, indications are that importers are experiencing delays in accessing foreign exchange. Given these developments, Myanmar and Papua New Guinea would likely benefit from greater exchange rate flexibility.

Recent depreciations have eased concerns about a trend loss in competitiveness, but many underlying supply constraints can be tackled only through structural reforms. Most countries experienced significant real effective appreciation from mid-2014 through mid-2015, reflecting limited bilateral depreciations against the globally strengthening U.S. dollar (part I.A). Continued currency adjustments in recent months have partially offset this trend. However, across much of the region, currency depreciation appears to have only a limited impact on trade volumes. Correcting this requires tackling key supply constraints, including inadequate infrastructure (the Philippines), and a weak investment climate, deterring entry into new sectors and in particular diversification from commodities into manufactures (Indonesia). Put differently, appropriate exchange rate policies complement rather than substitute for structural reforms. In a similar vein, highly dollarized economies and sectors may face competitiveness challenges that increase the urgency of appropriate structural reforms. Cambodia's tourist sector, for example, is experiencing serious headwinds as U.S.-dollar-denominated prices rise in terms of potential visitors' currencies.

Should risks to external growth and financing materialize, exchange rate flexibility will help buffer the shock and alleviate short-term real and financial stress. In general, international reserves should only be used to smooth very short-term market pressures. But depreciations are, again, relatively more likely to prove beneficial in a context of credible macroeconomic policies and favorable investment climates.

However, in countries with significant U.S.-dollar-denominated debt, further depreciations against the U.S. dollar could cause balance-sheet strains. Depreciation raises the cost of servicing foreign-currency-denominated debt. This may pressure balance sheets, particularly where income is not also denominated in foreign currency. Stress may arise whenever individual firms and sectors suffer from a significant concentration of liabilities, even if aggregate net foreign liabilities are low. Such risks are a special concern in Indonesia, Malaysia, Thailand, and Vietnam (part I.B), and must be carefully monitored. They may merit adopting policy settings consistent with a stronger exchange rate than suggested by considerations of trade competitiveness alone. At the same time, authorities should take into account that orderly depreciations generate appropriate incentives to hedge and reduce excessive external leverage, and avoid the severe damage to balance sheets that can be caused by abrupt, large exchange rate changes.

Over the medium term, the focus must be on boosting potential output, including by addressing key investment needs, re-evaluating fiscal incentives, reforming agricultural policies, and promoting further regional integration

In China, continued structural reforms will be required to support rapid, sustainable growth. The aim must be to improve the allocation of credit, facilitate resource reallocation from sectors with excess capacity to those with high growth potential, and encourage the expansion of more productive firms. Key policy steps would include strengthening market discipline in the financial sector and allowing inefficient firms, including state-owned enterprises, to exit. In this respect, the implementation of the recently released plan for state-owned enterprise reform will be critical. In some cases this will require a careful balancing between enhancing market discipline and avoiding disruptions to the labor market. In the long term, ad-hoc administrative measures in the financial sector must be gradually replaced by a market-based mechanism where interest rates clear the credit market and allocate capital.

Elsewhere in developing East Asia, there are three priority areas for medium-term reforms.

First, critical investment needs must be addressed. In several countries, **regulatory reforms are urgently needed to ignite investment**. In Indonesia, the recently announced policy package recognizes the need to reduce red tape and regulatory uncertainty; its effective implementation will prove critical to the growth outlook (part I.B). The Philippines also needs to induce more private investment, including foreign direct investment, by addressing its weak investment climate and costly business regulations.

Relatedly, reforms are required to boost the region's modest level of private infrastructure investment. Regional annual infrastructure investment demand may be conservatively estimated at US$212 billion (3.7 percent of GDP), comprising both new projects and the maintenance of existing assets. This translates into an infrastructure gap of US$52 billion per year. Public-private partnerships (PPPs) can help fill in this gap, if key obstacles are removed (Box I.C.1). A more supportive environment for the private sector must be built by developing enabling institutions, policies, and regulations. New PPP models should be adopted more widely and, for transport PPPs, means must be found to manage land acquisition challenges and demand risk. In upper-middle-income countries with a track record of successful transactions, a key challenge lies in diversifying the predominantly domestic investor base.

The region also needs to reexamine the use of fiscal incentives for investment. Several key points stand out (part II.A). Tax incentives complement rather than substitute for broader investment climate reforms. The cost of tax incentives, including the extent to which they subsidize investments that would have occurred in any case, must be carefully considered; put differently, tax expenditures need to be carefully weighed against their benefits. Discretionary tax incentives are particularly prone to abuse. And a regional approach, for instance through ASEAN, can help avoid harmful tax competition.

Second, the focus of agricultural policies needs to change. Regional food policy has traditionally centered on food security, typically defined narrowly in terms of national self-sufficiency and price stability in rice. However, as the region becomes more affluent and urbanized, the structure of food demand and production is seeing significant shifts, including from direct to indirect consumption of cereals, via increased consumption of animal products and, relatedly, increased imports of animal feed. This requires a broader, multisectoral food policy, and a flexible recasting of the concept of food security (part II.B). In particular, increased interdependence across countries places a premium on trade liberalization, trade facilitation, and logistics. Greater emphasis also needs to be placed on nutritional outcomes, food safety, and environmental risks.

Third, regional integration needs to be deepened. In December 2015, the ASEAN Economic Community (AEC) will be formally established. The associated regional integration process has already had several important beneficial effects: ASEAN tariffs have been significantly reduced, regional trade has been facilitated, trade in services has been liberalized, and foreign direct investment has been boosted (Box I.C.2). There are large potential gains from fully implementing and extending the AEC integration program. However, realizing these gains will require ASEAN to address several new challenges, including reversing the rising use of nontariff measures, accelerating services integration, and promoting regulatory cooperation.

Box I.C.1. Public-Private Partnerships in Infrastructure in East Asia and Pacific [1]

The significant benefits of public private partnerships (PPPs) in infrastructure are well recognized among practitioners.[2] Under the right circumstances, PPPs can draw on skills, information, and resources from both the public and private sector. This improves project prioritization and implementation, enhances the management of infrastructure services, increases incentives to carry out regular maintenance, increases innovation, and ultimately boosts efficiency (IMF 2004; PPIAF 2014). PPPs can also help identify, manage, and share risks. In addition, private sector participation can mobilize additional financing for infrastructure, reducing government borrowing and gross debt; and boost transparency.

PPPs can help fill in developing East Asia and Pacific's (EAP's) significant infrastructure gap, provided key obstacles are removed. Government budgets, traditionally the major source of infrastructure financing, are insufficient to finance the region's large infrastructure needs. PPPs can play a key role in boosting investment volumes and quality. Yet the volume of private participation in financing infrastructure in EAP remains relatively modest. This box discusses recent trends, challenges, and opportunities for infrastructure PPPs in EAP.

Infrastructure Investment Demands and Gaps

The demand for infrastructure in developing EAP is rising with the rapid pace of economic growth and urbanization. During 1990–2013, EAP experienced the fastest growth (8.5 percent per year on average) and the most rapid urbanization among all developing regions (Table I.C.1.1). Infrastructure investment is needed to keep pace with these changes.

Table I.C.1.1. Economic growth and urbanization by region

Region	GDP per capita, PPP (current int'l $)	Average GDP growth (1990–2013, %)	Urbanization rate (1990)	Urbanization rate (2000)	Urbanization rate (2013)	Changes in urban. rate (1990–2013)	Average urban growth rate (%)
EAP	10,795	8.5	28.2	36.6	50.9	22.8	3.6
ECA	13,966	2.4	56.8	57.5	60.1	3.3	0.7
LAC	14,517	3.1	69.9	74.9	79.0	9.0	2.0
MNA	11,850	3.8	51.7	55.5	60.1	8.4	2.5
SAS	5,036	6.1	25.0	27.4	32.2	7.1	2.8
SSA	3,429	3.6	27.0	30.7	36.7	9.7	4.1
WLD	14,402	2.7	42.9	46.6	53.0	10.1	2.2

Source: World Bank 2015.

Note: Regional aggregates include developing countries only. Urbanization rate refers to the percentage of the total population living in urban areas. Urban growth refers to the increase in the number of people living in urban areas.

Upgrading and expanding infrastructure is essential for developing EAP economies to remain competitive in global markets and, relatedly, to promote its economic integration. Infrastructure has a significant impact on growth, poverty alleviation, equality, job creation, market access, health, and education (Calderón and Servén 2004, 2008, 2010; Straub 2008). Reflecting this, ASEAN has been working on increasing connectivity and regional integration through better infrastructure.

While access to infrastructure services has increased significantly, more infrastructure investment is required to extend services, especially to people living in rural areas and the poor. Access to electricity,

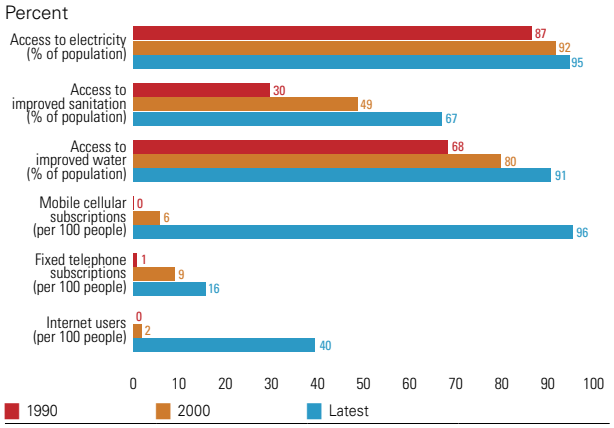
1 Prepared by Yumeka Hirano, Alexander Nicholas Jett, and Fernanda Ruiz-Nuñez.

2 See *Public-Private-Partnerships Reference Guide* (World Bank, ADB, and IDB 2014) for an overview of the range of features, modalities, and frameworks of PPPs.

Box I.C.1. continued

improved sanitation, and water has increased significantly over time (Figure I.C.1.1). However, 102 million people still lack access to electricity, and 659 million people lack access to improved sanitation. Further, there remains a significant rural-urban gap.[3]

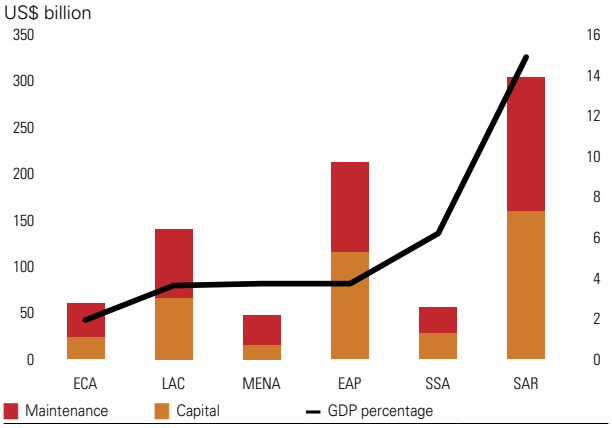
Figure I.C.1.1. Access to infrastructure services



Source: World Bank 2015.

Note: The latest available year is as follows: electricity, 2010; sanitation and water, 2012; mobile cellular, fixed telephone, and internet, 2013.

Figure I.C.1.2. Total annual infrastructure investment and maintenance requirements, by region, 2014–20 (at 2011 prices)



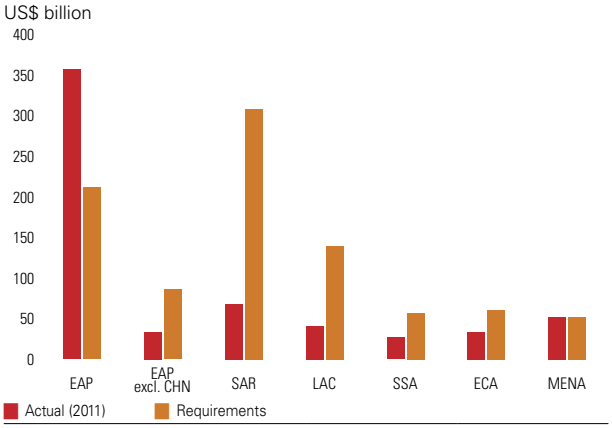
Source: Ruiz-Nuñez and Wei 2015.

Note: GDP percentage is calculated based on the projected GDP (2015) by income level and by region. Income level and regions are defined according to the World Bank's *World Development Indicators Report*.

As a result, EAP has very large infrastructure requirements, both for new projects and to maintain existing assets. The region's annual infrastructure investment demand between 2014 and 2020 is estimated at US$ 212 billion, or 3.7 percent of GDP (Figure I.C.1.2).[4] The maintenance cost of existing infrastructure comprises 45 percent of this amount. The only developing region with higher infrastructure requirements is South Asia.

Excluding China, developing EAP faces a significant infrastructure gap. China has been investing significantly in infrastructure. Excluding China, estimated investment requirements amount to US$87 billion per year during 2014–20, compared to actual spending of US$35 billion in 2011 (Figure I.C.1.3). Thus, the infrastructure gap exceeds US$50 billion per year.

Figure I.C.1.3. Infrastructure investment and maintenance, actual compared to requirements



Source: Ruiz-Nuñez and Wei 2015.

Note: EAP here includes Cambodia, China, Fiji, Indonesia, Lao PDR, Malaysia, Mongolia, Papua New Guinea, the Philippines, Thailand, and Vietnam. Owing to limited data, other EAP countries are excluded.

3 For instance, only 58 percent of the rural population has access to sanitation compared to 76 percent of the urban population.

4 "Infrastructure investment demand" refers to the amount needed to satisfy consumer and producer demand, based on predicted GDP growth and other growth trends. Owing to data limitations and the need to maintain comparability across regions, these estimates are a lower bound. In particular, they do not include the cost of upgrading and rehabilitating existing infrastructure in bad conditions (except for roads where the regional percentage of roads in bad condition is used). Moreover, the estimates do not include sectors such as airports, urban transport, energy transmission, and solid waste management. Bhattacharyayy (2010) estimates an upper bound for infrastructure investment demand in EAP of US$498 billion per year between 2010 and 2020, based on extrapolations from the data available for only a few countries.

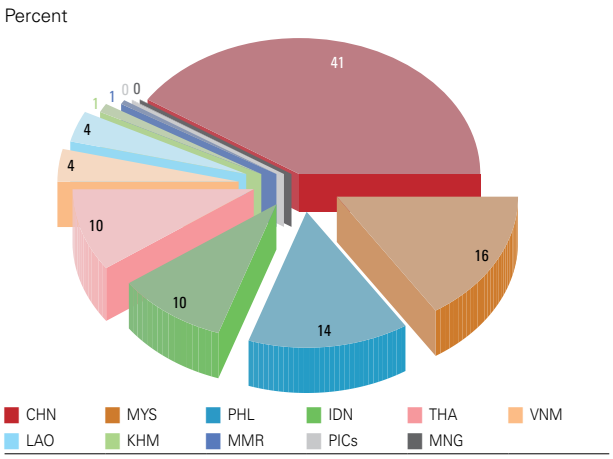
Box I.C.1. continued

Government financing alone may not be sufficient to meet these infrastructure investment demands. Most developing EAP countries need to more than double their current spending. Financing this infrastructure gap is a clear challenge.

Recent Progress and Trends in PPPs[5]

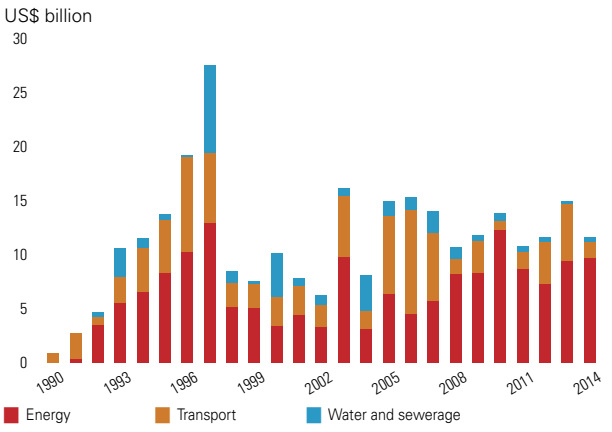
The private sector has already played some role in infrastructure PPPs in EAP. During 1990–2014, EAP attracted US$285 billion in infrastructure investment with private sector participation. In 2014, this investment amounted to US$11.5 billion, or 3 percent of total infrastructure spending.[6] China has traditionally accounted for a large share of the region's PPPs (Figure I.C.1.4). There has also been significant growth in PPPs in Malaysia and the Philippines.

Figure I.C.1.4. Share of total investment of infrastructure projects with private participation, by country, 1990–2014



Source: PPIAF 2015.

Figure I.C.1.5. Investment in infrastructure projects with private participation in EAP, by sector, 1990–2014



Sources: PPIAF 2015; World Bank 2015.

In recent years, the energy sector has accounted for the bulk of the region's infrastructure PPPs. In 2014, energy PPPs accounted for 85 percent of total PPPs (Figure I.C.1.5). Overall, during 1990–2014, the energy sector dominated in low- and lower-middle income countries. China saw relatively large investment in transport (49 percent of its total). Malaysia had a balanced mix between energy (40 percent of its total), transport (38 percent), and water and sewerage (22 percent).

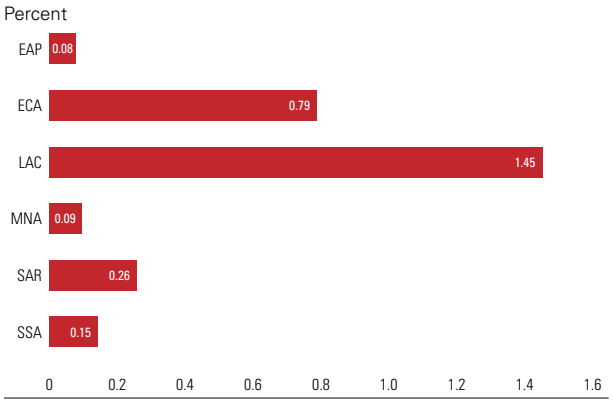
The EAP has seen relatively little infrastructure investment with private participation compared with other regions, after controlling for the size of the economy. EAP accounts for 10 percent of global infrastructure investment compared to 13 percent for Europe and Central Asia (ECA) and 65 percent for Latin America and the Caribbean (LAC). However, PPP investment in 2014 amounted to only 0.08 percent of GDP in EAP compared to 1.45 percent in LAC and 0.79 percent in ECA (Figure I.C.1.6).

5 All data on PPP are drawn from the World Bank's Private Participation in Infrastructure Database (PPI Database) (http://ppi.worldbank.org). The data exclude telecommunications; data for 2014 are preliminary.

6 Based on an estimated total spending on infrastructure in EAP of US$356 billion in 2011 U.S. dollars (Ruiz- Nuñez and Wei 2015).

Box I.C.1. continued

Figure I.C.1.6. Investment in infrastructure projects with private participation as percentage of GDP (2014)



Sources: PPIAF 2015; World Bank 2015.

Figure I.C.1.7. Average investment per project (1990–2014)

Source: PPIAF 2015.

The average PPP project size in EAP is about half the global average (Figure I.C.1.7). Larger infrastructure PPPs are more difficult to structure and manage, and the region has relatively limited capacity to handle them.

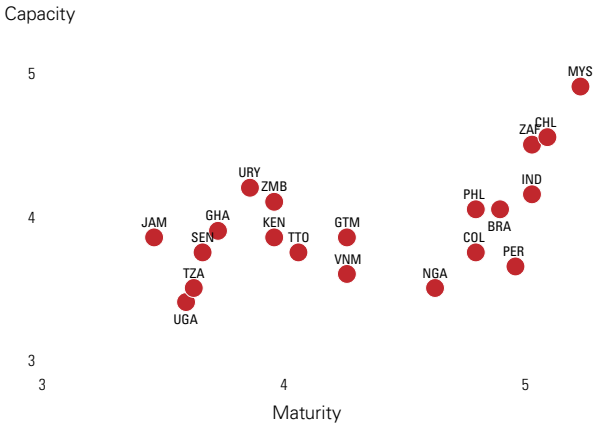
Challenges and Opportunities for Enhancing PPPs

Building a more supportive environment for the private sector is critical to promoting PPPs. "Enabling" institutions, policies, and regulations are critical to private infrastructure investment. In particular, private participation in infrastructure is highly sensitive to key measures of governance, such as corruption, the rule of law, and the quality of regulations (Moszoro et al. 2014). In several EAP countries, PPPs are limited by two key factors: (1) the market's low "maturity," defined in terms of the overall macroeconomic environment, the degree of financial development, and market size; and (2) low government "capacity" to prepare, procure, and manage PPPs (Figure I.C.1.8). Illustrating the importance of institutional capacity, when the Public-Private Partnership (PPP) Center of the Philippines improved its procurement process, a credible pipeline was rapidly developed, and 10 projects were quickly awarded.

Not just traditional PPP models, but also new PPP models, should be adopted more widely within EAP. Indonesia, for example, has supported a build-operate-transfer model, which allows for public sector grants to ensure the viability of the project. In addition, the Indonesia Infrastructure Guarantee Fund covers risk events caused by the contracting agency, including delays in obtaining licenses, changes in regulation, and lack of tariff adjustment. Also popular in Indonesia are "business-to-business" arrangements that involve a contract for private provision of infrastructure services between a state-owned enterprise (SOE) and a private enterprise. In China, SOEs act as the private partner in a PPP, and play a significant role in infrastructure development. Brazil has a similar framework in which SOEs in the water sector can bid for municipal water contracts and compete with the private sector. One challenge is to ensure that these models preserve competition and do not give an advantage to a particular SOE, particularly if the project lies within its territory.

Box I.C.1. continued

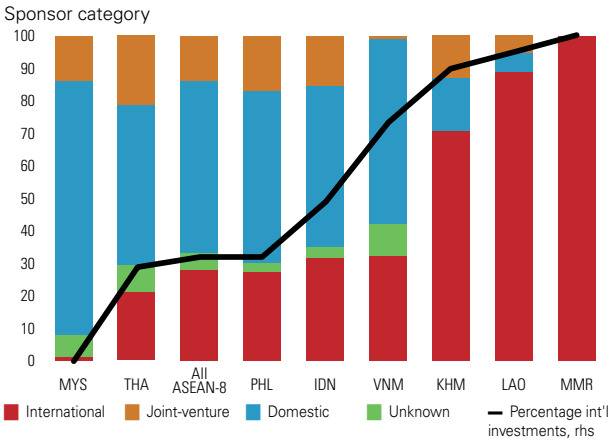
Figure I.C.1.8. Country scores on market maturity and institutional capacity



Source: PPIAF 2014.

Note: Data are based on the Global Competitiveness Index. "Maturity" denotes the average score on macroeconomic environment, financial market development, and market size. "Capacity" denotes the average score on institutions and on business sophistication.

Figure I.C.1.9. Origin of sponsors of ASEAN PPI projects, 1990–2012



Source: World Bank 2014.

Box I.C.1.1. Case Study: The Manila Light Rail Transit System Line 1 Extension Project[a]

The US$1.44 billion PPP project involves building an 11.7-kilometer line from the end of the light rail in Baclaran toward Cavite and integrating it with the current line, thereby increasing average weekday passenger-handling capacity from 560,000 to 820,000 passengers.

The project was structured as a 32-year build, transfer, and operate scheme, and the contract was signed in October 2014, by the Light Rail Manila Corp. (LRMC), which is owned by Metro Pacific Investment Corp. (55 percent), Ayala Corp. (35 percent), and Macquarie Infrastructure Holdings Philippines (10 percent).

LRMC officially began operating LRTA Line 1 on September 12, 2015. LRMC is responsible for building the extension and for operation and maintenance of the entire line. In return, the government is providing 32 new train sets. LRMC was also given the right to commercially explore opportunities within the line (including depots and stations) for the period of the concession, as long as they did not impede efficient passenger movement. This structure took advantage of the commercial demand for urban space and attracted financing from local conglomerates and traditional infrastructure investors.

Sources: **a.** Maria Lourdes S. Baclagon, Transaction Advisor, International Finance Corporation; IFC 2015; and PPP Center of the Philippines 2015.

Transport PPPs face particular challenges, but recent urban PPPs in EAP demonstrate that investors will take risks under the right conditions. Land acquisition challenges and demand risk have been a major constraint to successful transport PPPs. Managing such issues will be crucial to implementing the Master Plan for ASEAN Connectivity. In some cases, additional revenue sources can be tapped to ensure the project remains viable even in the face of uncertain demand. For instance, the private sector can be granted the right to commercially develop the land in urban settings (see case study in Box I.C.1.1).

Box I.C.1. continued

Upper-middle-income ASEAN countries have a strong domestic investor base, but will need to diversify it to expand PPPs. Upper-middle-income countries have allowed domestic sponsors to dominate the PPP market (Figure I.C.1.9).[7] As a result, they face the challenge that existing PPP sponsors are starting to face single-borrower limits from banks.

Going Forward

Improving government capacity and institutional quality will be critical to increasing EAP's relatively low level of infrastructure PPPs. PPPs have increased steadily over time, but there is much scope for further increases, and for scaling up new PPP forms. Most PPPs have been concentrated in the energy sector, but transport PPPs could expand if key sectoral obstacles are tackled. In upper-middle-income countries with a track record of successful transactions, a key challenges lies in diversifying the investor base.

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7 For instance, Malaysian domestic firms have a strong track record of winning domestic contracts, and only occasionally enter into joint ventures with foreign firms. In the Philippines and Thailand, international sponsors have won only about a third of contracts. Conversely, in Cambodia and Lao PDR, international sponsors account for 90 percent and 95 percent of contracts, respectively.

Box I.C.2. ASEAN Economic Community 2015: What Has Been Achieved and What Is Next?[1]

In December 2015, the 10 countries of the Association of Southeast Asian Nations (ASEAN) will formally establish the ASEAN Economic Community (AEC). According to the AEC Blueprint of 2007 signed by all the heads of government, the aim is to establish a "single market and production base" with a free flow of goods, services, investment, skilled labor, and freer flow of capital. The AEC's regional integration goals are being implemented by treaties such as the ASEAN Trade in Goods Agreement, the ASEAN Framework Agreement on Services, and the ASEAN Comprehensive Investment Agreement. The Chairman's statement of the recently concluded ASEAN Economic Ministers' meeting notes that over 90 percent of the priority measures set out in the Blueprint have been implemented.[2] But while the launching of the AEC in December 2015 will be a key milestone in regional integration, much remains to be done. In fact, a new AEC 2025 Blueprint is expected to be announced, laying out the regional integration agenda for 2015–25. Laying out such an agenda will prove useful; not only does the pending regional integration agenda remain substantial, but new challenges also need to be addressed.

With an aggregate GDP of over US$2.5 trillion, and over 620 million people, the AEC will become the sixth-largest economic entity in the world. It will also be of one of the most resilient and dynamic; since 2007, just before the start of the global financial crisis, the average nominal per capita income of ASEAN countries has nearly doubled to US$4,130 in 2014; exports have increased by 50 percent, to US$1.3 trillion; and total foreign direct investment (FDI) inflows and intra-ASEAN FDI flows have more than doubled to, respectively, US$136 billion and US$24 billion. The region's overall favorable demographics, rapidly growing middle class, and high savings rates of close to 30 percent of GDP suggest a promising future.

Figure I.C.2.1. ASEAN preferential tariffs have been slashed

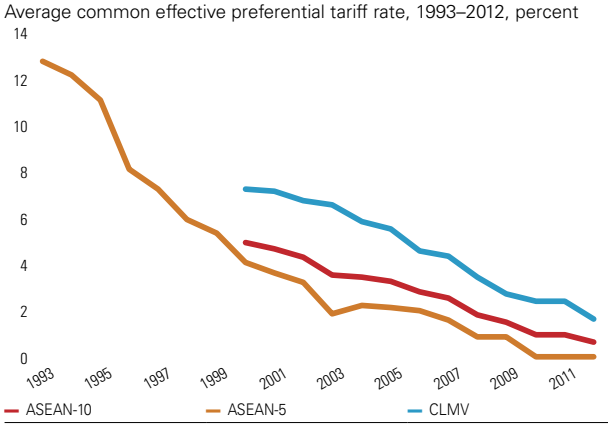
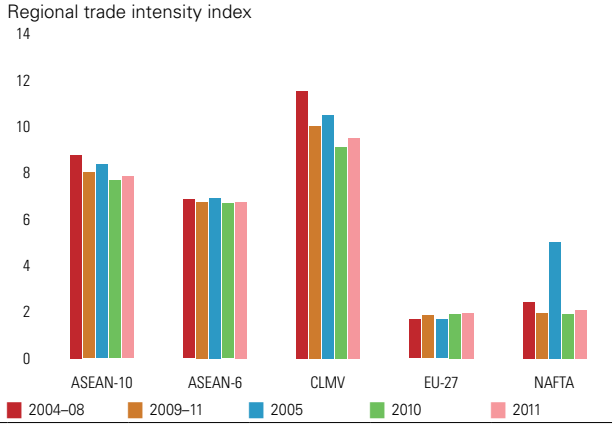


Figure I.C.2.2. ASEAN trade integration is high



Source: Estimates from COMTRADE.
Note: Regional trade intensity is defined as the ratio of (a) the share of intraregional trade in that region's trade; to (b) the share of that region in the rest of the world's trade.

The AEC's regional integration process has already had several important beneficial effects. First, **ASEAN tariffs on regional trade have been virtually eliminated** (to less than 1 percent on average; Figure I.C.2.1), **and tariffs on trade with other countries have been reduced**. As a result, trade has expanded rapidly both intra-ASEAN and with the rest of the world. Intra-ASEAN trade accounts for a significant 25 percent of total

1 Prepared by Ahmad Ahsan.

2 Joint Media Statement of the 47th ASEAN Economic Ministers' Meetings, Kuala Lumpur, August 22, 2015.

Box I.C.2. continued

ASEAN trade, and ASEAN is highly integrated compared to other regional organizations such as the European Union or the North American Free Trade Agreement (Figure I.C.2.2).

Second, **regional trade has been facilitated** by setting up the ASEAN Trade Repository, national "single windows," and customs transit systems, all aimed at providing key information, and simplifying and facilitating trade and investment transactions. ASEAN's regional trade costs have fallen by more than 15 percent on average, and by about 8 percent with the rest of the world (ASEAN and World Bank 2013).

Third, **trade in services has been liberalized, and FDI has been boosted**. The commitments made by ASEAN countries to liberalize services trade now exceed commitments made under the WTO Doha Round. And ASEAN integration has helped to increase FDI inflows (from US$30 billion in 2003, when the goal of forming the AEC was announced, to US$136 billion in 2014). Within the ASEAN region, FDI flows have also increased markedly (from US$4 billion in 2003 to US$24 billion in 2014).

The integration process has helped stimulate the development in particular of the lower-income ASEAN countries of Cambodia, Lao PDR, Myanmar, and Vietnam (CLMV). Indeed, the CLMV countries have reaped the largest income gains from ASEAN's regional integration (ADB and ILO 2014). This reflects these countries' high degree of trade complementarity with the rest of ASEAN, and the rapid increase in their FDI inflows from ASEAN, to one-quarter of all FDI (US$3.6 billion). Partly reflecting this, the share of CLMV countries in ASEAN's GDP has increased from around 3.5 percent in 1990 to over 10 percent in 2014.

ASEAN's regional integration goals are ever more relevant: research suggests large potential gains from fully implementing and extending the AEC integration program. In a context of slow world trade growth, ASEAN economies can no longer rely on exports to advanced economies, and must instead search for new demand in regional markets. On the supply side, the freer flow of investment, technology, and services across the region will boost productivity through better resource allocation. In particular, implementing the AEC could lead by 2025 to an increase in GDP of 7.1 percent compared to the baseline, with the largest gains for lower-income ASEAN Member States (ADB and ILO 2014; ASEAN and World Bank 2013, 2015).

Likewise, employment in the six ASEAN economies of Cambodia, Indonesia, Lao PDR, the Philippines, Thailand, and Vietnam would increase by 14 million, or 2 percent (Indonesia) to 10 percent (Cambodia) of the labor force. The potential gains from facilitating regional cross-border capital flows, and pooling regional savings to finance investment, including in infrastructure, are particularly large. Further, integration through the AEC will provide the central platform for the larger economic integration being discussed among ASEAN, China, Japan, and the Republic of Korea (ASEAN + 3), and also with Australia, India, and New Zealand (ASEAN + 6, or the "Regional Comprehensive Economic Partnership").

However, realizing these gains will require ASEAN to address the pending reform agenda, and in particular four new challenges. First is **reversing the rising use of nontariff measures** in a range of sectors (Figure I.C.2.3) and through a variety of measures (Figure I.C.2.4).

Second is **accelerating services integration**. While nine rounds of negotiations have yielded significant commitments to integrate services, implementation has lagged. ASEAN countries suffer from the most restrictive policies on services trade outside the Gulf countries, and do not yet offer any preferential access to each other in services trade (ASEAN and World Bank 2015). Regional services trade remains low given the economic size, complementarity, and geographic proximity of ASEAN countries.

Box I.C.2. continued

Figure I.C.2.3. Nontariff measures in ASEAN by industry—officially notified

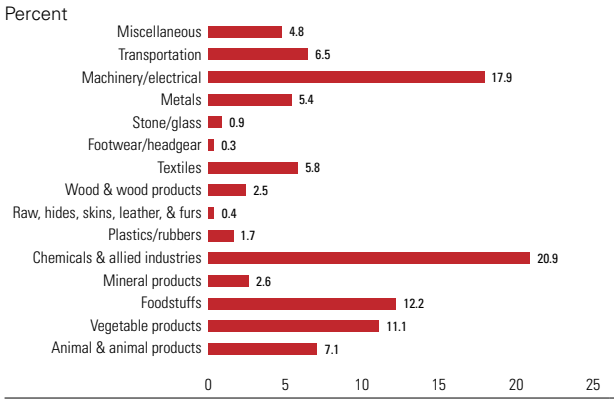
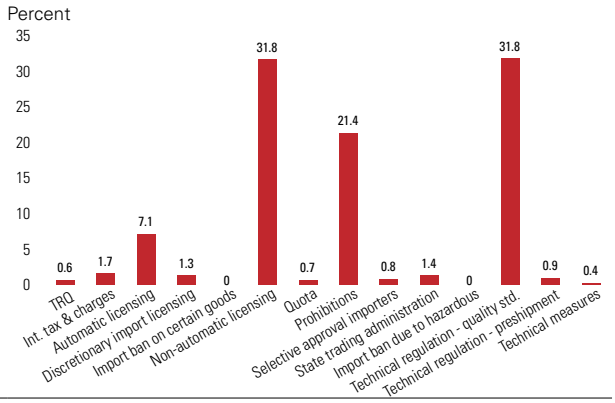


Figure I.C.2.4. Nontariff measures by types of measures



Source: ASEAN Secretariat and World Bank, *ASEAN Integration Monitoring Report*, 2013.

Third is **promoting regulatory cooperation among ASEAN countries**. Progress in the first two areas will hinge on significant regulatory reforms and cooperation across ASEAN countries. Regulations are key policy tools affecting nontariff barriers and services integration, and their reform will need careful review and coordination. Many regulations, establishing minimum standards and quality of goods and services that can be supplied by domestic or foreign producers, may be justified in order to address crucial market failures and policy goals. This applies particularly to pharmaceuticals and the medical and engineering sectors. Other regulations may be well-meaning but have unintended harmful consequences. Yet other regulations directly serve vested interests that want to protect their market power.

The high degree of unevenness in regulatory quality across ASEAN[3] makes regulatory reform more difficult, but also increases its potential benefits. Regulatory cooperation can start by establishing commonly accepted principles of good regulation, such as transparency, consultation (both public and interagency), due process, and efficiency, leading to eventual mutual recognition of licenses and authorizations. In addition, more detailed regulatory principles could be developed on a sectoral basis, in particular for heavily regulated services. This process would follow the steps already taken for some services, such as air transport and some financial services.

Finally, **the integration process needs to be broadened and deepened**. The AEC was a bold vision of the leaders of the 10 ASEAN Member States, but outreach to the larger population has been lacking. As a result, the AEC has become a top-down process facing considerable domestic opposition. Despite evidence to the contrary, there are significant concerns about its alleged negative impact on less advanced economies and on small and medium-sized enterprises. These concerns need to be addressed through broad-based dialogue and consultations among the government, business, and labor groups. Research on what policies can best help all groups adjust to and take advantage of regional integration will help underpin this dialogue and deepen the integration process. Regional organizations such as the ASEAN Business Advisory Council and the ASEAN University Network can be charged with the task of carrying out such a consultative program.

3 As measured by the *World Governance Indicators*' index of regulatory quality.

Box I.C.2. continued

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Part II. Medium-Term Development Agenda

II.A. Rethinking the Use of Tax Incentives in East Asia and Pacific[1]

The countries in East Asia and Pacific need to rethink their use of tax incentives, recognizing the tension between investment promotion and revenue generation. International experience suggests four key points: (1) tax incentives complement rather than substitute for broader investment climate reforms, and are not effective when the investment climate is weak; (2) the cost of tax incentives, and whether they subsidize investment that would have occurred in any case, needs to be carefully considered; (3) discretionary tax incentives are particularly prone to abuse; and (4) a regional approach is required to avoid harmful tax competition.

Tax incentives can boost investment, but may also impose significant costs in forgone revenue. In particular, attracting foreign investment can help increase the size and quality of the capital stock, and facilitate spillover effects into the labor market (through skills). However, the revenue cost may be significant, especially if competitor countries issue their own equal or increasingly generous incentives in order to remain competitive, leading to a "race to the bottom" where countries make themselves collectively worse off. This perennial "tug-of-war" in the use of the tax system to simultaneously generate investment and resource mobilization is not new. But there is now renewed interest in properly balancing the two goals by rethinking incentives policy and administration.

Developing countries commonly offer tax incentives for investment (Box II.A.1). Tax holidays are the most widely used fiscal incentive, especially in East Asia and Pacific and South Asia (Table II.A.1).[2] Reduced tax rates, and research and development (R&D) incentives, are most common in East Asia and Pacific. The region also has the highest share of countries granting tax incentives on a discretionary basis.[3] Relatedly, typically tax incentives are provided via investment laws and codes, rather than through the tax laws. The use of tax and duty exemptions in Special Economic Zones is popular across all regions. This reflects a move in some countries toward containing the tax incentives to certain geographic locations and minimizing their impact on the wider economy for revenue reasons.

Countries in the Association of Southeast Asian Nations (ASEAN) offer a broad range of incentives. Overall, Southeast Asian countries provide five to eight types of tax incentives to firms. By contrast, advanced East Asian economies such as Japan and Hong Kong SAR, China, offer only two or three types of incentives (Table II.A.2). The breadth and similarity of incentives offered by Southeast Asian economies points to the potential importance of harmonizing and coordinating such incentives. Relatedly, Thailand, Vietnam, Lao PDR, the Philippines, Singapore, and Indonesia all collect in taxes less than 20 percent of GDP (the last four countries, 15 percent of GDP or less), and curtailing tax incentives might generate new revenue sources (see below).

1 Prepared by Richard Stern, Lead Public Sector Management Specialist, and Sebastian James, Senior Economist.

2 Used by more than 90 percent of countries surveyed in South Asia, East Asia and Pacific, and Latin America and the Caribbean; and more than 80 percent of countries surveyed in the Middle East and North Africa, Eastern Europe and Central Asia, and Sub-Saharan Africa.

3 That is, tax incentives are provided, typically by the investment promotion agency, through a preapproval process before the investment is made, rather than automatically while completing tax filing requirements based on criteria set forth in the tax laws.

Table II.A.1. Prevalence of tax incentives around the world

	Countries surveyed	Tax holiday/ 100% tax exemption (%)	Reduced tax rate (%)	Investment allowance/ investment tax credit (%)	R&D tax incentive (%)	Super deductions (%)	SEZ/ free zones/ EPZ/free port (%)	Discretionary process for granting incentives (%)
East Asia and Pacific	12	92	75	67	83	33	92	83
Eastern Europe and Central Asia	17	82	35	24	29	0	94	35
Latin America and the Caribbean	24	92	33	50	8	4	71	42
Middle East and North Africa	15	80	40	13	0	0	80	40
OECD	34	12	32	65	76	21	68	35
South Asia	8	100	38	75	25	63	63	38
Sub-Saharan Africa	44	80	64	77	11	18	66	77

Sources: Tax guides by PKF, Deloitte, EY, IBFD, US Investment Climate Statements 2014, and James 2014.
Note: EPZ = Export Processing Zone; SEZ = Special Economic Zone; OECD = Organisation for Economic Co-operation and Development.

Box II.A.1. Main Types of Tax Incentives for Investment

- **Tax holidays:** One hundred percent exemption from income taxes for a certain period, typically for new investment. These exemptions may be limited to certain classes of income (say, export income). In some cases after the period during which the investment enjoys complete exemption, it may be followed by a period of partial exemption (say, as an income tax at 50 percent of the regular rate).
- **Reduced tax rates:** Reduction in the income tax rate for income from investments based on sector, type, or location.
- **Investment tax credit:** Deduction of a fixed percentage of an investment from tax liability. Rules differ regarding excess credits (credits in excess of tax liability) and include the possibility that they may be lost, carried forward, or refunded.
- **Investment allowance:** Deduction of a fixed percentage of an investment from taxable profits (in addition to depreciation). The value of an allowance is the product of the allowance and the tax rate. Unlike a tax credit, its value will vary across firms unless there is a single tax rate. Moreover, the value is affected by changes to the tax rate, with a tax cut reducing it.
- **Accelerated depreciation:** Depreciation at a faster schedule than available for other companies. This can be implemented in many different ways, including higher first-year depreciation allowances, or increased depreciation rates. Total tax payments over time (in nominal terms) are unaffected, but the net present value of the tax liability is reduced (increasing firm liquidity).
- **Exemptions from various taxes:** Exemption from certain taxes, often those collected at the border, such as tariffs, excises, and the value-added tax (VAT) on imported inputs.
- **Super-Deductions:** Deductions from taxable profits of more than 100 percent of the cost of the investment (for instance, deductions of 150 percent of expenditure on R&D and training).
- **Special Economic Zones/Export Processing Zones/Free Zones:** Geographically limited areas in which qualified firms can locate and thus benefit from exemption of varying scope of taxes/import duties and/or administrative requirements. Zones are often aimed at exporters and located close to a port. In some countries, however, qualifying companies can be declared "zones" irrespective of their location.

Table II.A.2. Tax incentives in East Asia and Pacific

	Tax holiday/ exemption	Reduced tax rate	Investment allowance/ tax credit	R&D incentives	Super deductions	SEZ/ free zones/ EPZ/free port	Discretionary	Investment code
Cambodia	X	X	X	…	…	X	X	X
China	X	X	X	X	X	X	X	…
Hong Kong SAR, China	…	…	X	X	…	…	…	…
Indonesia	X	…	X	…	…	X	X	X
Japan	…	X	X	X	…	…	…	…
Korea, Rep.	X	X	X	…	…	X	X	X
Lao PDR	X	X	…	X	…	X	X	X
Malaysia	X	X	X	X	X	X	X	X
Myanmar	X	X	X	X	…	X	X	X
Philippines	X	X	…	X	…	X	…	…
Singapore	X	X	X	X	X	X	X	X
Thailand	X	X	X	X	X	X	X	X
Vietnam	X	X	…	X	…	X	X	X

Note: "…" denotes that the relevant incentive is not applicable.

How effective are tax incentives in attracting foreign investment?

The views of different tax policy experts, policy makers, and investment promotion agencies on the effectiveness of tax incentives diverge markedly. Some argue that there is little evidence that such incentives are effective—a view that has guided considerable technical assistance recommending that governments curtail their use. Others argue that investment incentives have contributed to the rapid economic growth of countries such as the Republic of Korea, Mauritius, and Singapore. These disparate views are not surprising given that tax incentives are just one of the many factors that influence the success of investments. Countries typically pursue growth-related reforms using a combination of approaches, including macroeconomic policies, investment-climate improvements, and changes in industrial policy, as well as investment incentives.

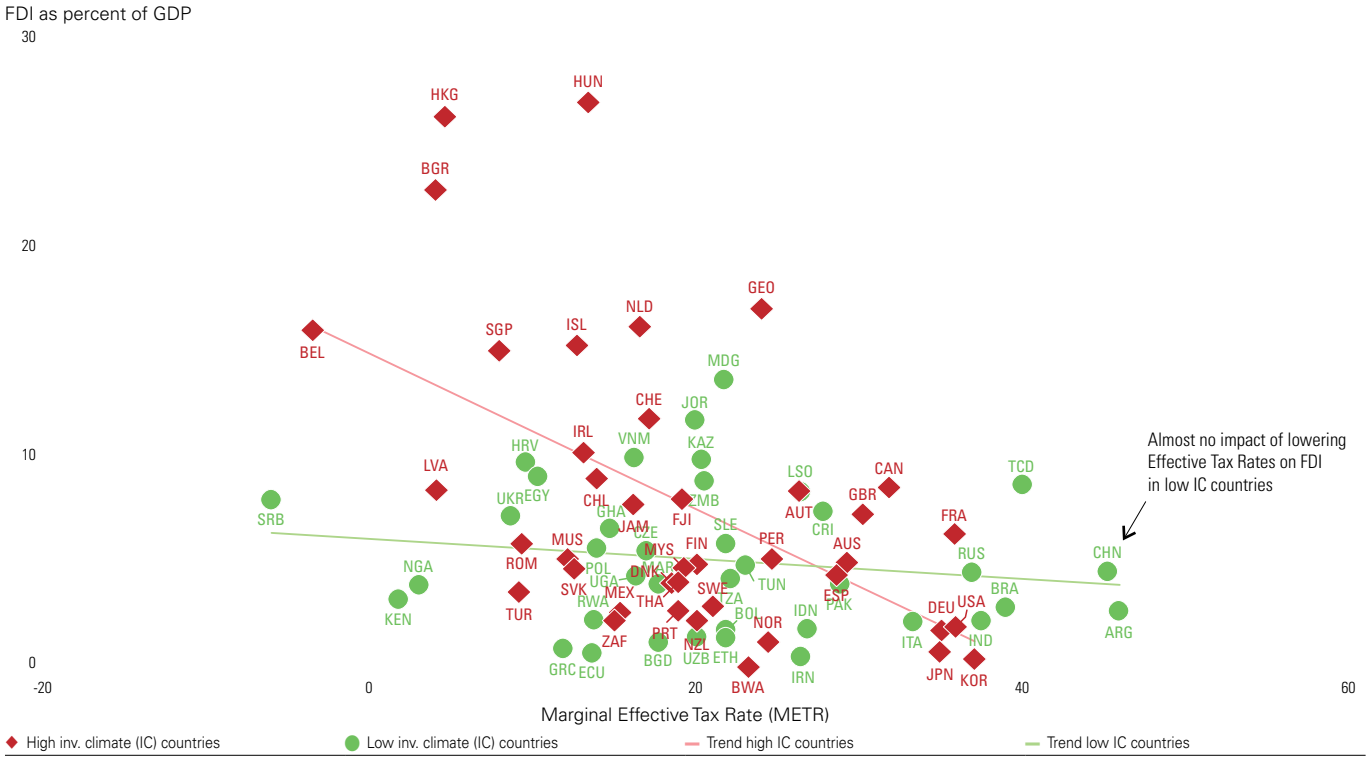
Research, including both econometric studies and World Bank investor surveys in over 15 countries, indicates that tax incentives are of limited effectiveness in attracting foreign direct investment (FDI). In general, surveys indicate that tax incentives are not the primary reason for investing in a country. FDI responds positively to lower tax rates in host countries, but the response is smaller in developing than in developed countries (Desai, Foley, and Hines 2004; Klemm and Van Parys 2012; Mooij and Enderveen 2003). Also, the effect depends on the type of cross-border investment: export-oriented investments and highly mobile investors (for instance, in the garment sector) are relatively more sensitive to tax incentives, and investments oriented toward domestic markets, less so (Grubert and Mutti 2004). Policy makers therefore need to adjust incentive policies depending on the type of FDI they aim to attract (Table II.A.3) (James 2014). Focusing on specific tax incentives among countries that share a common currency, in the Eastern Caribbean, FDI responds positively when tax holidays are expanded. However, there is a corresponding drop in FDI to neighboring countries, indicative of tax competition for a fixed amount of FDI (James and Van Parys 2010a). In contrast, in Central and West Africa, widening tax holidays has no impact on FDI inflows, whereas increasing legal safeguards to investors does have a positive effect (James and Van Parys 2010b).

Table II.A.3. Typology of FDI and response to tax incentives

Type of Investment	Factors that drive investment	Response to investment incentives
Resource-seeking FDI	Location of natural resources / skill / agglomeration benefits	Low response. FDI driven primarily by nontax factors.
Market-seeking FDI	Market potential • Market dimensions • Income per capita • Customer specific preferences • Kind of goods and services to be provided	Low response. Level playing field among firms is critical (same tax system for all competitors).
Strategic-asset-seeking FDI	Acquiring strategic assets • Brands and market positioning • Know-how • Technology • Distribution networks • Human capital	Low response. FDI is driven by the location of the asset. However, lower taxes on capital gains reduce the costs of the transfer of these assets.
Efficiency-seeking FDI	Lower costs • Mostly export oriented • Availability of skills at a low-cost • Close to markets • Low relocation costs	High response to tax incentives. Firms are expected to compete globally, hence, the lower the costs, the better their ability to compete globally.

Most important, tax incentives are not effective in compensating for a weak investment climate. In countries with weak investment climates, lowering the effective tax rate has a limited impact on FDI. The response is far more pronounced in countries with good investment climates (James and Van Parys 2009; Zhang 2007). For instance, lowering the effective tax rate from 40 percent to 20 percent raises FDI by only 1 percent of GDP on average in countries ranked in the bottom half in terms of their investment climate, but raises FDI by 8 percent of GDP in countries in the top half (Figure II.A.1). Put differently, a good investment

Figure II.A.1. Efficacy of Fiscal Incentives and Investment Climate

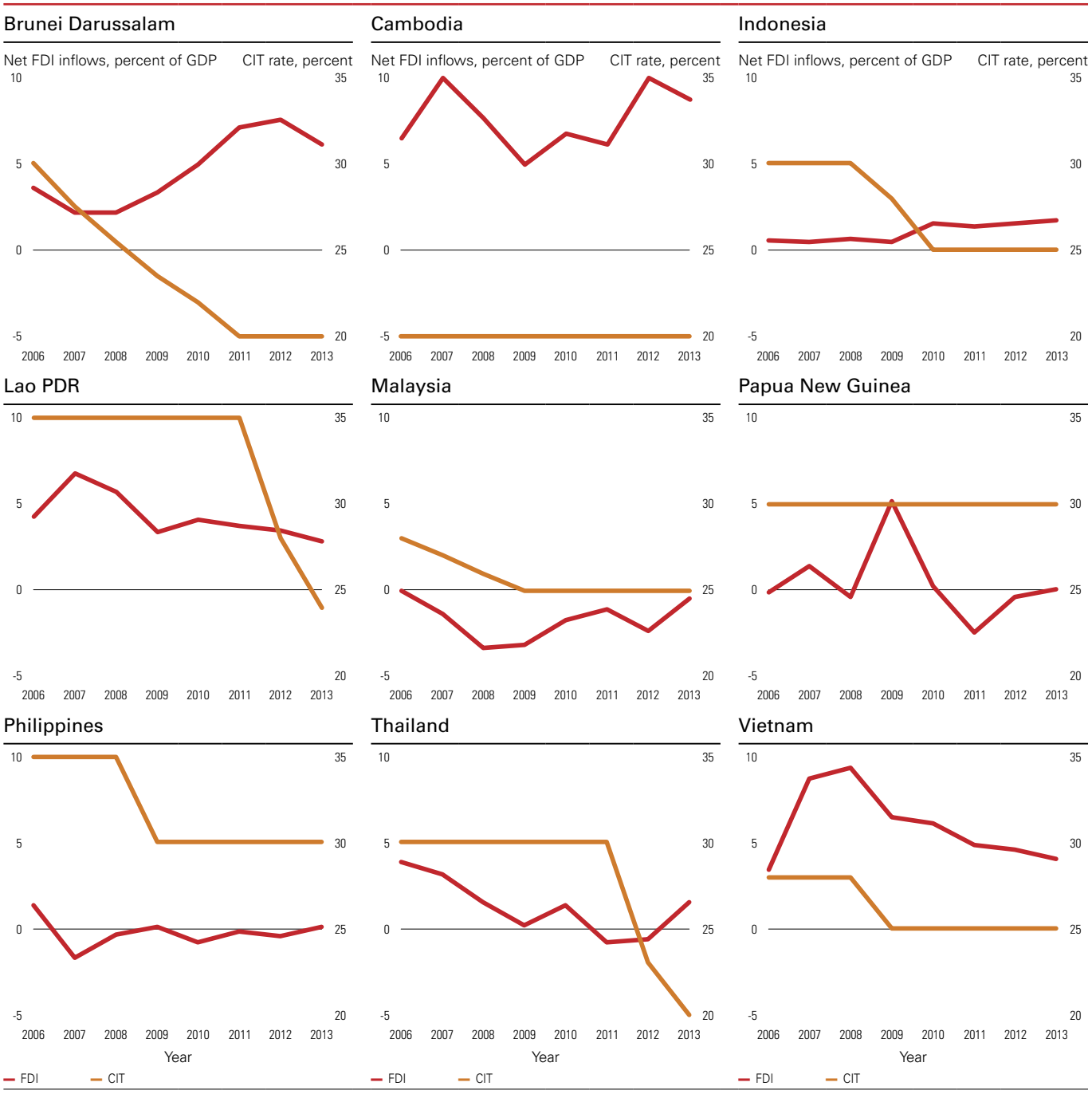


Source: World Bank staff estimates.

climate is a necessary condition for investment; tax incentives may complement it, but cannot compensate for serious deficiencies. This explains why tax incentives appear to more effective in some countries than in others.

In East Asia and Pacific, tax incentives appear to have had lackluster effects. Most countries have both provided increasingly generous tax holidays (Table II.A.4) and other incentives, and lowered their standard corporate tax rates,[4] with the aim of encouraging both foreign and domestic investment. However, FDI inflows have not consistently increased, and in some cases have decreased (Figure II.A.2).

Figure II.A.2. Foreign direct investment and corporate tax rates in EAP



Sources: UNCTAD FDI Statistics and KPMG Tax Database.

4 From an average of 29.6 percent in 2006 to 24.3 percent in 2013, to 23.8 percent in 2015.

Relatedly, there is little consensus on the magnitude of the potential response of investment to changes in the cost of capital, including through changes in tax incentives. Estimates of the elasticity of investment with respect to the user cost of capital vary between -0.16 and -2.[5] This wide disparity reflects measurement problems, methodological differences, and uneven data quality, and suggests a need for more fine-grained country-level studies based on firm-level data.

Table II.A.4. Tax holidays in East Asia and Pacific

	Maximum tax holiday period, years
Brunei	20
Cambodia	9
China	2
Fiji	10
Hong Kong SAR, China	Not applicable
Indonesia	20
Lao PDR	10
Malaysia	10
Myanmar	5
Papua New Guinea	10
Philippines	6
Samoa	15
Singapore	Subject to negotiation
Solomon Islands	10
Thailand	11
Vietnam	4

Costs and benefits of incentives

The immediate cost of tax incentives is the revenue forgone; however, some investments would not have occurred without these tax incentives. Estimating which investments would not have been made without tax incentives (the marginal investments) is not straightforward. At one extreme, if all investments would have been made even without tax incentives, then the revenue forgone is the entire amount of tax that has not been paid. However, if no investments would have been made without tax incentives, no revenue has been forgone. Further, tax incentives may also affect the size of the investment.

Tax incentives may have a negative impact on other activities that are forced to bear a higher tax burden. For given spending, governments need to offset any revenue forgone because of tax incentives, with higher taxes on other activities. The overall impact on welfare, and indeed investment, may be negative.[6]

Tax incentives may lead to revenue loss through higher tax evasion. Unscrupulous investors may try to take advantage of tax incentives even when they do not qualify. For instance, investors could funnel profits, using transfer pricing, from an existing profitable company through the "tax holiday" company and completely avoid paying taxes. As a result, more resources must be spent on tax administration to fight tax evasion.

The benefits of tax incentives include the additional jobs and skills that the new investments deliver. The additional investments may yield valuable benefits and externalities, including:

- Investments in technology—such as research and development or high-tech industries—that upgrade worker skills
- Infrastructure projects that encourage business growth
- Investments that create jobs in areas with high unemployment

5 For instance, Dwenger (2014) estimates an elasticity of -1.0.

6 For instance, if tax incentives are provided for investments that would have been made anyway, but as a result taxes are raised on other investments that are instead highly sensitive to tax rates, then overall investment will decrease.

- Environmentally friendly technology
- Anchor investments—that is, those that provide multiplier effects through signaling and by creating backward linkages into the local economy.

Such investments can have positive, often long-term, spillover effects on the economy or the environment.

Tax incentives need to be targeted to sectors that generate significant economic (social) returns, but limited financial (private) returns. Tax incentives are not required for investments that generate high financial returns. Further, tax incentives for investments that generate low economic returns are not beneficial (Table II.A.5). Such an analysis may be done investment by investment or at the sectoral level.

Table II.A.5. Need for tax incentives—financial returns compared to economic returns

	Low economic returns	High economic returns
Low financial returns	Tax incentives may be needed because the investment needs support, but are not useful because the economic impact is low	Tax incentives are useful because the investment needs support, while the economic impact is high
High financial returns	Tax incentives are redundant because the investment needs support, but are not useful because the economic impact is low	Tax incentives are redundant because the investment has higher financial returns anyway

"Good" incentives and "bad" incentives

Tax incentives that reduce the tax burden on capital inputs increase returns to an investment. Such incentives include duty exemptions on plant and machinery, which are common across East Asia and Pacific. They would also include the introduction of a VAT, which allows for all taxes on inputs to be credited.

Income tax holidays are the least effective tax incentive. Tax holidays are used extensively in the region, but suffer from serious problems:

- Tax holidays are a blanket benefit unrelated to the amount of capital invested or its growth during the holiday.
- Firms have an incentive to close and sell their businesses at the end of the tax holiday—only to reopen as a "new" investment, thus gaining an indefinite tax holiday.
- If FDI operates under double taxation agreements, tax holidays simply transfer tax revenues from the country receiving the investments to the investing home country.
- Tax holidays enable firms to funnel profits, using transfer pricing, from an existing profitable company through the "tax holiday" company and so avoid paying taxes on either.

- Most capital-intensive investments do not yield a profit until several years after operations start. Thus tax holidays for a "start-up" period of five years are ineffective. Indeed, tax liabilities often kick in just about when a business starts to make a profit.

- As a result, several countries in the region offer extended tax holidays, with a maximum period of up to 20 years in Brunei and Indonesia (Table II.A.4). However, this limits the flexibility of countries to adjust their tax incentives and tax policies should they prove wasteful.

Investment-linked incentives are in general superior to tax holidays. Incentives such as investment allowances, accelerated depreciation, and training incentives are directly related to capital invested and jobs created. They therefore better align the incentives of investors and governments.

Minimum taxes mitigate some of the problems associated with excessive tax incentives. Tax incentives may have unintended consequences: for instance, they may benefit investments that already generate high financial returns. Minimum taxes can mitigate the resulting revenue risk. For instance, India's minimum alternative taxes for companies have reduced the revenue losses stemming from tax incentives. Minimum taxes may be based on sales or assets, and if desired separate provisions may allow them to be carried forward and credited against taxes when tax liabilities are above the minimum.

Political economy and tax incentives

Countries in East Asia and Pacific have expanded their tax incentives over time, despite mixed evidence on their effectiveness. Indonesia in August 2015 expanded its tax holiday from 10 years to 20 years, with the option of adjusting the amount of tax exempted from 10 percent to 100 percent for several sectors.[7] This occurred even though its previous attempts at introducing tax holidays suggest that such incentives are relatively ineffective when investment is hindered by binding investment-climate constraints (Wells et al. 2001). Thailand in December 2014 offered a new seven-year investment promotion strategy. Foreign investors setting up an international headquarters in Thailand will be entitled to a 10 percent corporate income tax cut on qualified service income received from local affiliated entities, and will be exempted from the withholding tax on dividends received from or paid by the local headquarters to foreign entities. The Philippines' latest Investment Priorities Plan for 2013 identifies industries entitled to government fiscal incentives such as an income tax holiday, and also provides nonfiscal incentives, such as assistance in employment permits and work visas for foreign staff. Vietnam reduced the common tax rate from 25 percent to 22 percent in 2014, to be cut to 20 percent in 2016, and reintroduced previously expired incentives for new manufacturing investments and business expansions in selected industrial parks.

The expansion of tax incentives is often driven by political economy considerations. Investors routinely demand expanded tax breaks as a condition for investing. These investments would often prove viable even without tax incentives, but policy makers face a critical asymmetry of information. They may believe that incentives will sway marginal investments their way, and conversely may be loath to risk "losing" investments.

7 Specifically, for nine sectors, including six "pioneer" sectors (base metal, oil refinery, basic petrochemicals, machinery, renewable energy and telecom equipment, and marine transportation), processing industries in special economy zones, and joint public-private economic infrastructure.

Further, while policy makers appreciate the short-term benefits of investments in terms of "new" jobs, the revenue cost of incentives is unknown and occurs over the long term.

In particular, large "prize" investors deciding where to locate their activities can play one country against the other to reach a favorable deal that involves long tax holidays. In 2014, as a condition for investing in Indonesia, Samsung demanded that the tax holiday be increased from 10 to 30 years. When the Industry Minister refused to budge, and Samsung started negotiating with other countries, the Minister came under considerable pressure (Jakarta Globe 2014). In 2001, to attract an investment by Canon, Vietnam offered a 10-year corporate income tax exemption, but was outbid by the Philippines, which expanded its corporate income tax exemption from 8 to 12 years (Budiantoro 2015).

Tax competition[8] among countries for footloose investments exerts downward pressure on tax rates and leads to more generous tax breaks. Across developing countries, when one country increases the length of its tax holiday, its neighbors quickly respond similarly (Klemm and Van Parys 2012). In Africa, effective tax rates have effectively fallen to zero in industries where special regimes are in place (Abbas and Klemm 2013). In the Caribbean, in the face of tax competition and aggressive bargaining by multinational hotel chains, Barbados offers tax holiday of up to 40 years for hotel investments.

Few countries in East Asia and Pacific estimate the revenue forgone as a result of tax incentives. Measuring the costs of tax incentives and making this information public and part of the annual budget process would allow for proper debate on the effectiveness of tax incentives. In the region, only the Philippines (Box II.A.2) and Papua New Guinea undertake and report systematic "tax expenditure" analysis. In other regions, relatively more countries do (Table II.A.6). However, few countries estimate the relative costs and benefits of existing incentives.

Table II.A.6. Tax expenditures globally: Number of countries

	Total countries	Number of countries where tax expenditures are calculated	Percent of countries reporting
East Asia and Pacific	33	2	9
Europe and Central Asia	32	3	9
Latin America and the Caribbean	40	13	33
Middle East and North Africa	20	2	10
OECD	34	21	62
South Asia	7	1	14
Sub-Saharan Africa	48	10	21

Sources: Burton and Sadiq 2013; James 2014.
Note: OECD = Organisation for Economic Co-operation and Development.

Discretion in providing tax incentives aggravates the problems associated with these incentives. Policy makers need to move from discretionary to automatic tax incentives, provided as part of the tax filing process. This reduces the potential pressure from powerful players on governments to provide case-by-case tax incentives through negotiation.

8 Tax competition is the process whereby countries, and especially neighboring countries, try compete for investments by offering tax incentives or corporate tax rates that are relatively more attractive than each other's.

Box II.A.2. Case study: Quantifying the cost of fiscal incentives in the Philippines

Compared to neighboring countries, corporate income tax rates in the Philippines are relatively high (30 percent of gross income).[a] Noting these comparative conditions, the Philippine government argues that it uses fiscal incentives to lower the effective tax rate for eligible companies in the country.

The Philippine Bureau of Internal Revenue (2015) estimates that the forgone revenue from fiscal incentives in the Philippines reached Peso 157 billion (US$3.4 billion) in 2012, which equaled 1.49 percent of GDP, 10.23 percent of government revenues, and 8.84 percent of government expenditure in the same year. Free import duty and a tax holiday were the two biggest sources, contributing Peso 69.8 billion and Peso 64.4 billion, respectively, to the estimation (Kim 2015).

The Philippines has 211 special laws regulating fiscal incentives, administered through 14 Investment Promotion Agencies (IPAs). The Philippine government is putting considerable effort into implementing institutional and regulatory reform to improve this situation. Efforts include consolidating all the fiscal incentives regulations under one law, increasing the role of the Department of Finance, and promoting transparency and accountability through improved incentive monitoring and evaluation.

Among this broad set of fiscal incentives, the Bureau of Internal Revenue indicates that tax holiday provision is the most challenging. Their analysis found that investors tend to switch to short-term investment projects so they can maximize the use of incentives. In other words, before the tax holiday ended, investors would close the business and then reinvest again to access another eight-year tax payment exemption. This result was confirmed by Botman, Klemm, and Baqir (2008), who found that the tax holiday in the Philippines benefits "footloose" investors who only invest in short-lived assets.

Note: a. The corporate income tax is 25 percent in Indonesia and Malaysia, 22 percent in Vietnam, 20 percent in Thailand, and 17 percent in Singapore.

Table II.A.7. Lessons from international experience with tax harmonization/integration

Objective	Possible areas of agreement
Minimize harmful tax competition	Define and limit the scope of fiscal incentives offered (EU)
	Decide on a code of conduct on use of tax incentives (East African Community)
	Publish tax expenditure statements (EAC, EU)
Dispute resolution for tax competition and international tax issues	Implement dispute resolution mechanisms—the EU uses two tools: the abuse of state aid tribunal and mandatory arbitration for transfer pricing disputes (to settle costly disputes before they go to court)
	Establish a tribunal to settle within-region disputes on transfer pricing (EAC)
	Agree on a set of acceptable calculation methods for transfer pricing cases, and on definitions of goods and services (for comparables)
Exchange information for tax harmonization purposes	Information can be provided on request, eventually moving toward an automatic exchange of information among members (EAC, EU)
	CARICOM's survey on transfer pricing is periodically updated to share information among countries about best practices and promote harmonization.

Note: CARICOM = Caribbean Community and Common Market; EAC = Europe and Central Asia; EU = European Union.

Tax competition in East Asia and Pacific is an issue that needs to be addressed in regional forums, rather than being left to individual countries. Otherwise, a race to the bottom could develop, with competing tax breaks leading to the long-term loss of tax revenue and few offsetting benefits. There are several different approaches the region could adopt, ranging from coordination of tax incentives, as in the East African Community

(EAC), to a rules-based approach, as in the European Union (Table II.A.7).[9] As a first step, countries could use regional forums such as ASEAN and Asia-Pacific Economic Cooperation (APEC) to provide more transparency on the tax incentives being offered, and to estimate publicly the revenue forgone because of such incentives. This might then lay the foundation for greater coordination.

Conclusion

Tax incentives should complement broader investment climate reforms. Further, tax incentives need to be:

- **Affordable.** Forgone income should not severely undermine government revenue streams.
- **Targeted.** Targets should be based on research to confirm that they will benefit the country in ways that would not have been possible if there were no incentives, thereby reducing revenue costs.
- **Simple.** Incentive administration should permit easy accessibility and determination of eligibility.
- **Provided transparently,** through legislation. Incentives are more transparent and less subject to abuse when provided by law and approved by the legislature rather than provided in a discretionary manner.
- **Reviewed periodically.** Investment incentives should be regularly reviewed to determine their relevance and economic benefit relative to their budgetary and other costs, including long-term impacts on resource allocation.
- **Coordinated among neighboring countries** to avoid tax competition.

Tax incentives create risks for overall fiscal compliance. They also encourage lobbying and rent-seeking. Greater transparency on the costs and benefits of incentives would help frame future policy. In general, providing a level playing field to all businesses through a broad-based, low, uniform tax rate remains the best investment incentive.

9 In the EAC, any new tax incentives are in principle discussed with neighboring countries before being introduced, which curtails their over use. The EAC is also discussing a Code of Conduct on avoiding harmful tax incentives, including systematically measuring the revenue forgone because of them. The European Union's State Aid Rules are one example of a formal framework developed to avoid harmful tax competition, which prohibits member states from using certain kinds of tax incentives.

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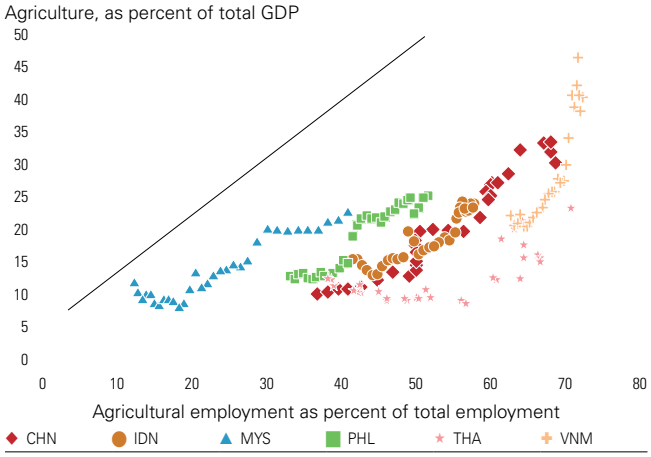
II.B. Food Policy for an Urbanizing East Asia[1]

In East Asia, food policy has traditionally centered on "food security," typically defined narrowly in terms of national self-sufficiency and price stability in rice. However, over the last few decades, the region has witnessed rapid growth, urbanization, and integration into the global economy. Associated with this have been significant shifts in the structure of food demand and production, including from direct to indirect consumption of cereals, via increased consumption of animal products and, relatedly, increased imports of animal feed. The magnitude of these changes is expected to accelerate in the future. This raises significant challenges for public policy, and will require a broader, multisectoral food policy, and a flexible recasting of the concept of food security. In particular, increased interdependence across countries places a premium on trade liberalization, trade facilitation, and logistics. In addition, greater emphasis needs to be placed on nutritional outcomes, food safety, value chain investment and governance, and managing risks to and from the environment.

Structural transformation in East Asian agriculture

Economic growth and development in the region has been associated with broad structural change. The share of agriculture and other primary, natural-resource-based sectors in GDP and employment has decreased (Figure II.B.1 and Figure II.B.2). The trajectories followed by all the middle-income countries over the last 10 to 15 years have been similar.[2]

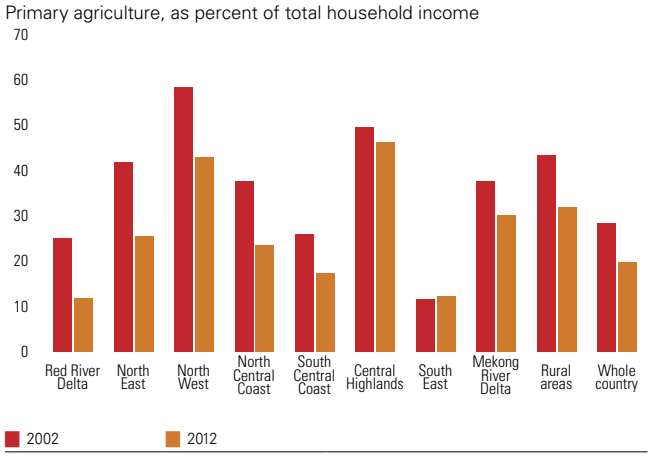
Figure II.B.1. Agriculture's share of GDP and employment, selected countries, 1980–2011



Sources: Basic data are drawn from the *World Development Indicators*, elaborated by Dawe (2015).

Note: Data start in 1980 in the upper right, and move year by year toward the lower left; data end in 2011.

Figure II.B.2. Share of primary agriculture in total household income by region in Vietnam



Source: Based on results of the Vietnam Household Living Standard Surveys.

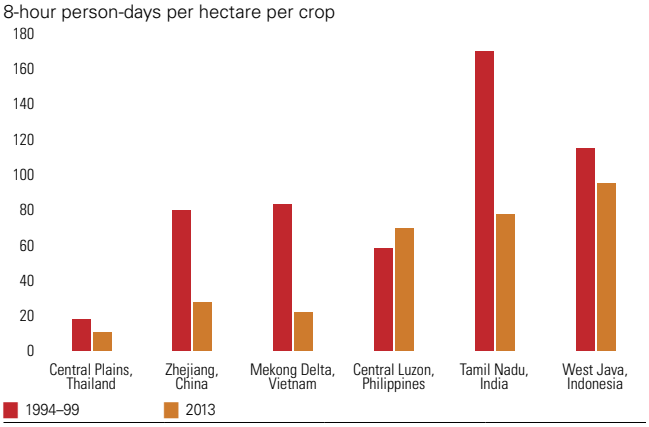
1 Prepared by Steven Jaffee, Lead Agricultural Economist and Global Lead on Food Quality in the World Bank's Agriculture Global Practice. This note draws on the background papers and synthesis prepared for the World Bank's East Asia and Pacific Regional Study, *Farm Gate to Market*, and on recent country-level analytical work (see Labaste and Jaffee, forthcoming).

2 However, their specific position depends on the exact definition of employment in agriculture. Many so-called "farm" households also rely substantially (if not primarily) on nonfarm income.

Structural change within the region's agriculture is taking many forms, including mechanization of farm operations, consolidation of production, and crop and product diversification (Reardon and Timmer 2014). In China, rural wage rates have risen sharply, encouraging the emergence of a rapidly growing market in farm machinery rental services (Christiaensen 2012). Mechanization and the release of surplus agricultural labor have also been occurring in some of the region's major rice-growing areas (Figure II.B.3). While the average farmholding size is small and subject to slow overall change, there is increased consolidation of commercial production in several countries, especially for livestock products, aquaculture, and industrial crops. Several countries, including China, Thailand, and Vietnam, have seen diversification in food and tree-crop production, and higher growth rates for livestock products than crop production.

Organizational and behavioral changes are also occurring beyond the farm gate in the downstream segments of agrofood systems. A transition is occurring from supply chains characterized by local, small-scale, spot-market, multilevel, and labor-intensive activity to supply chains that are geographically longer, use coordination mechanisms like contracts and standards, have varying degrees of disintermediation, and use increasingly capital-intensive technology in each segment (Reardon 2015). Changes are most notable at the food retail level, with the growing role of supermarkets and smaller format "modern" outlets. The progression to modern retail starts with storable milled grains and packaged foods, then proceeds to fresh processed foods (dairy and meat), and last to fresh produce, reflecting risks linked to perishable produce, marketed volumes, seasonality in supply, and the challenge of standardizing quality.

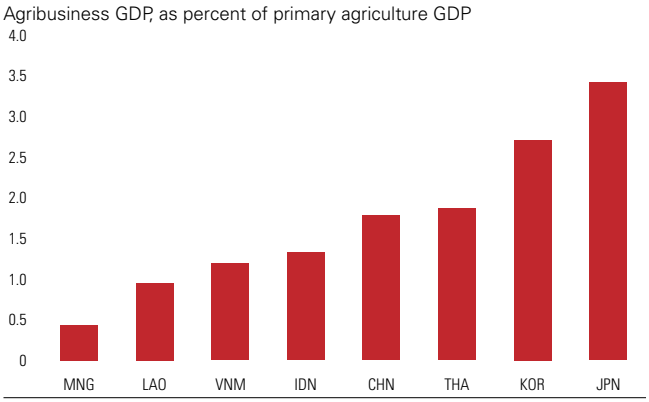
Figure II.B.3. Declining labor use in the major "Rice Bowls" of Asia



Source: Bordey et al. 2014.

The composition of agrofood GDP is changing. While the share of agriculture in GDP is declining, that of "agribusiness" (defined as agroindustry plus food distribution services) has grown or been maintained. More farm products are being (cold) stored, transformed, packaged, transported, distributed, and served to make them available to, and comply with, the preferences of urban and other consumers. The value-added of agribusiness to primary agriculture tends to increase with the level of development, and is highest for industrialized countries (Wilkinson and Rocha 2009). This pattern holds also in East Asia; in China and Thailand, this ratio is approaching 2, and in the region's high-income countries, it is even higher (Figure II.B.4).

Figure II.B.4. Agribusiness GDP/primary agriculture GDP for East Asian countries, 2011

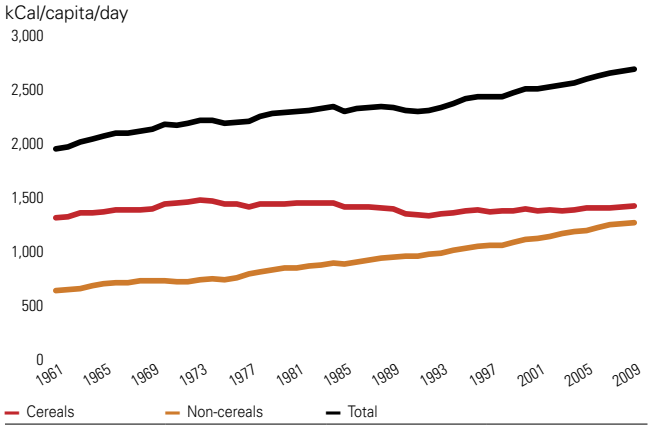


Source: Jaffee and Son, forthcoming, based on Global Trade Analysis Project (GTAP) data.

The evolution of regional food demand

As incomes have risen and urbanization increased, diets have diversified and substitution has occurred between types of food. The composition of diet changes as wealthier consumers shift to preferred, income-elastic foods. The pattern and speed of dietary change, often referred to as "diet upgrading," differ across countries, with a declining share of income spent on food, a declining share of dietary calories from starchy staples, and a switch toward more diverse foods. This diet upgrading includes an increase in the level and shares of (a) non-grains, including vegetables and fruits, animal proteins (meat, fish, eggs, and milk), and pulses and oilseeds (animal protein demand in turn creates derived intermediate demand for feed-grains for animals); (b) processed products to cook at home; and (c) prepared foods bought away from home.

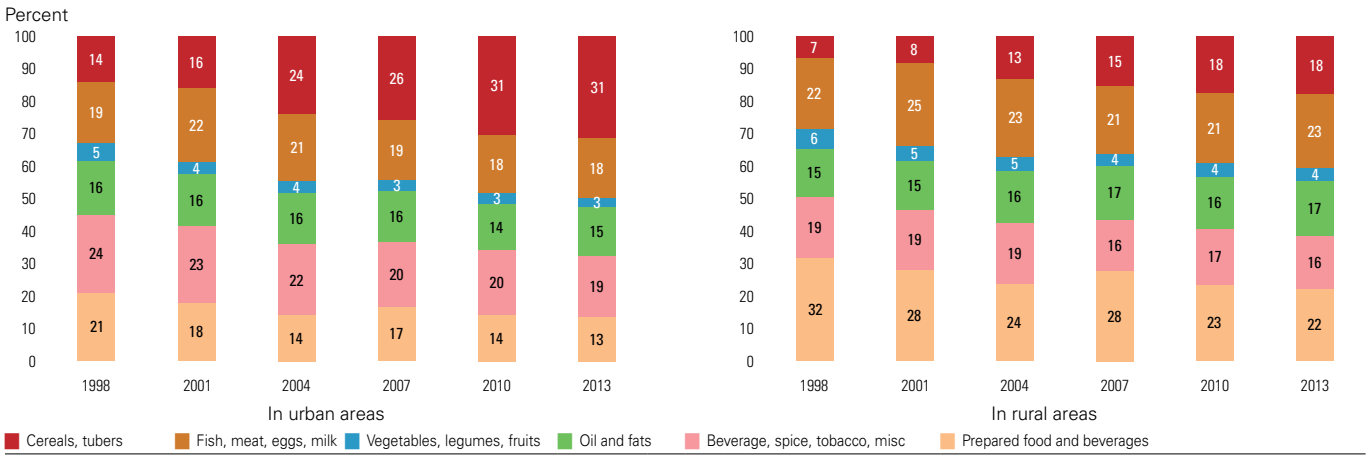
Figure II.B.5. Daily per capita calorie availability in East Asia



Source: Jamora and Labaste (2015) based on data from FAO's food balance sheets.

A major trend has been a shift from direct to indirect consumption of cereals, via increased consumption of animal products. In East Asia as a whole, total availability of cereal calories peaked in the early 1970s, then declined slightly from the mid-1980s to the early 1990s, and has increased modestly since then (Figure II.B.5).[3] Rice consumption is declining among the urban population and higher-income groups. The share of rice in regional caloric intake fell from 48 percent in 1985 to 38 percent in 2009. Direct (food) consumption of wheat and maize is projected to increase. Total calorie intake of cereals will grow slightly, but indirect cereal and oilseed consumption as feed will grow much more rapidly, in proportion to the demand for meat. Consumption of non-grains is growing faster in urban areas than in

Figure II.B.6. Food expenditure patterns: urban and rural areas in Indonesia



Source: Central Agency on Statistics, Indonesia.

3 The reason for the decline (from about 1,450 kilo calories (kCal) per day to about 1,350, or 7 percent) is unknown but may be related to the statistical methodology used by Food and Agricultural Organization (FAO) in preparing the national food balance sheets. It could also be that the increase is due to stock buildup not reflected in the food balance sheets.

rural areas. Also, as countries urbanize, the value chain embodies a much higher degree of processing and cold storage. Urban consumers have a much higher share of prepared foods in their diet (Figure II.B.6).

Demand for meat per capita doubled during the 50 years between 1961 and 2009, and can be expected to double again in the next 15 years. Animal product consumption is growing across the income spectrum. For instance, among Vietnam's lowest income quintile, the share of household food expenditure devoted to animal products grew from 27 percent in 2002 to 39 percent in 2012, eclipsing the share spent on rice. The strong and steady growth in regional meat consumption, particularly pork and poultry, has huge indirect consequences through the rapid growth in the demand for animal feed (ACI 2014; World Bank and China DRC 2014). Demand for meat will continue to grow at a sustained rate, and is expected to double by 2030, mainly owing to pork and poultry. Demand for fish and seafood products more than doubled in per capita terms between 1961 and 2009, and is expected to increase by around 50 percent between now and 2030. Dairy products are expected to be the most rapidly growing category in the food sector, as demand continues to catch up with the consumption levels now found in higher-income countries.

Total food consumption is projected to continue to increase and diversify rapidly in East Asia, driven by a growing population, economic growth, rising incomes, and urbanization. Food demand will both grow and exhibit significant shifts among food categories (Table II.B.1). Diversification in food composition will also continue to be influenced by the trend toward more processed, elaborate, and away-from-home types of consumption. Growing populations, rising incomes, and dietary changes will require large additional volumes of some groups of commodities, apart from the basic staples. Overall, the value of food demand in East Asia is expected to increase by 30 percent between 2009 and 2030 in constant dollars. In 2030, the value of demand for fish, milk, meat, and vegetables is projected at five times the aggregate value for rice and other cereals.

Table II.B.1. Daily calorie intake by commodity group in East Asia

	2009	2030 (proj.)	Change
Rice	889	850	-4%
Other cereals	535	645	21%
All meats	350	664	90%
Fish	54	79	46%
Milk	55	78	42%
Vegetables	74	111	50%
Fruits	160	280	75%
Edible oil	143	210	47%
Others	434	273	-37%
Total	**2,694**	**3,190**	**29%**

Source: Jamora and Labaste 2015.
Note: "Others" includes sugar, other sweeteners, legumes, pulses, nuts, spices, and animal fats.

Policy implications

Across the region governments have traditionally viewed food and food-security challenges through a lens of "staple grain fundamentalism" (Pingali 2015). Public policy and public expenditure in agriculture have centered predominantly on raising productivity and expanding output for rice, and sometimes other cereal grains, and on managing domestic markets and international trade in such food staples. Input subsidies, agricultural research, public advisory services, and public investments in irrigation have all been oriented primarily to achieving national targets for rice and cereals output and self-sufficiency (Figure II.B.7).[4] This policy and public spending bias has persisted in the face of changing demographics, economics, and consumer behavior.

4 The range of policy instruments used in relation to rice is summarized in Dawe, Jaffee, and Santos (2014).

The changing dietary and food expenditure patterns in East Asia necessitate changes in how governments view and approach food security. Many countries have adopted the broad definition of food security laid out by the FAO some 15 years ago: "all people at all times have physical, social and economic access to sufficient, safe and nutritious food that meets their dietary needs and food preferences for an active and healthy life" (FAO 2001). In practice, however, food security strategies have centered largely on "access" and not on safety, nutrition, or preferences. For middle-income countries, such a narrow focus is no longer tenable.

Considerations of national "self-sufficiency" take on a different meaning when a rapidly growing share of calories, other food nutrients, and food expenditures are accounted for by commodities other than those around which earlier food security policies centered. Governments need to reconsider the economic and political significance of self-sufficiency in rice in a context in which rice consumption is falling, and a majority of food expenditures involve animal products and a diverse array of processed foods. In which foods should countries strive to attain or retain self-sufficiency? At what point does a food commodity begin or cease to warrant close policy attention? All advanced countries import food, and some rely heavily on such imports. For instance, in Japan, the food self-sufficiency ratio fell from 73 percent in 1965 to 40 percent in 1998, and has remained at that level since. How this trend plays out elsewhere in East Asia will be driven by agroecological, economic, and political factors.

Figure II.B.7. Traditional food policy expressed in the form of "staple grain fundamentalism"

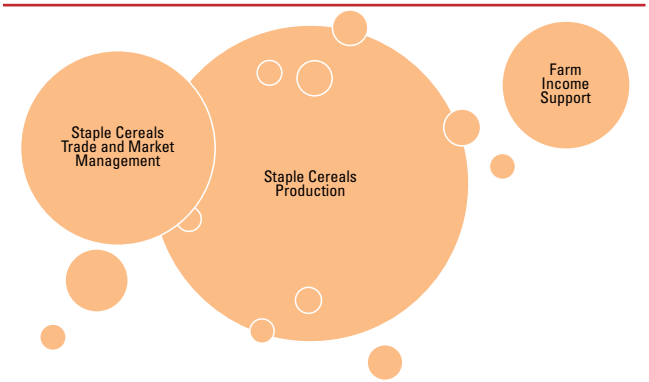
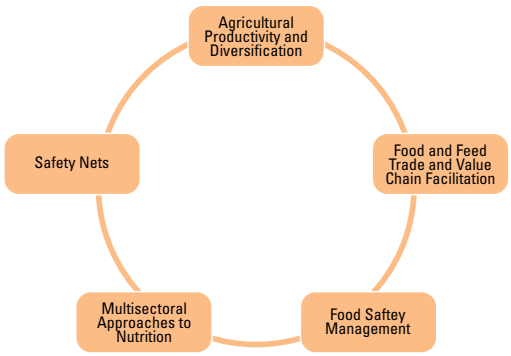


Figure II.B.8. A food policy framework for urbanizing East Asia



The change in food demand heightens the interdependence within and outside East Asia with regard to the availability of, and access to, food commodities. Growth and substitution in food demand open up significant opportunities for agricultural production and investment. Reaping the benefits requires a reassessment of barriers that limit access to markets, and an emphasis on more liberal trade policies, improved trade facilitation and logistics, and increased flexibility in managing food security objectives.

The rapid growth in demand for animal products has created a growing challenge of "feed security in several countries in the region. Even if future direct consumption of cereals increases only modestly, livestock production will require high cereal inputs.[5] The priority given to maintaining self-sufficiency in meat and fish production, and expanding export-oriented aquaculture industries, has resulted in a surge in imports of nearly all major feed ingredients in China and Vietnam, and of high-protein feeds in Indonesia and the Philippines (ACI

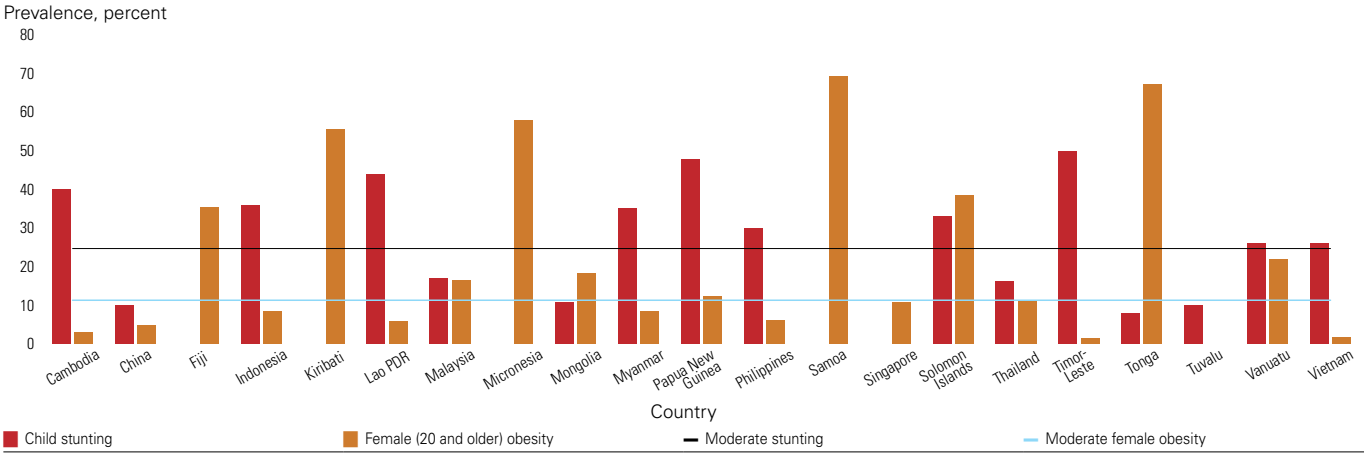
5 Indeed, total required cereal inputs per final dietary calorie are significantly higher when consuming meat than when consuming cereals directly; the multiple ranges from a coefficient of 5 for eggs and poultry to nearly 20 for beef.

2014; World Bank and China DRC 2014). These trade deficits in feed components in East Asia are contributing to higher prices for feed ingredients in the global market. China is now the world's largest importer of soybeans. And, for Vietnam, the value of feed and feed ingredient imports now exceeds the value of its rice exports. Policy makers must now consider how a country's underlying comparative advantage determines an optimal balance between domestic production and imports of feed ingredients and livestock products. And they must implement improved oversight and biosecurity measures to ensure feed quality and safety and facilitate trade in feed, feed ingredients, live animals, and meat (ACI 2014).

Food security policies in most East Asian countries need to "rebalance" and progressively remove the distortionary effects of staple grain fundamentalist policies. The playing field needs to be leveled so that farmers and firms no longer encounter disincentives to diversify production and to move toward specialization in the supply of higher-value and nutrient-dense foods. Productivity needs to increase and be measured across a broad range of indicators, extending well beyond rice yields. For instance, climate change and increased competition for water will raise the importance of water productivity. Water productivity is much higher in irrigation schemes supporting mixed cropping or rotation crops rather than rice monocropping (Burke et al. 2014). The same applies to labor productivity (Keyser, Jaffee, and Nguyen 2013; World Bank 2015a). Growing demand for animal products will put a premium on improving animal nutrition and feed conversion rates. Overall, the food security framework must become more balanced (Figure II.B.8).

Two other areas are assuming growing importance in the food security landscape of East Asia: nutrition and food safety.

Figure II.B.9. Frequency of child stunting and female obesity in East Asian and Pacific countries



Source: World Bank 2015a.

East Asia is confronted with nutritional challenges across its income spectrum. For several lower-income countries, including Cambodia, Lao PDR, and Myanmar, the increases in rice production that have generated exportable surpluses has not translated into major gains in nutritional outcomes. In these countries, malnutrition remains widespread, with child under-five stunting rates exceeding 40 percent (Figure II.B.9). Middle-income Indonesia has also seen recent gains in national self-sufficiency in rice and maize, yet malnutrition remains a serious and widespread problem across its eastern territories, with little evidence of improvement since the mid-2000s. Under-nutrition among infants and small children prevents their full cognitive development, and is closely linked with lower school performance and a long-term loss in earnings. Over-nutrition is also a growing problem in the region, illustrated by rising rates of obesity among both children and adults. Reductions in

physical activity, together with increased consumption of foods that are high in fat, salt, refined sugar, and other "empty" calories, are among the contributing factors. Rising obesity rates are especially alarming in the Pacific Island countries, but concerns are also growing in China, Indonesia, and the Philippines.

Improving nutritional outcomes in East Asia will require a multisectoral effort (World Bank 2013). A set of nutrition-specific interventions, involving the use of food supplements and other measures to improve maternal and infant health, has proven successful in reducing the incidence of stunting. Yet, increasing the incomes of the poor is also of vital importance, especially where this process is twinned with improved nutritional awareness, which alters eating habits and food preparation practices. Many other initiatives can be taken that fall under the rubric of "nutrition-sensitive agriculture". Some examples include biofortification (breeding nutritional traits into crop varieties), agronomic fortification (adding zinc to fertilizer), food fortification (adding iron to salt), promotion of mixed cropping and livestock systems, and changes in food processing practices.

Governments may use an array of policy instruments to promote healthier eating patterns. Examples include restricting marketing to children, setting food standards for schools, providing healthy eating education, legislating for consumer-friendly food labeling, and taxing unhealthy foods. Trade policy also has a role to play. Restricting rice imports to protect farmers may have adverse nutritional consequences. In Indonesia and the Philippines, in some years retail prices for rice have been more than 50 percent higher than elsewhere in Southeast Asia, leading the urban poor to devote a higher share of their spending to their rice staple (rather than to foods with higher nutrient value), while adversely affecting the many farming and other rural households that are net buyers of rice. Better approaches to 'protecting' rice-producing farms would include measures to reduce pre- and post-harvest losses in cereals, and to support diversifying (and improving rotations in) crop production, so as to raise profitability and better manage risks.

New food safety problems have been emerging that reflect strains on East Asian food systems. Many food safety problems were also encountered by developed nations during their periods of intense industrialization and urbanization. However, since these processes have been accelerated in the fast-growing East Asian economies, food safety problems have tended to overwhelm the institutions in place for managing such risks. With a lack of reliable data and poor monitoring capabilities, concerted food safety efforts tend to be reactive, with a focus on solving the last high-profile "incident". In many countries in the region, it is the media that are shaping public perceptions about the scale and nature of food safety problems. While the media have tended to focus on cases of criminal behavior (that is, food and feed adulteration), the region's food safety problems are diverse—stemming from environmental conditions (including soils contaminated with heavy metals), poor hygienic conditions, and excessive or improper use of fertilizers, pesticides, and antibiotics.

In East Asia, food safety is more than a public health issue; it is also a competitiveness issue. Food safety is important for continued food export success. Overseas regulators, importers, and consumers are concerned with biological and chemical contamination of fish, pesticide residues in fruits and vegetables, and unlawful additives found in the processed foods exported from East Asia. These concerns are manifested in product consignment retentions or rejections, price discounts, and difficulties in accessing certain market segments. Yet the competitiveness challenge also exists on the home turf. Consumers are beginning to demand information about safety, provenance, nutritional value, and so forth, and this information will provide a significant part of the value of a food product. In the coming years, East Asian domestic markets will be captured by suppliers that customers trust because they are able to demonstrate the safety, quality, and identity of their food. Regardless of the quantity of food produced in a country, if domestic consumers distrust its safety, then the country can hardly be considered "food secure".

There are no simple solutions to the myriad of food safety challenges facing East Asia. The effort requires a comprehensive approach to improving food safety awareness, practices, and governance, including addressing fragmented and often weakly coordinated institutional responsibilities, building up capacities for risk analysis and risk communication, enhancing systems for surveillance and food product traceability and recall, and moving from a focus on end-product testing to a system that places emphasis on supporting good agricultural practices among farmers and upgrading private sector management systems. Increasing consumer awareness and improving consumer food storage, handling, and preparation practices are also critical.

Conclusion

Applying a more balanced approach to food security and facilitating the modernization of domestic agrofood systems will involve mandates extending well beyond ministries of agriculture. Ministries of agriculture have generally been slow to adapt to changes in domestic food demand, and often do not understand the business-enabling conditions required by private food processors and food distribution companies. In some countries, ministries of agriculture have yet to develop the capacity for effective, proactive support for agricultural diversification and inclusive agribusiness. Further, many emerging issues fall outside the traditional boundaries and mandates of such ministries, and rather relate to the technical and regulatory bodies involved with public health, social protection, manufacturing, logistics, trade, and environmental protection. Multidisciplinary and collaborative approaches across ministries and with a range of stakeholders (public, private, and civil society organizations) will be required. In higher-value food segments, the private sector will be expected to play the dominant role in commercial activity, with important roles for the government in facilitating investment and trade, promoting competition, monitoring and protecting the environment, and ensuring biosecurity.

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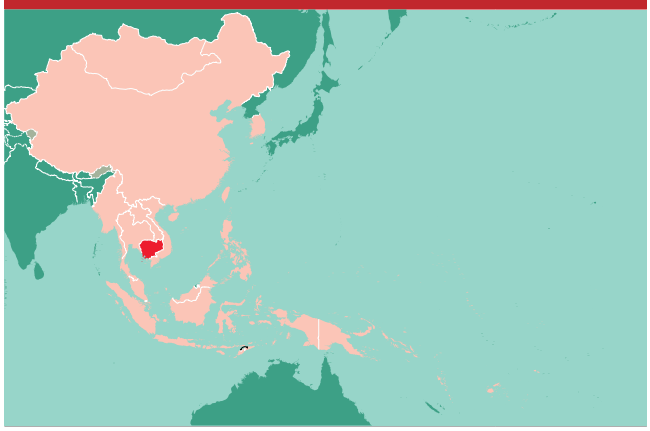
Part III. Country Pages and Key Indicators

CAMBODIA



	2014
Population, million	15.4
GDP, US$ billion	16.7
GDP per capita, US$	1,084.4
GDP per capita, US$ PPP	3,242.3
Gini index (WB estimate) (2012)	28.8
Life expectancy at birth, total (yrs) (2013)	71.7
School enrollment rate, primary (%, net) (2012)	98.3

Source: World Development Indicators.

Summary

Real growth for 2014 has been estimated at 7.1 percent (Figure 1). In the first half of 2015, some signs of moderation persist, particularly in the tourism and agricultural sectors. As a result, growth is projected to slightly ease to 6.9 percent in 2015. Sustained growth in the last two years has increased the standard of living in Cambodia. This trend will continue in 2015 and 2016, mainly in urban areas, where the construction and services sectors are strong.

Recent Economic Developments

Construction was the most dynamic engine of growth in the first half of 2015, partly due to the return of political stability. Imported construction materials rose, with steel imports growing at 32.7 percent yoy during the first six months.

The tourism sector keeps underperforming despite the initial recovery in tourist arrivals to Thailand. Tourist arrivals during the first six months grew by only 4.6 percent (reaching 2.3 million visitors), compared to 6.9 percent during the same period last year.

The welfare of rural households has improved little since 2012, given the slowdown of the agricultural sector since then (Figure 1). Growth in this sector remains sluggish due to slow crop yield improvements and depressed agricultural commodity prices. Ninety percent of Cambodians live in rural areas, and agricultural growth, the rice sector in particular, was the main driver of poverty reduction in the country in the last decade.

The dynamism of the construction and industrial sectors helped improve the standards of living in urban areas during 2012–15. However the improvement has been less palpable in the case of Phnom Penh, as recent trends show.

The value of garment exports eased to a yoy growth rate of 7.8 percent during the first six months of the year, compared to 9.2 percent in 2014. The appreciation of the dollar, the emergence of other low-wage competitors, and uncertainty in wage negotiations exert pressure on the sector.

The slowdown in exports slightly widened the current account deficit (excluding official transfers) to 10.8 percent of GDP in 2014. The deficit is financed by rising FDI inflows. The riel-dollar exchange rate remains stable, which facilitates the flow of foreign capital. The riel slightly depreciated against the dollar, reaching 4,098 per dollar by mid-2015, but appreciated against the Thai baht and the Vietnamese dong. Export competitiveness has therefore eroded.

Financial deepening continues, with domestic credit growth accelerating further, to 28.1 percent yoy, spurred in part by a construction boom and consumption. Private sector deposits growth, however, moderated to 21.1 percent yoy. Despite rapid credit growth, low international food and oil prices have further subdued inflationary pressures,

with inflation decreasing to 0.7 percent yoy in June 2015.

Fiscal consolidation has been sustained. Despite slightly weaker economic performance, revenue collection improved markedly, reaching 16.6 percent of GDP in 2014, thanks to improvements in tax administration. Expenditure remained contained at 20.1 percent of GDP, although the wage bill rose, resulting in an overall fiscal deficit (including grants) of 0.3 percent of GDP.

Outlook

Growth is expected to slightly ease to 6.9 percent in 2015, in a context of sluggish agricultural growth, uncertainty in the tourism sector, and moderate garment exports. A sharper than expected slowdown in the Chinese economy would somewhat dampen growth prospects, mainly due to potentially lower Chinese tourist arrivals, while export dependency is low. Nonetheless, in a context of limited capital markets, Cambodia would be relatively shielded from financial volatility.

Moderate improvement in the standard of living of urban households will be seen throughout 2015–16, given the expectations of the economic sectors in which they participate (mainly construction and services). Per capita GDP is expected to reach US$1,145 in 2015, a 5.6 percent increase over 2014.

Meanwhile, the standard of living in rural areas is expected to remain stable in the short run. The rainy season this year was delayed because of the effects of El Niño, but recent reports suggest that the area of cultivated land affected is similar to the one observed last year. Following recent trends, comparable consumption growth for both poor and better-off households is anticipated, leaving inequality unchanged (Figure 2).

The expected effects of the recent oil price decline on poverty reduction appear to be moderate. The decline will directly benefit consumers, since no price controls are in place. Nonetheless the magnitude of the effects is likely to be minor. The 20 percent fall in the local domestic prices would at most represent a 1.5 percent consumption gain for the average household in Cambodia. The benefits would be even smaller for poorer households, since fuel (and oil-related goods) represents a smaller share of their budget.

Downside risks include potential renewed labor unrest, continued appreciation of the dollar, a delay in economic recovery in Europe, and a sharper than expected slowdown in the Chinese economy.

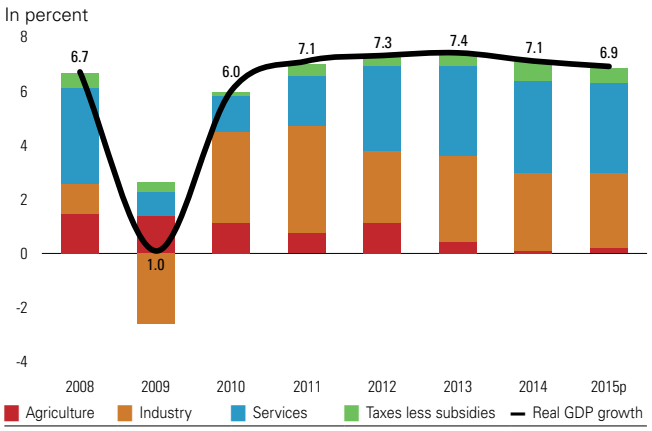
Challenges

In the face of a slowdown in exports, sharpening the country's competitive edge is a priority. Given Cambodia's highly dollarized economy, gaining external competitiveness by adopting exchange rate flexibility is not a viable option. Addressing key bottlenecks constraining productivity growth is, therefore, essential to remain competitive abroad. A better-trained workforce, enhanced trade facilitation, and an environment conducive to investment are required. Increasing public investment in agricultural advisory activities, seed development, and irrigation to revitalize the agricultural sector is also a priority.

A construction boom and rapid credit expansion also warrant further strengthening banking supervision to safeguard stability. Recently introduced interministerial coordination, including close coordination with monetary authorities, is a positive step.

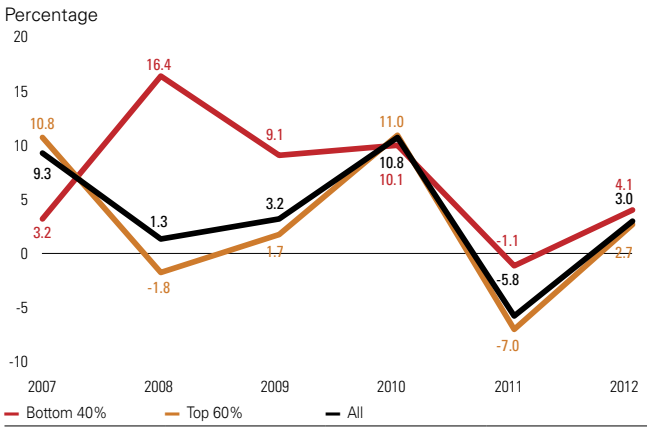
Cambodian households remain highly vulnerable. The recent success in reducing poverty has resulted in many households that are living just above the poverty line. The impact of negative shocks (such as droughts and regional unrest) on poor households is exacerbated because of the limited social protection system in place.

Figure 1. Contribution to real GDP growth



Sources. Cambodian authorities; Bank staff estimates.

Figure 2. Growth in real consumption per capita per day



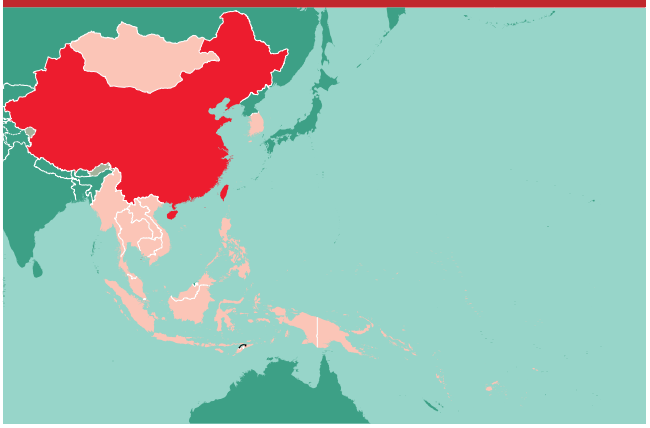
Sources. Cambodian authorities; Bank staff estimates.

Cambodia Selected Indicators

	2012	2013	2014	2015f	2016f	2017f
Real GDP (% change yoy)	7.3	7.4	7.1	6.9	6.9	6.8
Agriculture	4.3	1.6	0.3	1.0	1.1	1.5
Industry	9.2	11.0	9.8	9.0	7.5	6.0
Services	8.1	8.7	8.7	8.3	9.3	9.9
Inflation (eop, % change)	2.5	4.6	1.2	1.5	2.0	2.0
Fiscal balance including grants (% of GDP)	-3.3	-2.7	-0.3	-1.6	-2.0	-2.3
Exports, goods & services (% change yoy)	13.7	17.0	8.9	7.9	13.1	10.9
Imports, goods & services (% change yoy)	16.6	17.4	11.6	8.5	11.1	11.3
Current account balance excluding official transfers (% of GDP)	-9.7	-10.7	-10.8	-10.5	-10.3	-10.6
Foreign direct investment, US$ million	1,697.9	1,826.1	1,676.9	1,549.5	1,652.9	1,747.7

Sources: National authorities; World Bank.

CHINA



	2014
Population, million	1,364.3
GDP, current US$ billion	10,360.1
GDP per capita, current US$	7,593.9
GDP per capita, current US$ PPP	13,216.5
Poverty headcount ratio at $1.90 a day, 2011 PPP, % of population/1	4.1
Poverty headcount ratio at $3.10 a day, 2011 PPP, % of population/1	14.8
Gini coefficient, household disposable income/2	0.47
Life expectancy at birth, total, years/3	75.4
School enrollment, secondary, % gross/4	88.9
School enrollment, tertiary, % gross/4	26.7

Source: Statistics China, World Development Indicators, 2014.
1/ Data for 2014. World Bank estimate.
2/ Official data released by National Bureau of Statistics.
3/ Data for 2013.
4/ Data for 2012.

Summary

GDP growth moderated to 7.0 percent in the second quarter of 2015 reflecting policy steps to put economic growth on a more sustainable footing. Growth is expected to decelerate to about 7 percent in 2015 and 6.5 percent by 2017. Poverty rates are projected to decline from 4.1 percent in 2014 to 1.9 percent in 2017 (using the new World Bank poverty line of US$ 1.90/day and the new Purchasing Power Parity exchange rates based on 2011 prices).

Recent Developments

China's GDP grew by 7 percent yoy in the first half of the year. The real estate sector saw an orderly correction, reflecting policy efforts to reduce oversupply and tighten nonbank credit. The adjustment in credit conditions, a buildup of excess capacity, and decelerating exports all affected industrial activity. Partly offsetting this, growth in services was robust.

Household income and expenditures growth, the main determinants of poverty reduction, decelerated. By the second quarter of 2015, accumulated per capita disposable income grew by 8.1 percent in urban areas and by 9.5 percent in rural areas; lower than the 9.6 and 12.0 percent seen by the second quarter of 2014. Per capita expenditures show a similar deceleration. This deceleration is less pronounced in real terms. Real disposable incomes and expenditures grew by at least 6.5 percent year-to-year through the second quarter of 2015, still robust enough growth to yield a continuation of poverty reduction.

Outstanding credit, as measured broadly by aggregate financing, continues to decelerate. Issuance of new debt to finance new projects is falling as the authorities introduced guidelines on management of local government debt. This policy tightening has been partially offset by a series of targeted stimulus measures to prevent growth from slowing excessively.

Domestic equities markets corrected lower after a rapid increase beginning late 2014. The stock market boom was in part a result of policy efforts to diversify funding sources for the corporate sector, particularly encouraging initial public offering (IPOs). This led to more borrowing to buy shares (margin trading) and a rapid buildup of leverage and risks, triggering a technical correction as policies to tighten margin lending rules were introduced.

On August 11, 2015, the People's Bank of China (PBOC) modified its exchange rate regime to allow a greater role for the market in setting the daily opening reference rate of the renminbi (RMB). This policy shift is consistent with China's long-term agenda of allowing market forces to play a greater role in the economy and liberalizing its capital account. In part because of a lack of clear initial communication

of policy intentions from the PBOC, some analysts interpreted the exchange rate move as a competitive depreciation.

On the external front, merchandise exports growth was a low 0.9 percent in nominal terms in Q2, and import growth remained weak, reflecting weakening domestic demand and declining commodity prices, contracting 15.5 percent in nominal terms. Net non-FDI capital outflows reached an estimated USD 178 billion in Q2. Foreign exchange reserves declined by about USD 300 billion to USD 3,694 billion at end-Q2 2015, down from a historical high of USD 3,993 billion at end Q2 2014.

Outlook

China's GDP growth will gradually decline in the medium term as structural adjustments and policy efforts to address accumulated financial vulnerabilities continue. Growth is expected to moderate from 6.9 percent in 2015 to 6.7 percent in 2016 and 6.5 percent in 2017, assuming continued reforms. However, the speed at which the sources of domestic demand rebalance will remain modest, depending critically on an increase in the labor share of GDP. China still has the potential to use reforms to unlock growth dividends from increased labor force participation, reallocation of excess labor from agriculture, better allocation of capital and strong total factor productivity growth.

There is considerable uncertainty around the baseline projections for China's economy in 2016 and beyond. In particular, the accumulated imbalances present a risk of a sharper than expected slowdown in investment, a significant tightening of credit conditions, and increased capital outflows. In mitigation of this risk, both the monetary and fiscal policy stance is expected to remain broadly accommodative. Poverty will continue to fall, though at a slower pace due to the expected moderation in economic and household income growth. Poverty rates in are projected to decline from 4.1 percent in 2014 to 1.9 percent in 2017 (using the new World Bank poverty line of US$ 1.90/day and new Purchasing Power Parity exchange rates based on 2011 prices). Using the previous standard (i.e., poverty line of US$ 1.25/day and 2005 Purchasing Power Parity) the decline would be from 3.1 in 2014 to 1.3 percent in 2017 (see Figure 2).[1]

Challenges

Engineering a gradual shift to a more sustainable growth path poses challenges for policymakers, given real sector weaknesses and financial-system vulnerabilities. The key short-term policy challenge is to lower leverage in the economy, and continue rebalancing the economy toward consumption and services. Policies should aim to strengthen local government finances, through better alignment of local revenue with expenditure and improved management and oversight of local government borrowing. Reform should also continue to facilitate a reorientation from investment toward consumption, and from manufacturing and construction toward services. Overall, the process of deleveraging and rebalancing will be associated with slower, but more sustainable growth. However, some priority reforms can boost economic activity and growth even in the short term, including removing barriers to entry in restricted sectors, reducing administrative and regulatory burdens, and improving the use of land.

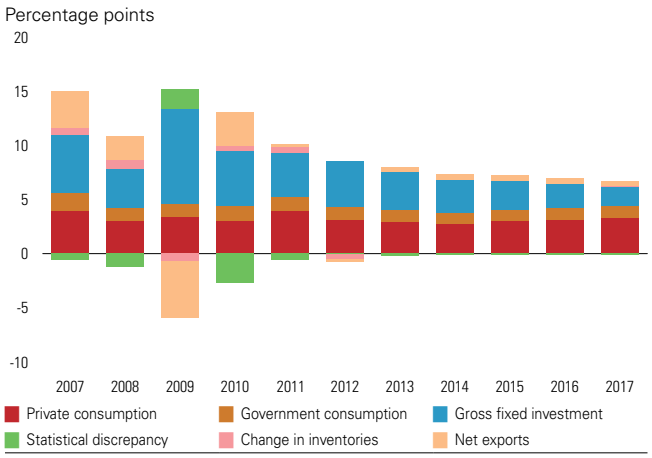
China has sufficient policy buffers to address risks and prevent a sharp slowdown. There is fiscal space to apply limited stimulus in the event of a sharper than expected slowdown. Government debt is moderate (41 percent of GDP at end-2014),[2] and it is predominantly held domestically by a small group of institutions, reducing exchange rate and refinancing risks. Regulations restrict savings instruments outside the banking system and the financial system is still predominantly state-owned. Capital controls

1 World Bank poverty estimates for China are preliminary and are subject to revision following the release by the National Bureau of Statistics of China (NBS) of latest estimates based on a new integrated survey, expected later in 2015.

2 General gross government debt (2014; Source: IMF).

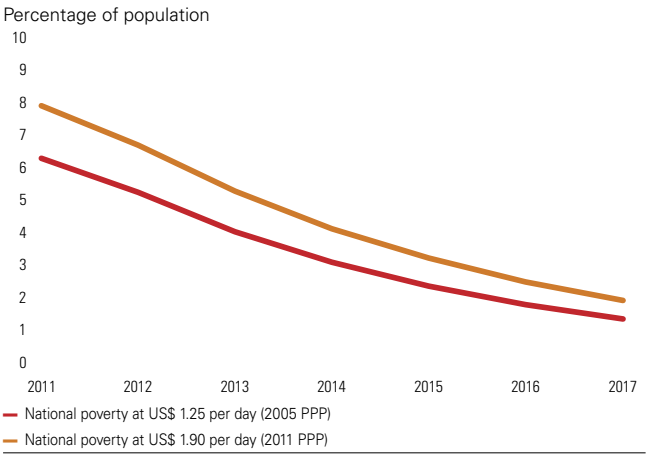
on portfolio investment and bank lending can limit surges in capital outflows. Finally, if reduced confidence in the financial system translated into attempts to convert local currency deposits into foreign currency, these could be met using the ample international reserves, which still amount to over USD 3 trillion.

Figure 1. Contributions to annual GDP growth, 2007–17



Source: World Bank staff forecasts.

Figure 2. Poverty in China, 2011–17

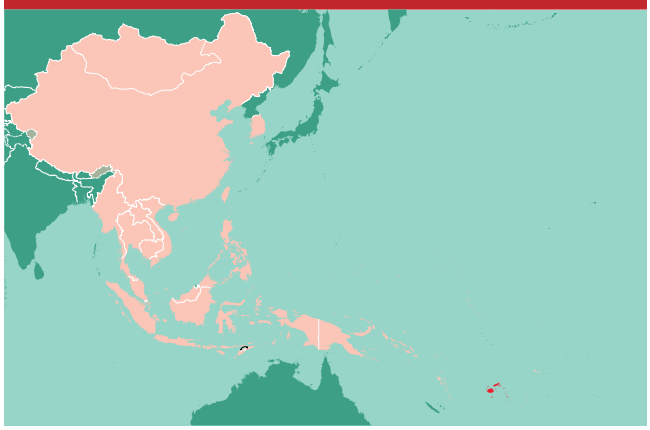


Source: World Bank staff forecasts.

China Selected Indicators

	2012	2013	2014	2015	2016	2017
Real GDP growth, at constant market prices	7.7	7.7	7.3	6.9	6.7	6.5
Private consumption	8.4	7.8	7.6	8.0	8.3	8.6
Government consumption	8.6	8.1	7.2	8.0	8.0	8.0
Gross fixed capital investment	9.5	8.1	6.7	5.6	4.9	4.1
Exports, goods and services	3.9	6.9	6.5	5.4	5.0	4.6
Imports, goods and services	5.3	7.2	5.9	4.5	4.2	3.9
Inflation (consumer price index)	2.6	2.6	2.1	1.3	1.3	1.3
Current account balance (% of GDP)	2.6	2.2	2.5	3.5	3.9	3.6
Fiscal balance (% of GDP)	0.0	-1.1	-1.9	-2.8	-1.9	-1.1
Poverty rate ($1.90 a day, 2011 PPP terms)	6.7	5.3	4.1	3.2	2.5	1.9
Poverty rate ($3.10 a day, 2011 PPP terms)	20.0	17.3	14.8	12.8	10.9	9.3

FIJI



	2014
Population, million	0.9
GDP, US$ billion	4.07
GNI per capita, US$	4,540
GDP per capita, current US$	3,944
Gini coefficient (2008)	0.41
Life expectancy	73

Sources: Fiji Bureau of Statistics; World Development Indicators.

Summary

The economy is on track for a fifth consecutive year of expansion on continued strength in private spending, visitor arrivals, and public investment. Fiscal policy remains expansionary and slow progress in privatization risks a repeat of last year's ad hoc cuts in capital spending to contain the deficit. The above-trend growth is expected to continue in 2016–17. Safeguarding stability in the rapidly-expanding financial sector and accelerating structural reforms to improve business climate are among the priorities for sustained poverty reduction.

Recent Economic Developments

In Fiji, growth reached 4 percent in 2014, spurred in part by increases in investor confidence, visitor arrivals, and private spending following the September election (the first since a military coup in 2006). The economy remains on track for a fifth consecutive year of expansion, with growth projected at around 3.4 percent on continued strength in private spending, visitor arrivals, and public investment.

Inflation moderated, averaging 0.8 percent year-on-year in June, as imported commodity and food prices continued to ease. The authorities continue to maintain price controls on a large part of the CPI basket, however, which might cause the CPI to understate the inflationary pressures. The exchange rate remained largely stable in the first half of the year, depreciating against the US dollar (-5.2 percent) and the yen (-2.5 percent), but appreciating against the euro (2.8 percent), the Australian dollar (1.3 percent), and the New Zealand dollar (7.9 percent).

The external deficit remains high, with the total import bill continuing to rise despite lower oil and food prices. This year, rising imports are expected to be offset by buoyant inward remittances (up by 29.3 percent to June 2015) and the large surplus in services trade (relating to tourism and transport), leading to a current account deficit of about 9 percent of GDP.

The fiscal deficit widened to an estimated 4 percent of GDP in 2014. A deficit of 7.8 percent of GDP had been budgeted, which would have been mostly financed by one-off privatization receipts. These, however, did not materialize. A combination of revenue overperformance and underexecution of capital spending nevertheless kept the deficit contained. Slow progress in privatization this year risks creating a large financing gap or a repeat of last year's cuts in capital spending.

Fiji has relatively low external debt—at around 15 percent of GDP—but it has been rising sharply in recent years, with additional borrowing for infrastructure. With improved access to external finance following the election, the government's external borrowing is likely to rise further. In September, the government issued a new five-year US dollar bond of US$200 million at 6.6 percent to refinance the US$250 million global US dollar sovereign bond issued in 2011 carrying a 9 percent coupon rate, and using the cash from sinking funds to finance the remainder.

Some poverty reduction has been achieved in urban areas where service sector growth has generated new opportunities, but rural poverty remains stubbornly high, reflecting weak agricultural growth and the declining sugar sector. In its 2015 budget address, the government renewed its commitment to promoting inclusive growth and lifting the living standards of the poor through social protection, better infrastructure, and income-generating activities in remoter islands.

Outlook

Growth should remain healthy, averaging 3 percent a year in 2016–17 and gradually returning to potential growth of around 2.5 percent in the medium term. Inflation is expected to be about 3 percent, since continued softness in international food and commodity prices will be offset by a weaker local currency and stronger domestic price pressures from above-trend GDP growth.

Lower gold prices and declining EU prices for the country's sugar exports will restrain merchandize exports. Tourist arrivals from Australia and New Zealand may weaken due to weaker exchange rates, lower commodity prices, and softer demand from China. External financing difficulties will be a risk, although foreign reserves remain comfortable, with increased access to donor financing.

The fiscal deficit is expected to gradually decline. Strong consumption and import growth are likely to increase tax and duties revenue, partially offsetting the slow progress in asset sales. The ambitious capital spending plans may encounter capacity constraints, resulting in underspending. Medium-term fiscal sustainability depends on significant fiscal consolidation over the coming years through a combination of increased revenue, prudent borrowing, and expenditure control.

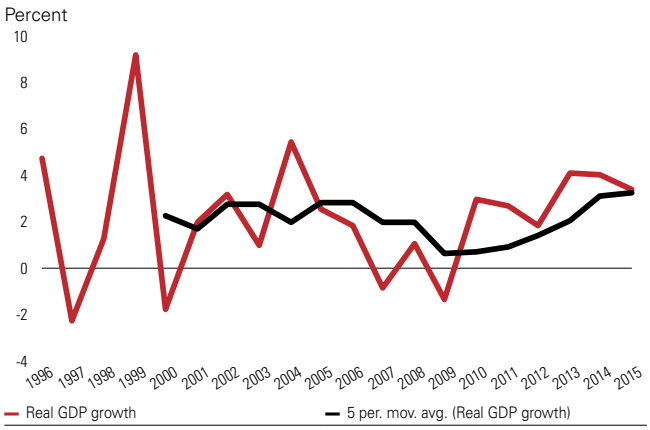
There are risks to the outlook. A sharper-than-expected slowdown in China could have a significant knock-on effect on demand for Fiji's exports, directly and indirectly through reduced demand from Australia and New Zealand. As a small island nation, Fiji is also vulnerable to extreme weather, which could simultaneously disrupt several export industries, including sugar, fisheries, and tourism.

Emerging Challenges

Safeguarding stability in the rapidly expanding financial sector will require enhanced banking supervision. While the banking sector remains well capitalized and the nonperforming loans (NPLs) remain low at around 2 percent, the record-low interest rates (0.5 percent since 2011), rising competition, and increased confidence have led to double-digit credit growth over the last two years, in the household and corporate sectors. Many loans carry variable rates, making borrowers vulnerable to the risk of an interest rate hike. With an increase in global interest rates on the horizon, there is a risk that NPLs could increase.

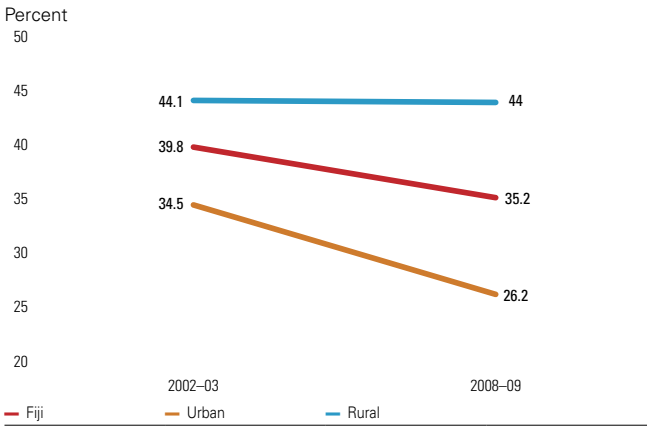
Encouraging private sector growth will require a more supportive business environment. Fiji's overall Doing Business ranking declined to 81 in 2015, down from 99 in 2009, and its "distance to frontier" score declined to 63.9 from 68.2. Fiji's worsening performance was due to deterioration in those areas where Fiji had already ranked low, including starting a business, protecting minority investors, paying taxes, and registering property. Fiji scores particularly poorly—160th of 189 countries—in starting a business, with 59 days required to start one.

Figure 1. GDP growth



Source: Fiji Bureau of Statistics; World Bank.

Figure 2. Poverty incidence



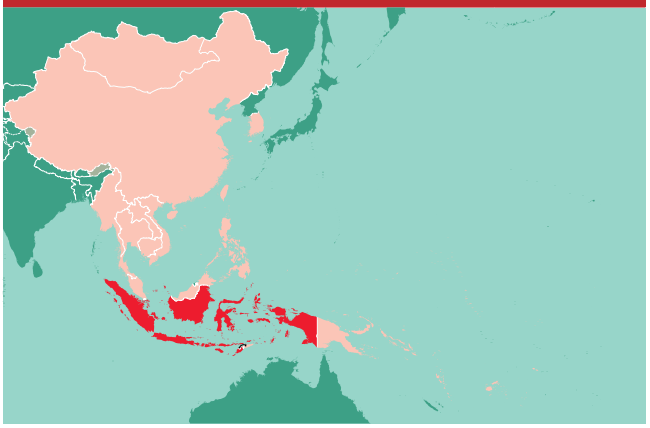
Source: Fiji Bureau of Statistics & World Bank (2011), "Poverty trends, Profiles and Small Area Estimation in Republic of Fiji (2003–2009)".

Fiji Selected Indicators

	2012	2013	2014	2015 e	2016 f	2017 f
Real gross domestic product	1.8	4.6	4.0	3.4	3.1	3.0
Exports, goods & services	9.1	-6.7	10.2	5.2	3.5	7.5
Imports, goods & services	4.0	20.6	6.8	3.0	3.6	3.6
Agriculture	3.5	2.6	3.5	3.0	3.9	3.6
Industry	0.2	2.5	4.0	3.0	3.1	3.1
Services	1.9	5.4	4.8	4.7	3.0	2.9
CPI Inflation, period average	3.4	2.9	0.5	1.0	2.8	3.0
Current account balance, % of GDP	-1.8	-20.7	-9.4	-8.4	-8.6	-8.7
Fiscal balance, % of GDP	-1.1	-0.5	-4.0	-3.1	-2.2	-2.1

Sources: Fiji Bureau of Statistics, Reserve Bank of Fiji, World Development Indicators, and staff estimates.

INDONESIA



	2014
Population, million	250
GDP, US$ billion	889
GDP per capita, US$	3,524
GDP per capita, US$ PPP	9,561
Poverty rate, US$1.90/day, PPP/1	8.3
Poverty rate, US$3.10/day, PPP/1	36.7
Gini coefficient	0.41
Life expectancy	72
School enrollment rate, primary	93

Sources: Indonesia National Statistics Agency; World Development Indicators, 2014.
1/ World Bank estimate.

Summary

Moderating growth and weaker job creation since the commodity downturn in 2012 have slowed the pace of poverty reduction in Indonesia. With limited room for both monetary and fiscal stimulus, new policy initiatives are needed to avoid increases in poverty. In this respect, the draft 2016 State Budget, which proposes larger and better-targeted social programs and redirects spending from energy subsidies to infrastructure development, is a positive step in the reform process.

Recent Economic Developments

GDP grew by 4.7 percent yoy in both the first and second quarters of 2015, compared to 5.0 percent yoy in the final quarter of 2014, as Indonesia's economy continued to adjust to the global commodity downturn. Nevertheless, growth in Indonesia has remained resilient compared with growth in other countries that depend on Chinese commodity demand. Lower investment growth continued to drive the slowdown, contributing only 1.3 percentage points yoy to growth, which was less than half of the 2010–12 average. Private consumption growth, which had previously been resilient, also moderated, to 4.7 percent yoy in the first half of 2015. Since its share in total GDP expenditure is about 55 percent, weakening private consumption weighed heavily on overall growth. Net exports contributed positively to growth, and helped reduce the current account deficit to around 2 percent of GDP, from around 3 percent in 2013–14, but this was mostly due to import compression rather than better export performance.

The growth moderation has resulted in slower job creation, with recent employment rising only just enough to absorb the increase in the working-age population. While the commodity downturn since 2012 and policy responses have reduced growth in the most in resource-rich provinces, employment creation has come under pressure across Indonesia. As a result, the slow progress in poverty reduction since 2012 has continued. Recent initiatives by the government to protect the 15.5 million poor and vulnerable households from the impact of the January 2015 fuel subsidy reform are likely to be effective, with the first three months of a temporary cash compensation already disbursed (this will not be reflected in the 2015 poverty numbers, which are measured in March, since the disbursement occurred in April).

Yet the scope for policy stimulus is limited. Despite the moderation in credit growth and economic activity, and unchanged fuel prices, inflation has averaged 7.1 percent yoy since March, mainly owing to a broad-based rise in food prices. Sticky inflation and persistent nominal exchange rate depreciation pressures have prompted Bank Indonesia to keep its main policy rate unchanged since February 2015, and instead to introduce accommodative macroprudential measures. At the same time, support to the economy from fiscal policy has been so far been impeded by weak revenues and low

capital spending. Total revenue collection in the first six months was 39.6 percent of the target set in the revised 2015 budget. Capital spending reached only 11 percent of the budget target, curtailing the government's ambitious infrastructure development plans.

Outlook and Emerging Challenges

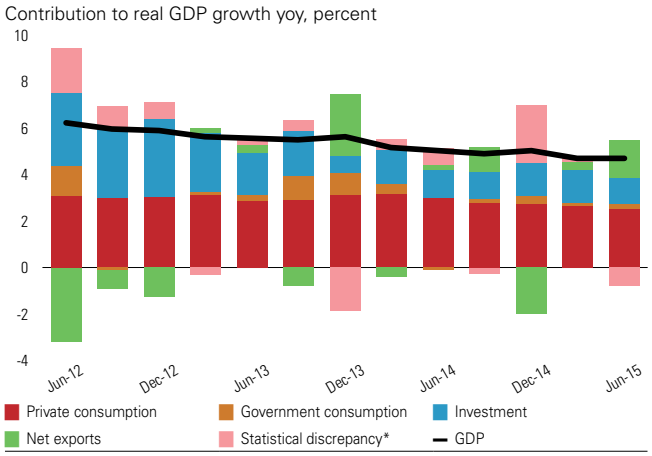
The World Bank forecasts GDP growth of 4.7 percent for 2015, increasing to 5.3 percent in 2016. Weaker commodity prices are expected to continue to put pressure on profits and incomes, constraining domestic demand growth. Nevertheless, investment growth is projected to increase somewhat toward the end of the year, as public capital spending picks up, albeit by less than planned in the budget, and leads to crowding-in of private investment. Inflation is projected at 6.8 percent in 2015, declining to 5.5 percent in 2016, though the forecast is subject to considerable uncertainty due to a lack of transparency regarding the adjustment of fuel prices by the government. A major policy package was also announced on September 9, 2015, recognizing the need to reduce red tape and regulatory uncertainty; its effective implementation will also be critical to the growth outlook.

Strengthening growth and lower inflation would provide a more positive environment for poverty reduction, but high inequality and difficulty reaching the remaining poor mean that, without new policy initiatives, the slow pace of poverty reduction may continue. Extreme poverty (those living below US$1.90 per person per day) is projected to decline by only around 1.1 percentage points to 7.2 percent in 2015 and 5.9 percent in 2016. The rate of those living beneath the international moderate poverty line of US$3.10 is expected to fall by slightly more—1.9 to 2.3 percentage points—to 34.8 percent in 2015 and 32.5 percent in 2016. Moreover, if food price inflation remains high, or is compounded by El-Nino-reduced agricultural production, poverty reduction could be even slower.

The draft 2016 budget expands the coverage and improves the targeting of selected social programs and continues to redirect spending from poorly targeted energy subsidies to infrastructure development. In 2016, the government plans to double the conditional cash transfer program by covering 6 million households, up from 3 million in 2015, and by allocating IDR 13.8 trillion (US$1 billion), an increase of IDR 6.1 trillion (US$460 million) over 2015. If implemented appropriately, this initiative alone would reduce extreme poverty by an additional 0.5 percentage points in 2016, to 5.2 percent. Furthermore, to support implementation of the health dimension of the social security program, in 2016, 92.4 million people will receive a state subsidy to pay their social insurance contribution, compared with 88.2 million people in 2015. In line with the government's development priorities, the 2016 budget includes a further reduction in energy subsidies and an increase in infrastructure investment, mainly channeled through higher transfers to local governments and capital injections for state-owned enterprises.

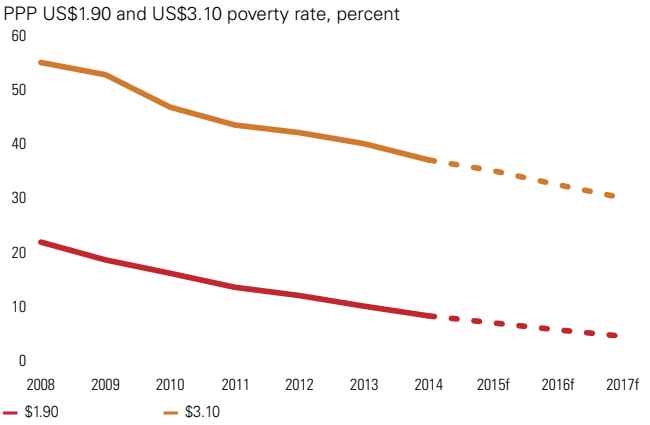
Indonesia continues to be confronted with an uncertain external environment and significant domestic policy challenges. Since monetary policy seems constrained in the short term, the focus is on the fiscal sector and the regulatory environment. To achieve a sustainable return to higher and more inclusive growth, the government has to push through with its ambitious infrastructure development plans and further improve business conditions to attract private investment. In this respect, budget execution is a key challenge, especially because local governments have limited implementation capacity but are expected to receive higher infrastructure spending allocations in 2016. In addition, the unfavorable macroeconomic environment will make achieving the 2016 revenue target an uphill task, further emphasizing the importance of fiscal reforms.

Figure 1. Indonesia's growth moderation continued into 2015, with investment weakening



Sources: National statistics agency; World Bank.
Note: *Statistical discrepancy includes change in inventories.

Figure 2. Poverty has been declining, but at a slowing rate



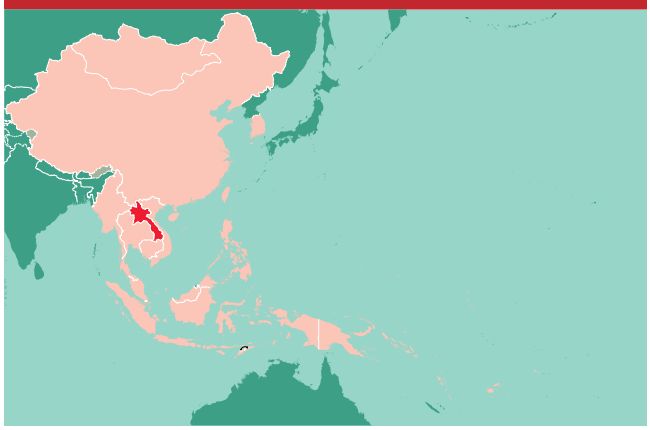
Sources: National household consumption survey (Susenas); World Bank calculations.

Indonesia Selected Indicators

	2012	2013	2014	2015f	2016f	2017f
Real GDP growth, at constant market prices	6.0	5.6	5.0	4.7	5.3	5.5
Private consumption	5.5	5.4	5.3	4.7	5.2	5.2
Government consumption	4.5	6.9	2.0	2.1	3.2	4.5
Gross fixed capital investment	9.1	5.3	4.1	3.7	5.0	5.8
Exports, goods and services	1.6	4.2	1.0	-0.2	4.7	5.7
Imports, goods and services	8.0	1.9	2.2	-3.2	3.6	5.9
Inflation (consumer price index)	4.0	6.4	6.4	6.8	5.5	5.0
Current account balance (% of GDP)	-2.7	-3.2	-3.1	-2.0	-2.6	-2.7
Fiscal balance (% of GDP)	-1.8	-2.2	-2.2	-2.5	-2.5	-2.5
Poverty Rate[a, b, c]						
Poverty rate ($1.9/day 2011 PPP terms)	11.8	9.9	8.3	7.2	5.9	4.8
Poverty rate ($3.1/day 2011 PPP terms)	41.9	39.7	36.7	34.8	32.5	30.2

(a) Calculations based on 2014-SUSENAS survey.
(b) Projection using Neutral Distribution (2014) with pass-through = 0.87 based on GDP per capita constant PPP.
(c) Actual data: 2012, 2013, 2014. Projections are from 2015 to 2017.

LAO PDR



	2014
Population, million	6.7
GDP, US$ billion	12.5
GNI per capita, US$[1]	1,600
GDP per capita, US$ PPP[2]	5,162
Gini coefficient[3]	0.36
Life expectancy	66
School enrollment rate, primary	121

Sources: National authorities; World Bank estimates.
1/ 2014. *2/* 2014. *3/* Data as of 2012.

Summary

GDP growth will moderate to 6.4 percent in 2015. The start of operation of the Hongsa power plant and slightly higher mining output will help compensate for lower external demand, slower credit growth and public spending controls. Economic activity will accelerate next year driven by the power sector, but with downside risks from external factors. Despite some improvement in living conditions, in the absence of reforms, the strong growth rates will yield only moderate job creation and poverty reduction.

Recent Economic Developments

Economic activity in Lao PDR remains vibrant, consistent with GDP growth of around 6.4 percent in 2015. Growth has benefited from continued robust investments in the energy sector, the commissioning of plants (including one block of the 1,878 MW Hongsa lignite power plant), and slightly higher than expected copper and gold output as higher-grade ore was reached and processed at the two big mines. The construction sector remains strong, despite a slight slowdown from last year, driven by FDI into the power sector and commercial real estate. However, lower demand and prices, as well as unfavorable weather, may have affected agricultural output. Expanding the customer base to China and the Republic of Korea has increased the inflow of tourists, with tourism becoming one of the biggest foreign exchange earners. Average annual inflation is expected at around 2 percent, half of that in 2014, due to declining fuel prices and moderation in domestic demand associated with the slowdown in credit growth and public spending.

The growth pattern remains similar to previous years when high economic growth was accompanied by a less-than-proportionate decline in poverty and rising inequality. Most jobs are in subsistence agriculture, which grew more slowly than the rest of the economy, while creation of manufacturing jobs is hampered by a difficult business environment and stagnant labor productivity. Consequently, this reduced the benefits of growth to the poor and widened inequality, while an inadequate safety net system left people vulnerable to shocks (half of the poor in 2012/13 were nonpoor in 2007/08). The Gini coefficient increased to 36.2 from 32.5 in 2002/03 driven by widening disparities between rural-urban areas and within urban areas. The current growth path therefore offered limited opportunities for the poor.

The budget is likely to largely meet its deficit target for FY14/15 of around 4.1 percent of GDP, only slightly below initial projections. Still, this is widening compared to the revised FY13/14 fiscal data, which show an improvement in the fiscal deficit from around 4.3 percent of GDP to 3.8 percent of GDP, reflecting largely one-off revenue inflow. Total revenues as a share to GDP are estimated to decline to 22.9 percent from 23.7 percent a year earlier, as improved nonresource revenues collection (VAT, excise) is offset by a fall in mining revenues due to lower commodity prices and grants. Total expenditure

is estimated to drop to around 27 percent, reflecting the wage freeze and lower public recruitment. Preparations for the events leading to the Party Congress and ASEAN Chairmanship in 2016 are likely to keep spending on goods and services and capital investments high. Controls on public spending and weak balance sheets of some banks have contributed to credit deceleration at about 14 percent yoy in March 2015, compared to about 30 percent in 2014. Nevertheless, some systemic risks in the banking system remain.

The current account deficit is estimated to widen as mining and agriculture exports are affected by lower commodity prices and slower demand. Wood exports to neighboring countries are also estimated to decline by about 30 percent from a very high base last year. This is only partly being offset by higher electricity exports from new power plants and lower imports due to falling oil prices and reduced capital imports, as some power plants move from construction phase to generation. Investment inflows into the power projects are still robust, reflecting the strong pipeline of projects in the sector. This, together with increased external borrowing, appears to have fully financed the current account deficit and, as a result, foreign exchange reserves are estimated to moderately increase by year end, but still cover about 2 months of imports of goods and services and less than half of the foreign currency deposits. The authorities continued to tightly manage the exchange rate, allowing it to depreciate by only around 1.3 percent yoy against the US dollar by end-August 2015. With the US dollar strengthening globally, the kip appreciated strongly against other currencies, including by around 7.5 percent against the Thai baht. The real effective exchange rate has continued to appreciate, adding to other supply-side constraints affecting the competitiveness of domestic products.

Outlook

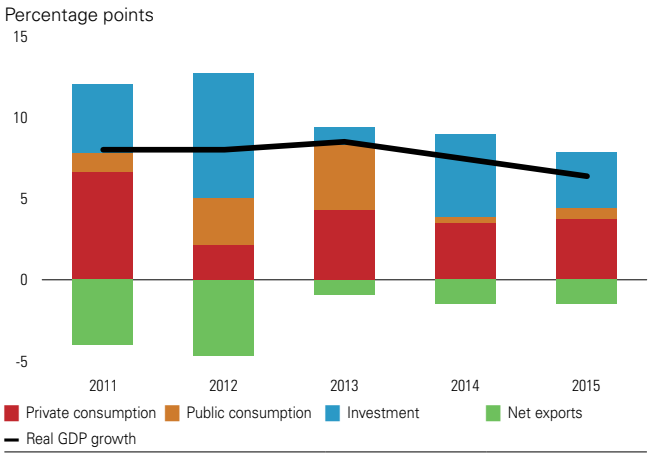
The economic outlook for the medium term remains broadly positive but subject to growing downside risks. The power sector is likely to continue to drive growth over the medium term as a number of projects currently under construction come on stream and new ones are launched. The nonresource sector is expected to remain dynamic as rents from the resource sector trickle down into higher domestic demand and efforts on investment climate reforms continue. However, downside risks have increased recently. Trade and investment could be affected if China's economy slows more than expected and if growth in Thailand continues to remain sluggish, reflecting recent political, security, and weather events in the country. Inflation pressures are likely to remain moderate.

The fiscal and external balances are expected to improve over the medium term. The fiscal deficit is projected to decline to less than 4 percent in FY15/16 and further to around 3.5 percent of GDP in FY16/17 as authorities continue to improve revenue administration and increase excises while consolidating expenditures by continuing tight control over new investment projects and nonessential spending. On the external side, continued FDI inflows to pipeline power projects will keep imports high; however, expanding electricity exports from new plants and low energy prices are expected to narrow the overall deficit.

Emerging Challenges

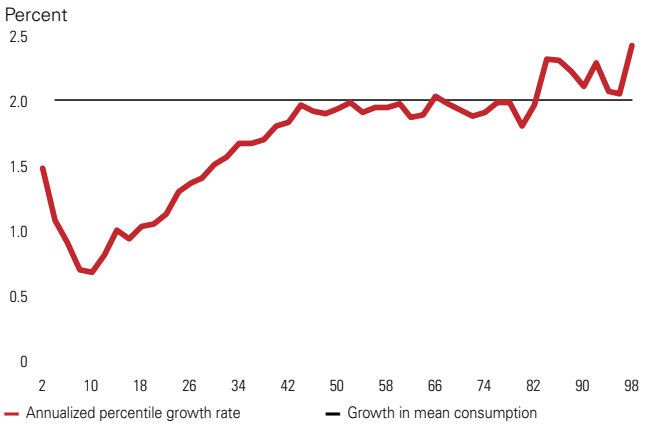
Continuation of the current growth pattern may deter inclusive growth and improved human development outcomes. Since the resource sector creates few productive jobs and carries more volatility to revenue flows (from mining), promoting diversification in nonresource sectors can broaden growth sources and generate more attractive job opportunities. For the near term, despite moderation in credit growth and public spending, systemic risks in the financial sector are yet to be addressed. Furthermore, the elevated public debt levels and the low level of reserves undermine the ability to mitigate adverse shocks.

Figure 1. Contributions to annual GDP growth



Source: Staff estimates based on national statistics.

Figure 2. Growth incidence curve, 2002/03–2012/13



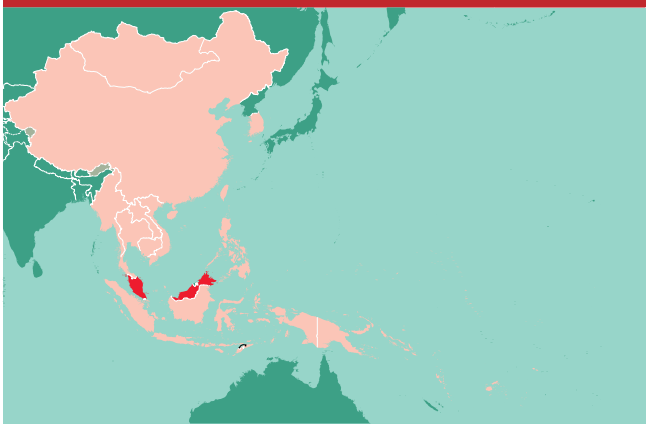
Source: Staff calculations based on LECS 4-5.

Lao PDR Selected Indicators

	2012	2013	2014	2015 f	2016 f	2017 f
Real GDP growth, at constant market prices	8.0	8.5	7.5	6.4	7.0	6.9
Private consumption	3.1	6.5	5.4	5.9	6.0	6.0
Government consumption	29.2	33.9	2.6	5.0	4.8	4.5
Gross fixed capital investment	29.0	3.4	16.8	10.5	7.1	7.9
Exports, goods and services	12.9	14.0	16.0	4.0	8.1	7.2
Imports, goods and services	21.9	13.0	15.8	6.0	6.2	6.1
Real GDP growth, at constant factor prices	8.0	8.5	7.5	6.4	7.0	6.9
Agriculture	2.7	6.4	7.9	0.6	0.7	2.8
Industry	12.9	12.4	6.9	9.6	11.4	9.7
Services	7.8	6.5	7.7	7.7	7.0	6.8
Inflation (consumer price index)	4.3	6.4	4.2	2.0	4.0	4.0
Current account balance (% of GDP)	-12.7	-11.5	-11.2	-12.8	-11.5	-11.0
Fiscal balance (% of GDP)	-1.3	-6.0	-3.8	-4.1	-3.8	-3.6

Sources: National authorities; staff estimates.

MALAYSIA



	2014
Population, million	30.2
GDP per capita, US$ PPP	23,298
Gini coefficient, disposable income	0.41
Life expectancy at birth (2013)	75
School enrollment rate, primary[1]	101.4
Life expectancy	74.8

Source: World Development Indicators 2014.
1/ UNESCO Institute for Statistics; gross enrollment ratio in 2005.

Summary

Malaysia's economy has performed strongly in delivering inclusive growth, but external balance pressures have recently mounted and growth is now slowing. While sound macroeconomic management, including fiscal reforms and consolidation efforts, have helped to contain near-term economic risks, the urgency has increased for Malaysia to continue making the structural reforms and investments necessary to shift toward a more skills-intensive, high-productivity economy.

Recent Economic Developments

Strong domestic demand helped shield Malaysia's economy from the impact of weakening exports until the early part of 2015, but a broad-based moderation in output growth is now underway. Private consumption received a temporary boost from a surge in retail spending ahead of the introduction of a 6 percent general sales tax (GST) in April. Fixed investment also had a strong start to the year, especially in the construction sector, but slowed sharply in the second quarter. Consequently, domestic demand growth has cooled. Turning to external demand, export volumes contracted over the first half of 2015, and imports were also subdued, in combination subtracting about 1 percentage point per quarter from output growth. Overall GDP has decelerated from a rapid 7.3 percent quarter-on-quarter at a seasonally adjusted annual rate (qoq SAAR) in Q4 2014, down to 4.5 percent qoq SAAR in Q2 2015, when quarterly GDP was 5.0 percent above its level of a year ago (compared with 6.0 percent growth in 2014).

The moderation in output growth should be seen in the context of the Malaysian economy weathering a marked deterioration in the external balances, which has weighed on the currency. Weaker export revenues have significantly reduced Malaysia's trade surplus, contributing to a narrowing of the overall current account surplus, to 2.7 percent of GDP in Q2 2015, down from 3.6 percent in the first quarter, and 4.4 percent in 2014. Portfolio investment outflows continued through the second half of 2015. Consistent with this challenging external backdrop, the ringgit depreciated by 20.6 percent and 8.9 percent against the US dollar and in real trade-weighted terms, respectively, in 2015 through August. This significant weakening of the currency has helped cushion the shock to exporters' incomes and facilitate domestic expenditure switching following the reduction in Malaysia's terms of trade, yet it also generates new challenges, particularly for foreign currency debtors and domestic firms now facing higher costs of investing in imported capital goods.

Exchange rate, monetary, and fiscal management responses have been broadly appropriate to maintain economic stability. Alongside the flexible approach to the currency, the authorities have also smoothed volatility and drawn down reserves, which fell by US$20.3 billion in 2015 through August (affected also by US dollar valuation effects). Bank Negara Malaysia has held its overnight policy rate at 3.25 percent since July 2014. Since that time,

loan growth has held relatively steady (9.6 percent yoy in July 2015). Headline inflation, after dipping below 1 percent yoy in March 2015, increased to 3.3 percent yoy in July, attributable mainly to supply-side factors. The drop in global oil prices since 2014 has posed a major fiscal challenge, since oil-linked revenues account for approximately 30 percent of the total; the scrapping of fuel subsidies at end-2014 and the new GST have helped preserve Malaysia's fiscal space.

Outlook

Malaysia's economic resilience to date has been underpinned by a solidly performing labor market, with employment climbing 1.6 percent in the year to June, unemployment stable at close to 3 percent in 2015 through June, and significant real wage growth in crucial sectors such as manufacturing. There has also been some stabilization in relatively high levels of household indebtedness, reducing vulnerabilities to financing shocks and supporting the sustainability of private consumption growth. Banking sector conditions through the latest available (July) data have remained conducive to expanding private sector access to credit and thus for economic activity, with headroom for more lending indicated, for example, by the loan-to-deposit ratio, which although increasing, remains below 90 percent.

Against these broadly positive factors, the dampening impact of external pressures is still playing out, and scope for more expansionary macro policies is likely to continue to be constrained by the need to preserve policy buffers. The potential impacts of the financial market volatility in late August, in Malaysia as in many other EMEs, make the outlook for bank liquidity, and also investor demand for credit, less certain. Overall, growth is expected to slow further, to 4.7 percent for 2015 and 2016, before picking up mildly toward 5.0 percent in 2017, helped by strengthening exports. The current account balance is projected to hold at approximately its recent level (at 2.5 percent of GDP in 2015). The ongoing moderation in domestic demand and global commodity prices, including oil, should help to cap inflation below 3 percent in 2015.

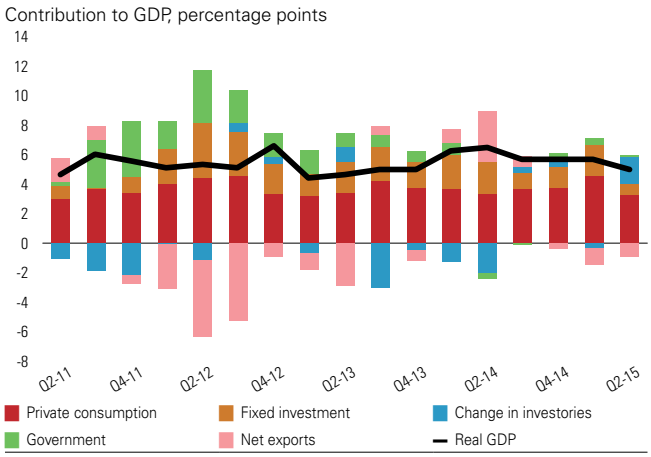
Risks to the growth outlook are tilted to the downside. Ongoing political noise has weighed on sentiment regarding Malaysian financial assets and the ringgit, with a risk of this further constraining policy space and filtering into real sector activity, especially productive investment, given that over 80 percent of machinery investment is in the form of imported capital goods. Consumer and business confidence and spending may be eroded more than currently expected by more negative income and wealth effects from exchange rate or other policy adjustments, including due to the trajectory of key trading partner economies and global financing conditions. The slowdown in China, which absorbs more than 8 percent of Malaysia's GDP, could pose further risks. Finally, should Brent crude prices move lower, this would erode Malaysia's fiscal position, external balances, and GDP growth.

Emerging Challenges

Lower global energy and other commodity prices increase the urgency of diversifying public revenues, and raising the efficiency of given levels of public spending in supporting critical sectors for future growth, such as education. Investment spending will also need to shift further toward skill-intensive production, to reduce Malaysia's continuing dependence on hydrocarbons, and to generate the high-productivity, high-income jobs needed for shared prosperity. This will require a base of more productivity-enhancing reforms, including modernizing social policies toward income-targeted programs focused on equality of opportunities, reforming the education system without increasing public spending, enhancing competition in the economy, and ensuring the sustainability of public finances by reducing dependence on energy revenues. Further gains in reducing inequality and boosting incomes at the bottom of the distribution hinge on speeding up these reforms to close skills-

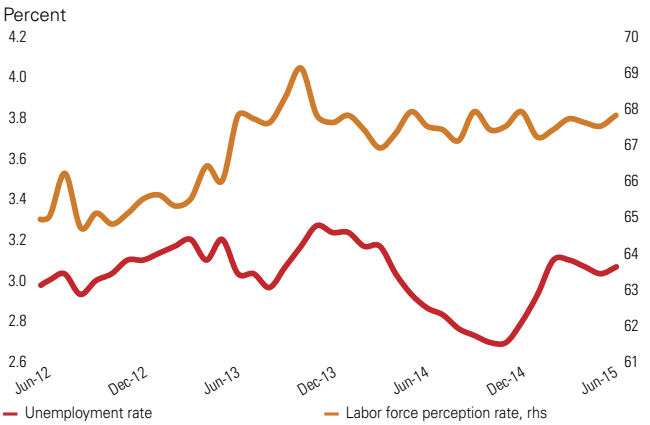
and income-based achievement gaps in education and the labor market.

Figure 1. GDP growth is moderating, weighed down by net exports and, in Q2, lower domestic demand growth



Sources: Malaysian Department of Statistics; World Bank.

Figure 2. Solid, inclusive growth in recent years has been underpinned by a strong labor market



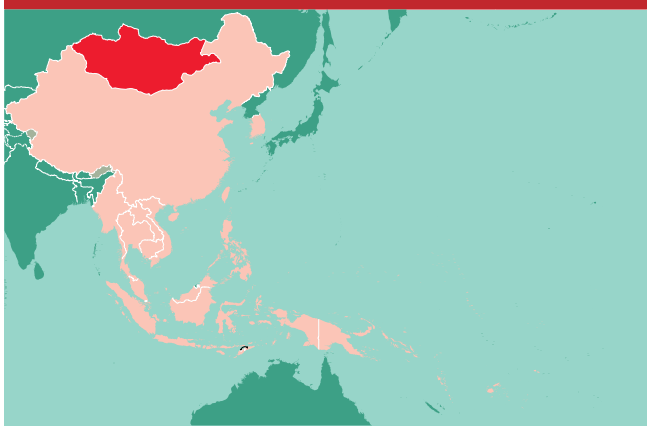
Sources: Malaysian Department of Statistics; World Bank.

Malaysia Selected Indicators

	2012	2013	2014	2015 f	2016 f	2017 f
Real GDP growth, at constant market prices	5.1	4.7	6.0	4.7	4.7	5.0
Private consumption	8.2	7.2	7.0	5.8	6.3	7.0
Government consumption	5.0	6.3	4.4	4.5	4.2	4.5
Gross fixed capital investment	19.0	8.2	4.8	3.5	7.6	4.9
Exports, goods and services	-1.8	0.3	5.1	1.9	5.5	5.5
Imports, goods and services	2.5	1.7	4.2	3.9	7.5	6.7
Inflation (consumer price index)	1.7	2.1	3.1	1.9	2.8	3.0
Current account balance (% of GDP)	5.8	4.0	4.3	2.5	2.6	2.4
Fiscal balance (% of GDP)	-3.8	-5.0	-3.7	-3.2	-2.9	-2.7

Sources: National statistics; staff estimates.

MONGOLIA



	2014
Population, million	3
GDP, current US$ billion	12
GDP per capita, current US$	4,129
Gini coefficient[1]	0.37
Life expectancy at birth, years[2]	67.5

Source: World Bank WDI.
/1 2007. */2* 2013.

Summary

Falling investment and slowing consumption were a drag on growth in 2015. The poverty rate declined to 21.6 percent in 2014, but the pace of poverty reduction is slowing. New external borrowing eased immediate external pressure, and a major new mining development was agreed to revive FDI. The external accounts, however, will likely remain vulnerable to shocks. Stronger policy adjustment is needed to reduce external vulnerability and safeguard the economy against risks.

Recent Economic Developments

Growth dropped to 3.0 percent (yoy) in the first half of the year due to falling investment and slowing consumption, amid weak FDI and the subdued commodity market. Mining GDP continued to grow, at 16.5 percent due to robust copper production. Nonmining GDP contracted by 0.2 percent. Agriculture maintained 9 percent growth, but wholesale and retail services and transportation contracted by 7.6 percent and 4 percent, respectively, resulting in asymmetric welfare gains and losses across different sectors.

Poverty, according to government estimates using the official poverty line of 146,650 tugriks in 2014, fell from 27.4 percent in 2012 to 21.6 percent in 2014, but its pace moderated compared with 2010–12, with mean consumption growth declining from 10.5 percent to 2.3 percent. Poverty declined faster in rural areas with robust agricultural growth compared with other sectors. Transition to the Child Money Program in 2013–14 from the previous unsustainable universal transfers reduced contributions of social transfers to household income across the board.

The current account deficit narrowed to US$410 million in the first seven months. Exports fell 6.2 percent, with weak coal and oil exports. Falling imports of oil products and machinery reduced total imports by 30 percent. The overall balance of payments displayed a US$82 million surplus in the same period due to large external debt financing. FDI remained weak, recording only a US$150 million net inflow. Portfolio investment, however, displayed a US$623 million net inflow due to sovereign and sovereign-guaranteed bonds issued in May and June, helping international reserves rebound to US$1.7 billion in July from US$1.3 billion in April. A US$320 million drawdown on the currency swap line with the People's Bank of China also provided buffers. The exchange rate remained around 1,995 tugriks against the US dollar, despite the recent exchange rate volatility in the region, with central bank interventions. National inflation moderated to 6.6 percent in August from 9.8 percent in January.

Revenue shortfalls reached 15 percent of the budget in the first seven months. In response, tight payment controls have been in place curbing budget execution at 75 percent of the spending plan. Monetary policy stayed tight. Bank credit growth including securitized mortgages slowed to 5.5 percent in July, with the slowing economy and the phasing out of the Price Stabilization Program (PSP). Outstanding mortgages financed by Bank of Mongolia, however, grew

18 percent over the same period. Nonperforming loans continued to rise to 5 percent of loans in July from 3.1 percent at end-2014.

Outlook

Overall growth is projected to slow to 3.3 percent in 2015, a decline from the 4.4 percent of the last projection. Mining growth will soften to around 10 percent in 2015 and further slow in 2016–17 amidst the weak minerals market. Nonmining growth will remain subdued in 2015 but is expected to rebound in 2016 with FDI recovery. Poverty reduction will also likely slow, with sluggish real income growth, particularly among households relying on low-skilled jobs in nonagricultural sectors.

The current account deficit is projected to narrow to 6 to 7 percent of GDP in 2015, but to widen next year with growing imports for mining investment. Oyu Tolgoi's underground mine project is expected to help revive FDI in 2016, and also support Mongolia's long-term growth potential.

The fiscal outlook remains weak. Without a supplementary budget to reduce spending further, the budget deficit would likely far exceed 5 percent of GDP in 2015. Off-budget spending through Development Bank of Mongolia's (DBM's) commercial portfolio could also weaken the credibility and effectiveness of the medium-term fiscal plan.

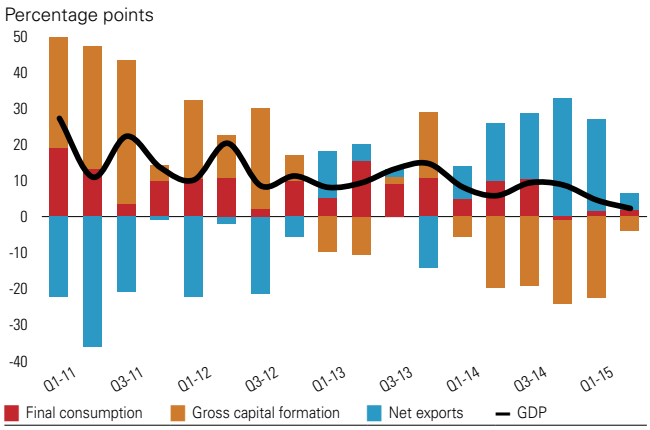
Challenges

Mongolia continues to face challenges from the weak external accounts and high downside risks. The balance of payments will remain weak due to the growing current account deficit and concentrated external debt repayments in 2017. Slower recoveries in FDI and the minerals market would further dampen growth and the balance of payments. Growing political uncertainty is likely to pose another risk to policy reforms during the election cycle.

The economic policy framework improved in 2015, but further actions are needed to restore a prudent policy framework and prepare for high downside risks. A supplementary budget for 2015 and proper control of DBM's commercial spending would strengthen the credibility and effectiveness of the fiscal plan. A tight monetary policy stance needs to be maintained, and liquidity injection to quasi-fiscal programs should be terminated.

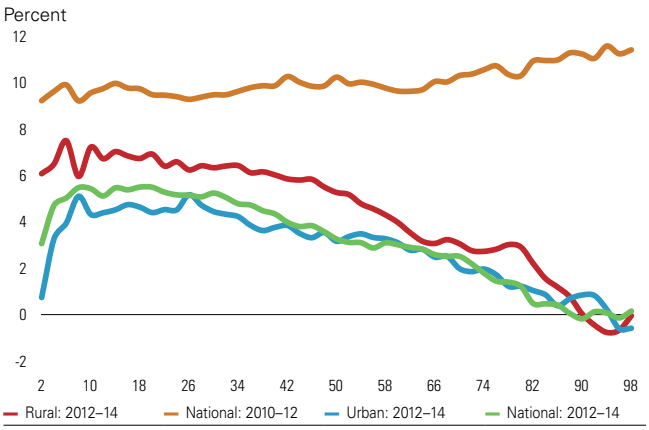
With the sluggish economy, the risk that many households close to the poverty line may slide back into poverty is growing. To preserve poverty gains under tight fiscal constraints, fiscal resources should be prioritized to mitigate adverse impacts on poverty reduction. The social safety net needs to be strengthened by consolidating fragmented programs, targeting them, and improving benefit coverage to the poor and near poor.

Figure 1. Contributions to GDP growth, yoy



Sources: National Statistical Office; World Bank staff estimates.

Figure 2. Growth incidence curve: 2010–14



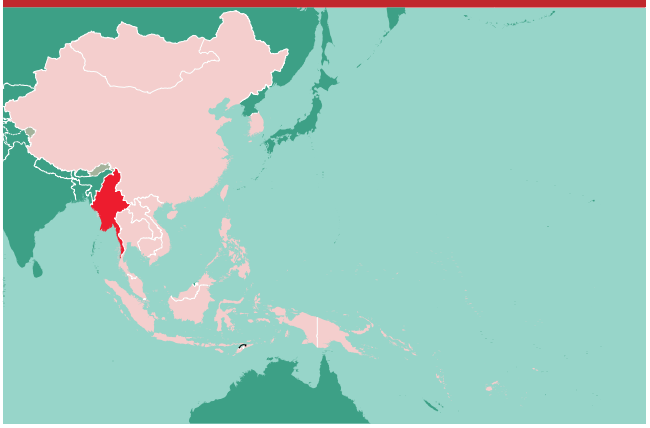
Source: World Bank staff estimates.

Mongolia Selected Indicators

	2012	2013	2014	2015f	2016f	2017f
Real GDP	12.3	11.6	7.8	3.3	4.1	4.0
Private consumption	13.3	14.1	10.6	4.5	7.3	5.8
Government consumption	18.5	15.2	-1.9	2.4	-0.3	2.3
Fixed investment	14.7	-4.3	-33.5	-27.0	29.8	13.1
Exports, goods & services	8.3	13.7	51.4	8.1	5.2	-1.6
Imports, goods & services	15.4	6.3	4.9	-3.4	14.2	2.4
GDP, at market prices	12.3	11.6	7.8	3.3	4.1	4.0
Agriculture	21.1	19.3	14.4	9.5	9.0	10.0
Industry (incl. mining)	14.8	15.3	16.1	7.6	0.7	-0.2
Services	10.3	6.8	4.8	1.3	5.2	5.6
CPI inflation, end of period	14.2	12.3	11.0	7.2	6.8	6.5
Current account balance, % of GDP	-27.4	-25.2	-11.7	-6.4	-16.0	-18.5
Fiscal balance, % of GDP /1	-9.1	-9.2	-10.8	-8.0	-6.9	-5.5

Sources: NSO; MOF; World Bank staff estimates.
1/ Fiscal balance includes all off-budget expenditures of the DBM and assumes a supplementary budget in October.

MYANMAR



	2014
Population, million[/1]	51.4
GDP, US$ billion	63.4
GDP per capita, US$	1,233
Life expectancy (2012)	65
School enrollment rate, primary (2010)	114

Sources: World Bank staff estimates; World Development Indicators, 2014.
1/ Provisional Census Results, 2014, Ministry of Immigration and Population, Myanmar.

Summary

Myanmar's economy grew at a strong pace in 2014/15 but is projected to moderate in 2015/16 due to floods and slowing investment during the elections. The current account deficit has widened on account on investment-related imports. Rapid credit growth has fueled monetary expansion. Inflation reached 10 percent in the year to July. Medium-term growth prospects remain strong assuming continued progress on reforms.

Recent Economic Developments

Myanmar grew at an estimated 8.5 percent in real terms in 2014/15. Economic reforms have supported consumer and investor confidence despite ongoing business environment and sociopolitical challenges. Public consumption and private investment on the demand side, and the services sector on the production side, were the main drivers of growth. Agricultural output picked up in 2014/15 after two years of sluggish growth. Output in manufacturing and industry has been strong thanks to natural gas in particular. There has been growing investment in light manufacturing, which slowed in early 2015/16 together with construction activity, linked in part to the upcoming period of political transition.

The economic impact of the floods that hit Myanmar in July 2015 is still being assessed, but will likely adversely affect the main rice crop this year. According to preliminary analysis of Census data, the areas most affected by the floods are those where people were relatively worse off. The floods are therefore affecting a population that was already vulnerable to poverty.

Strong demand for investment-related capital imports widened the current account deficit in 2014/15 to over 6 percent of GDP. Export fortunes remain closely linked to gas (around 40 percent of merchandise exports), which helped offset a drop in forestry exports last year. Agriculture trade was strong thanks to a rebound in the output of beans, pulses, and rice. The drop in international commodity prices helped reduce imports of refined oil, though this had not yet fully fed through to gas prices in Q1 of 2015/16.

Inflationary pressures increased during 2014/15, largely due to increasing food prices, with the CPI rising by 7.5 percent to end-March 2015, reaching just over 10 percent to July 2015 due to supply pressures and a weakening kyat. Although the price of rice, beans, and pulses in 2014/15 was stable, in line with international developments, the price of processed foods increased. Rising food prices are anticipated to particularly affect urban poor households and poor rural households that are net purchasers of food.

Reserve money remained relatively stable till the end of 2014 though overall money supply grew rapidly on account of increasing credit to the private sector. Banking sector exposure to vulnerabilities is limited by its low level of development, but strengthening banking supervision remains a priority to avoid a build-up of risks. The exchange rate depreciated by around 20 percent in nominal terms in the year to August 2015 due to a general strengthening of the

US Dollar, a growing current account deficit, and slowing foreign investment inflows in the run up to the elections. Recent efforts by the Central Bank to maintain exchange rate flexibility by allowing further depreciation of the kyat have helped to curtail the parallel market.

Estimates of Union Budget outturn for 2014/15 signal continued efforts at trying to maintain a prudent fiscal stance in the face of growing demands for public services. The general government budget deficit is estimated at 4 percent of GDP for 2014/15. Strong revenue performance was in part due to a windfall from telecom license receipts, though reforms in tax administration—including the introduction of self-assessment and the establishment of a Large Taxpayers' Office—are also beginning to pay off in terms of higher revenue collections. Spending on social sectors and economic services continued to trend up as a share of GDP in the 2015/16 Budget. These budget shifts aim in part to reduce household spending on education and health, and to support human development outcomes among poorer households.

Outlook

Economic growth in 2015/16 is expected to moderate to 6.5 percent in real terms, though this is subject to revision as more details come in on the impact of the floods. Agriculture growth will drop on account of the floods, and investment in manufacturing and industry will likely remain slow over the course of the political transition. Inflation in 2015/16 is projected to increase to 11.3 percent (period average) due to a combination of supply pressures caused by the floods and currency depreciation. Fiscal policy is expected to remain broadly on track, but the current account will come under further pressure due to import demand for post-flood rehabilitation and slowing agricultural exports.

Economic growth is expected to pick up over the medium term, assuming continued progress on economic reforms and a smooth political transition. The agricultural sector should bounce back rapidly, and services should continue to grow at a strong pace thanks to further expansion of telecommunications and banking services, in particular. Manufacturing and industry are also expected to pick up post-elections, particularly since recent investments in light manufacturing (for example, garments) begin their operations in newly established economic zones.

Emerging Challenges

While medium-term growth prospects remain strong, addressing the impact of the floods on poor households will be a challenge. The floods have hit two of the poorest states in Myanmar, namely Rakhine and Chin, which have been declared natural disaster zones.[3] Loss of livelihoods has been compounded by loss of assets and access to social services. This will require a strong public sector response.

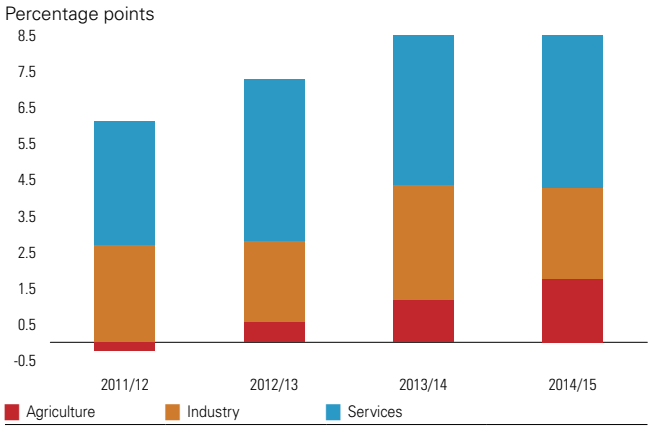
Strong growth prospects assume continued progress on reforms, which will hit a hiatus over the election period. These include adoption of legislation to strengthen the business environment (for example, the Investment Law and the Companies Law), modernization of the banking sector (the Banking and Financial Institutions Law), and strengthening public debt management (the Public Debt Law). It also includes efforts to address access to finance, which remains a big constraint, particularly for poorer households that have more limited sources of collateral and limited access to formal financial institutions.

Myanmar will face challenges from the external environment. Slowing growth in China could adversely affect the demand for Myanmar's merchandize exports. Low commodity prices will affect gas exports, though these could be offset by higher output from Shwe and Zawtika fields that came

3 *Reliefweb*, "Myanmar: Floods and Landslides – July 2015."

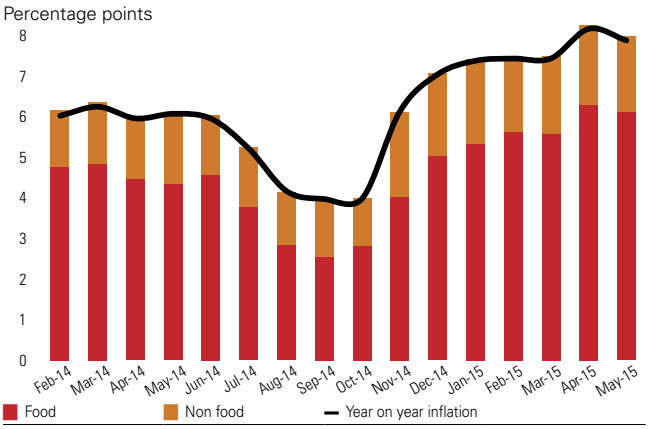
on stream two years ago and higher Kyat earnings from gas as a result of currency depreciation. The US Federal Reserve's eventual decision to raise interest rates could further strengthen the US Dollar and place added pressure on the exchange rate.

Figure 1. Real GDP growth and sector contributions



Sources: Central Statistics Office; WB Staff estimates.

Figure 2. Contribution to yearly inflation



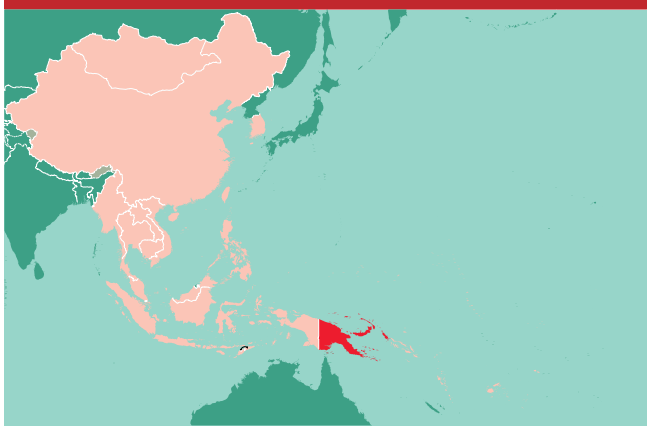
Sources: Central Statistics Office; WB Staff estimates.

Myanmar Selected Indicators

	2013/14	2014/15 e	2015/16 f	2016/17 f	2017/18 f
Real gross domestic product	8.5	8.5	6.5	7.8	8.5
GDP, at market prices	14.4	15.6	18.6	17.0	15.3
Agriculture	9.3	12.6	12.4	13.4	12.2
Industry	17.5	15.9	18.0	17.2	15.9
Services	16.6	17.8	23.6	19.3	17.0
CPI inflation, period average	5.7	5.9	11.3	8.5	6.3
Current account balance, % GDP	-5.3	-6.3	-7.9	-7.0	-5.6
Exports, goods & services	10.4	23.4	26.7	27.2	24.8
Imports, goods & services	15.6	26	31.4	21.4	18.5
Fiscal balance, % of GDP /1	-3.3	-4.0	-4.9	-4.6	-3.7
Revenue (% of GDP)	10.8	11.9	9.9	10.6	11.5
Expenditure (% of GDP)	14.1	15.8	14.8	15.2	15.2

Sources: National statistics; staff estimates.
1/ General government.

PAPUA NEW GUINEA



	2014
Population, million	7.7
GDP, US$ billion	20
GDP per capita, US$	2,597
GDP per capita, US$ PPP	2,818
Gini coefficient, consumption/1	0.41
Life expectancy	62.3
Primary school enrollment rate, gross percent/2	114

Sources: IMF WEO 2015, WDI 2014, World Bank staff estimates. */1* 2010. */2* 2012.

Summary

Papua New Guinea's economy is facing strong headwinds from lower global commodity prices, the suspension of production at a major mine, and unfavorable weather conditions brought on by El Niño.

Recent Economic Developments

Economic activity is expected to expand by about 8.7 percent in 2015, down from the April 2015 forecast of 16 percent. The downward revision stems largely from the drop in LNG prices, and from the suspension of production at the Ok Tedi mine due to both low copper prices and low water levels in the Fly River (making transport of ore difficult). This is expected to lead to a contraction of 20 percent (yoy) in the mining sector.

The nonextractive sectors are expected to contribute, on average, 0.5 percentage points to overall growth in 2015 compared to 0.6 percentage points in 2014. Anticipated lower growth in the nonextractive sectors in 2015 is due to the unfavorable weather conditions from El Niño, and lower government spending, dampening growth prospects in the agriculture and construction sectors, respectively.

The poverty rate in 2010 was 39.9 percent, according to government estimates, with poverty more prevalent in rural than in urban areas, at 42 percent and 29 percent, respectively. The level of consumption inequality, measured by the Gini coefficient, was 0.41 (the latest available data, for 2010).

The falling commodity prices and temporary suspension of production at the Ok Tedi mine, which accounts for around 10 percent of government revenue, have substantially lowered government revenue. Projections for mineral and petroleum tax revenue and dividends, and goods and services tax collection are expected to be originally forecast in the 2015 budget. This has contributed to a downward adjustment of expected overall government revenue from PGK 13.9 billion to PGK 11.4 billion.

Notwithstanding the expected revenue shortfall, the Mid-Year Economic and Fiscal Outlook for 2015 provides a scenario where spending remains unchanged at PGK 16.2 billion from the original 2015 budget. This results in a fiscal deficit of 9.4 percent of GDP (or PGK 4.8 billion), higher than the previously estimated deficit of 4.4 percent (or PGK 2.3 billion) in the 2015 budget. This scenario has a relatively high probability of occurring if the government does not curb appropriated expenditure, the budget is fully executed, and/or commodity prices remain subdued in 2015.

Over the first half of 2015, the Government of Papua New Guinea restricted the release of warrants to manage this revenue shortfall. The government also plans to introduce an Appropriation Reduction Bill (a mini-budget) to curb expenditure by PGK 1.3 billion.

To cover the anticipated budget deficit, the government is preparing to issue a Eurobond before end-2015, denominated in US dollars, with a face value of US$1 billion.

The current account deficit is expected to turn to a surplus of 4.1 percent of GDP in 2015, with the overall balance of payments broadly in balance, on the back of increasing LNG exports. Adequate reserves are expected to be maintained at US$2 billion (or 3 months of import cover).

Long and increasing delays in accessing foreign exchange by importers are causing costly disruptions to business activities, which highlights the need to improve the foreign exchange allocation mechanism to rectify the foreign exchange market imbalance.

CPI inflation is expected to stabilize at around 6 percent in 2015, as the effects of lower oil and commodity prices are offset by the kina depreciation.

Outlook

Over the next five years, GDP growth is expected to average 3.5 percent, with growth in the mining and petroleum sectors contributing 0.1 percentage points and other sectors contributing 3.4 percentage points. The growth momentum in the nonextractive sector is expected to be led by the construction, transport, and communication sectors, owing to the effects of significant public expenditure to prepare for the Asia-Pacific Economic Cooperation Summit in 2018.

Notwithstanding the possible improvement in revenue collection with the implementation of the recommendations of the Tax Review Committee next year, domestic revenue generation is expected to remain constrained in the near term due to subdued commodity prices, coupled with revenue receipts from Papua New Guinea LNG only reaching their full potential after 2022. This implies that expenditures will need to be curbed in a measured manner to avoid a ballooning budget deficit.

Papua New Guinea remains at a low risk of debt distress based on an assessment of public and publicly guaranteed external debt distress. The overall risk of debt distress remains heightened when considering the domestic public debt stock, off-budget public sector liabilities, and public enterprise debt.

For the medium term, the government is developing a new budget strategy, which is expected to focus on returning the budget deficit to a downward trajectory to ensure that debt remains on a sustainable path.

Challenges

There are increasing downside risks, including a risk of a precipitous decline in commodity prices in response to the slowdown in China and generally anemic global growth. This may exacerbate the poor revenue performance and continue to adversely affect foreign exchange earnings.

Moreover, the Papua New Guinea Treasury will need to curb expenditure in 2015 by more than the proposed expenditure cut of PGK 1.3 billion in 2015 to effect a reduction in the debt ratio after 2020. Thus, failure to consolidate the fiscal position would worsen debt dynamics. However, fiscal consolidation, necessitated by weaker-than-anticipated revenue performance, will dampen growth in the nonextractive sectors over the short run, while a weak global economy could further dampen external demand and commodity prices. This will adversely affect foreign exchange reserves.

To preserve the foreign exchange reserve position, consideration should be given to improving the foreign exchange allocation mechanism, underpinned by sound fiscal and monetary policies. Given that fiscal policy continues to be relatively expansionary, monetary policy should be tightened. This would help take pressure off the foreign exchange market.

Possible global financial market instability may also adversely affect prospects for external commercial financing and/or foreign direct investment.

Figure 1. GDP growth

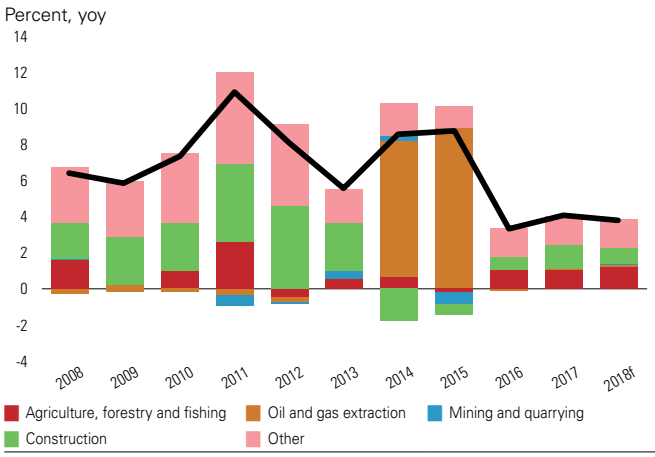
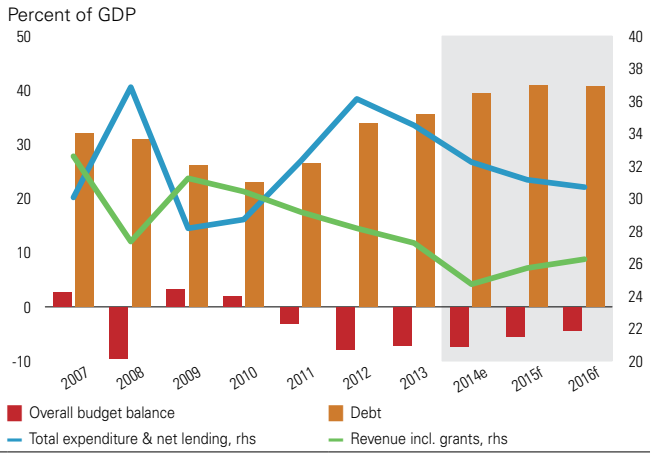


Figure 2. Key fiscal indicators



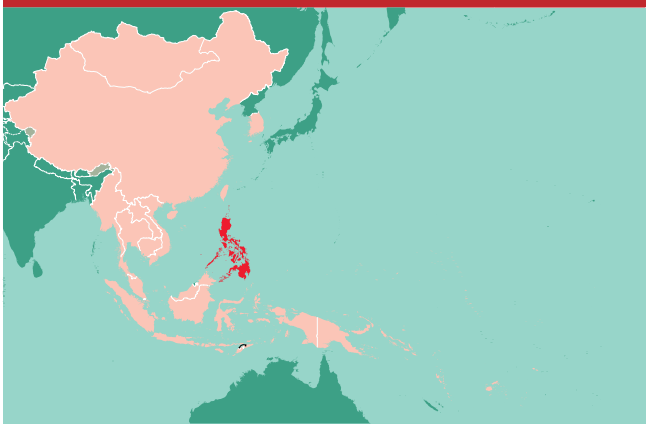
Sources: World Bank; IMF.

Papua New Guinea Selected Indicators

	2013	2014	2015e	2016f	2017f
Real					
GDP, at market prices	5.5	8.5	8.7	3.3	4.0
Mining and petroleum	0.5	7.9	8.2	0.0	0.1
Non-mining and non-petroleum	5.0	0.6	0.5	3.3	3.9
CPI inflation, period average	5.0	5.3	6.0	6.0	6.0
Fiscal (% of GDP)					
Revenue	28.4	27.3	24.7	25.7	26.3
Expenditure	36.1	34.5	32.3	31.2	30.7
Balance	-7.8	-7.2	-7.6	-5.5	-4.6
Debt	34.6	35.6	39.4	41.1	40.9
External (% of GDP)					
Current account balance	-31.8	-4.2	4.1	3.0	3.1
Resource	-16.4	7.4	14.5	14.0	14.9
Non-resource	-15.4	-11.5	-10.4	-11.0	-11.8

Sources: National statistics; staff estimates.

PHILIPPINES



	2014
Population, million	99.1
GDP, current US$ billion	284.6
GDP per capita, current US$	2,870.5
Poverty rate ($1.9/day 2011 PPP terms) [a]	11.2
Poverty rate ($3.1/day 2011 PPP terms) [a]	32.7
Gini coefficient [b]	0.43
Life expectancy at birth, years [c]	68.6

Source: World Development Indicators.
(a) Most recent full-year estimate (2012).
(b) Most recent WDI value (2012).
(c) Most recent WDI value (2013).

Summary

The Philippines remained among the stronger performers in the region, despite the relative slowdown brought about by weak government spending and net exports. In the medium term, growth prospects are positive, and poverty reduction is expected to continue. The remaining eight months of the Aquino Administration present an opportunity to clearly define the unfinished business on the structural reform agenda and formulate a practical approach to tackling them for the next administration.

Recent Economic Developments

The Philippines remained among the stronger performers in the region. In the first half of 2015 (H1 2015), among the major economies in the region, the only ones to accelerate were the Philippines and Vietnam. However, H1 growth of 5.3 percent was the lowest half-year growth rate since 2011. On the demand side, while the strong performance of private domestic demand at 8.1 percent, supported by record-low inflation and robust remittances, drove GDP growth, the slow pace of public spending and the contraction in net exports limited growth. On the supply side, the onset of El Niño led to stagnant agricultural growth. Meanwhile, growth in industry and services was solid, with both sectors growing by around 5.8 percent.

Continued job gains in other sectors could not compensate for the substantial job losses in agriculture caused by El Niño. In July 2015, job generation continued to be led by the services sector followed by industry. In industry, the construction sector, not manufacturing, drove job creation. However, job generation in both sectors was not enough to offset the substantial job losses in the agricultural sector of some 877,000 jobs, as agricultural production fell as a consequence of El Niño. As a result, there was a net loss of about 96,000 jobs between July 2014 and July 2015.

Stronger growth and effective government programs are helping improve poverty reduction, while natural disasters and distorted policies harm the poor. Results from the Annual Poverty Indicators Survey (APIS) suggest that poverty increased in H1 2014. The increase is attributed to Typhoon Yolanda (a one-time, unprecedented event) and artificially high rice prices (due to rice importation delays by the state monopoly), which offset the income growth of the poor. In contrast, after a decrease of only 0.8 percentage points (in PPP terms) between 2009 and 2012, the 2013 APIS suggests that poverty fell significantly between 2012 and 2013. This was in part due to a significant decrease in underemployment among the poor, and the substantial 30 percent growth in cash transfers to the bottom quintile, confirming that the government's conditional cash transfer program is well targeted and reaching the poor.

As in the rest of the region, the domestic financial market experienced considerable volatility in recent months, but underlying fundamentals remain

sound. In August, the equity market experienced a sharp decline. Uncertainties brought about by the anticipated hike in US interest rate and concerns about China's economy continue to exert volatility in the domestic market. Nonetheless, the domestic financial sector remains strong, with low levels of nonperforming loans and a higher capital adequacy ratio. A number of prudential measures are in place to mitigate risks. Likewise, monetary policy remains supportive, with room to respond to higher global interest rates. The peso remains flexible and is in line with market fundamentals, offering a cushion to large capital outflows.

Despite continuous improvement in the tax effort, the slow pace of government spending suggests that gains from higher revenues are not being maximized to support investment-led growth. In H1 2015, tax revenues grew by 14 percent due to improved tax administration. However, higher tax revenues have yet to translate into a commensurate increase in government spending due to capacity and institutional constraints. In particular, public infrastructure spending fell by 24 percent in Q1 and was partly offset in Q2. The government is keenly addressing budget execution bottlenecks and expediting priority programs and projects under the 2015 budget.

Outlook

In the medium term, growth prospects remain positive. In 2016, growth is expected to accelerate to 6.4 percent before tempering to 6.2 percent in 2017. However, for 2015, the growth projection is revised downward to 5.8 percent. This takes into account the relatively weak first-half growth brought about by slow government spending, negative net exports, and the initial impact of El Niño. In contrast, second-half growth is projected to improve as government spending is ramped up. In addition, accelerated implementation of public-private partnership projects, valued at around 0.6 percent of GDP for 2015, and the continuing effect of lower food inflation and declining oil prices, can further support growth. A stronger El Niño and weaker exports, however, could pull growth down considerably.

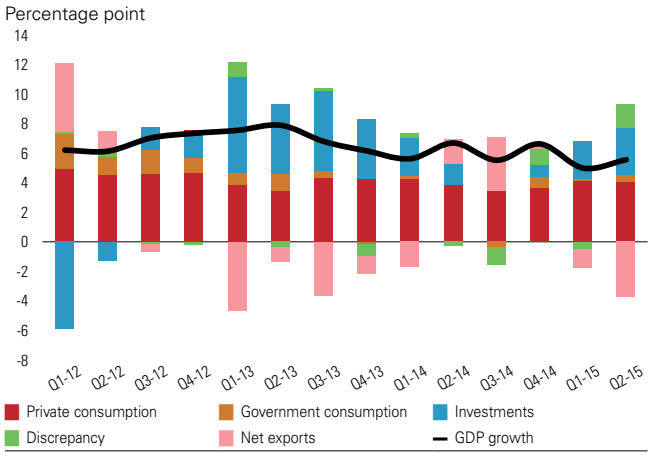
Poverty reduction is expected to continue if the country is able to maintain the relatively high economic growth and job trends of recent years, despite recent shocks to agriculture. Using the full-year estimates from the Family Income and Expenditure Survey, extreme poverty is estimated to have decreased from 11.2 percent in 2012 to 10.5 percent in 2014, and is projected to further decrease to 8.2 percent in 2017 (using the new international poverty line of US$1.90/day, new 2011 PPP prices, and the above assumptions). However, poverty estimates are particularly sensitive to food price inflation. Even as the outlook for international prices is favorable, poverty results will also depend on how the government manages rice imports, in particular.

Challenges

The remaining eight months of the Aquino Administration present an opportunity to clearly define the unfinished business in the structural reform agenda and lay out a practical approach to tackle them for the next administration. These are challenging reforms, since they would reverse decades of policies that have undermined the economy's capacity to generate more and better jobs. They include (a) institutionalizing current reforms to increase budget transparency and accountability; (b) crafting a simpler, more equitable, and more efficient tax system to finance investment-led growth, in particular, rationalization of tax incentives that are neither transparent nor performance based; (c) further opening up the economy to more competition by reducing the investment negative list; (d) securing property rights through land governance reforms; and (e) unleashing the full potential of the private sector, in particular, small and micro firms, through an overhaul of business regulations to make them simpler and less costly. When sustained, these reforms can accelerate good job creation and eliminate extreme poverty.

Figure 1. Growth was limited by weak government spending and net exports

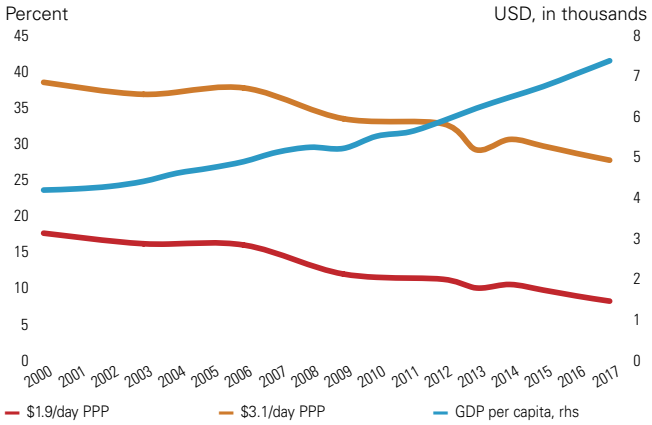
Demand side: contribution to growth



Source: Philippine Statistics Authority (PSA).

Figure 2. Poverty reduction is expected to continue as per capita income increases

Actual and projected poverty rates and GDP per capita



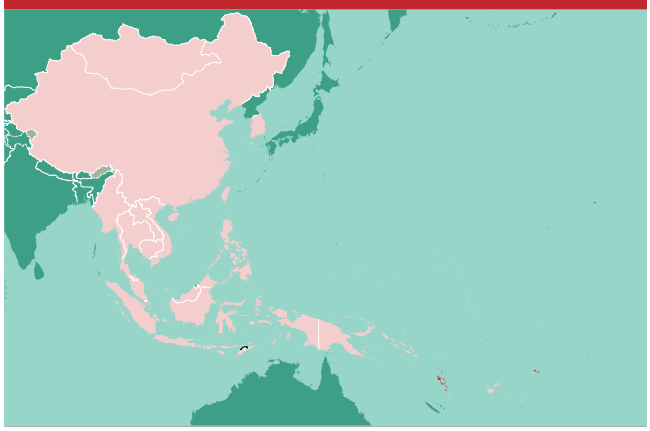
Sources: PSA, World Bank staff estimates.

Philippines Selected Indicators

	2012	2013	2014	2015	2016	2017
Real GDP growth, at constant market prices	6.7	7.1	6.1	5.8	6.4	6.2
Private consumption	6.6	5.6	5.4	6.1	5.8	5.6
Government consumption	15.5	5.0	1.7	5.0	8.0	6.0
Gross fixed capital investment	10.8	12.2	6.8	10.2	13.0	9.6
Exports, goods and services	8.6	-1.0	11.3	3.1	4.8	7.2
Imports, goods and services	5.6	4.4	8.7	4.5	7.4	8.0
Real GDP growth, at constant factor prices	6.7	7.1	6.1	5.8	6.4	6.2
Agriculture	2.8	1.1	1.6	0.0	2.0	3.0
Industry	7.3	9.2	7.9	7.0	7.7	7.3
Services	7.1	7.0	5.9	6.2	6.3	6.1
Inflation (consumer price index)	3.2	3.0	4.1	2.0	3.0	3.5
Current account balance (% of GDP)	2.8	4.2	3.8	3.5	3.1	2.9
Fiscal balance (% of GDP)	-2.3	-1.4	-0.6	-1.1	-2.0	-2.0
Poverty rate [a, b, c, d]						
Poverty rate ($1.9/day 2011 PPP terms)	11.2	10.0	10.5	9.7	8.9	8.2
Poverty rate ($3.1/day 2011 PPP terms)	32.7	29.2	30.6	29.7	28.7	27.8

(a) Calculations based on EAPPOV harmonization, using 2006-FIES and 2012-FIES.
(b) Projection using annualized elasticity (2006–2012) with pass-through = 1 based on GDP per capita constant PPP.
(c) The 2012 FIES is the last available full year survey. However, the 1st-semester 2013 and 2014 APIS surveys, which are official estimates of the PSA, were used to inform the estimates of 2013 and 2014.
(d) Actual data: 2012. Projections are from 2013 to 2017.

SMALL PACIFIC ISLAND COUNTRIES



	2014
Population, million	0.85
GDP, US$, billion	3.0
GDP per capita, current US$	3,540

Sources: World Development Indicators; World Bank staff estimates and projections.

Summary

Most of the Small Pacific Island Countries (the Federated States of Micronesia, Kiribati, Palau, the Republic of Marshall Islands, Samoa, Tonga, Tuvalu, and Vanuatu) experienced moderate growth over the last year, driven in several cases by donor-financed infrastructure projects. Low commodity prices have reduced inflationary pressures and supported the external positions of these economies, which have been relatively well insulated from regional financial market volatility. Tropical Cyclone Pam, which struck in March, severely impacted livelihoods and productive capacity in Vanuatu and Tuvalu.

Recent Economic Developments

Economic activity in the **Federated States of Micronesia** consists primarily of subsistence farming and fishing, and is heavily dependent on external assistance. Real GDP declined by 3.6 percent in FY2014 (year ended September) following a 3.4 percent contraction in FY2013. GDP declined in all four Micronesian states in both fiscal years for the first time since GDP was recorded. The contraction in the economy was explained by declines in fisheries output (much of the domestic fishing fleet underwent maintenance) and in construction activity, due to the completion of airport improvements and delays in other donor-funded infrastructure projects. Inflation continued to decline, to around 0.7 percent in FY2014, and is likely to moderate further in FY2015 due to the fall in world oil prices.

The Federated States of Micronesia achieved an estimated fiscal surplus of US$35.6 million (or 11.2 percent of GDP) in FY2014. The surplus was largely explained by rising fishing license fees (paid by the nondomestic fleet) and a one-off increase in tax payments from captive insurers. Excluding one-off factors, tax receipts remain low compared with regional peers, at around 10.5 percent of GDP, while legislation associated with ongoing tax reform initiatives (including the proposed introduction of a value-added tax) failed to pass. Continued efforts to maintain budget surpluses will help serve as a buffer against financial market volatility and reduce the pending fiscal shortfall after FY2024, when the Compact of Free Association grants are scheduled to end.

The current account recorded an estimated surplus equivalent to 6.8 percent of GDP in FY2014 (from a deficit of 9.9 percent in FY2013), due mainly to the one-off income receipt from the captive insurance industry. The current account is expected to record a deficit of around 10 percent of GDP in the medium term, and to be largely financed by the inflow of official transfers.

In **Kiribati**, growth has been strong and is expected to remain above trend this year. Real GDP growth reached an estimated 3.7 percent in 2014 and around 3 percent in 2015, driven by donor-financed infrastructure projects (in the road, port, and aviation sectors) and a pickup in household spending. Inflation picked up moderately in 2014 to 2.5 percent and will likely remain around 3 percent this year as lower prices of food and fuel imports are offset by the weaker Australian dollar and higher spending ahead of November's presidential election. The country's

trade deficits (ranging from 40 to 47 percent of GDP in the last five years) are expected to have worsened to 50 percent this year due to continued strength in capital imports relating to donor-financed infrastructure projects. However, buoyant fishing license revenues and steady income flows to the country's sovereign wealth fund (the Revenue Equalization Reserve Fund [RERF]) are expected to keep the current account deficit to around 5 percent of GDP. Continued strength in fishing license revenues is also expected to boost the fiscal surplus to 20 percent of GDP in 2015 from 10 percent in 2014, but the government continues to struggle to make a significant replenishment to the RERF, citing pressing expenditure needs. After a decade of unsustainable drawdowns to finance fiscal deficits, the value of the RERF fell from 565 percent of GDP in 2006 to 365 percent in 2014.

Looking ahead, growth is expected to weaken during 2016–18, with the completion of donor-financed infrastructure projects. Also, fishing license fees and seamen's remittances could be negatively affected if a sharper than expected slowdown in China results in lower growth in the Asia and Pacific region. Returns to RERF assets may also be affected by recent volatility in global financial markets. Restoring the sustainability of the RERF remains a key policy challenge to protect the country's overall economic stability, given its large structural trade deficits, highly volatile fishing license revenues, and large spending needs to address its widespread poverty (the highest rate in the region) and a severe infrastructure backlog.

Palau's economy relies heavily on tourism and grants. Economic growth surged to 8.0 percent in FY2014 (year ended September) on the back of a larger-than-expected rise in tourist arrivals from China, with new foreign investment also contributing to growth. The rise in tourism arrivals was partly due to new air links with Hong Kong SAR, China, and expanded accommodation capacity. In the first half of 2015, tourist arrivals grew by 40 percent compared to the same period in 2014, again driven by increased arrivals from China. However, given that Palau uses the US dollar, continued strengthening of the US dollar against the yuan or a weaker Chinese economy would weigh on the tourism sector. Inflation continued to moderate, falling from 3.8 percent over the year to June 2014 to 0.4 percent over the year to June 2015, driven by falling fuel and utility prices. The current account deficit widened from 8.75 percent of GDP in FY2013 to 13 percent of GDP in FY2014, largely owing to construction-related imports. A fiscal surplus equivalent to 1.25 percent of GDP is estimated for FY2014. Tax revenue continued to rise due to increases in the volume and rates of tourism-related taxes, higher prices in the tourism industry, and improved tax compliance. Recurrent expenditure, however, declined as a result of careful public sector management. With the scheduled end of U.S. Compact grants in FY2024, fiscal adjustment over the medium term remains necessary to build adequate government deposits and ensure long-term fiscal sustainability.

The economy of the Republic of the Marshall Islands is estimated to have expanded by 0.5 percent in FY2014 (year ended September). The lower growth reflects earlier completion of important infrastructure projects, and the postponement of some capital grants. Growth is, however, projected to rebound to 1.7 percent this fiscal year, driven by the resumption of several donor-funded infrastructure projects. Inflation moderated in FY2014 to 0.5 percent, and is expected to ease further this fiscal year, due to lower global oil prices. The fiscal balance is estimated to have recorded a surplus of US$2.3 million (1.2 percent of GDP) in FY2014, reflecting higher revenues, mainly from fishing license fees. A fiscal balance of US$4.6 million (2.4 percent of GDP) is projected in FY2015. However, persistent subsidies to loss-making state-owned enterprises continue to have a negative impact on the fiscal accounts. Moreover, widening deficits in the social security system will likely trigger requests for transfers from the central government. Comprehensive public sector reforms are needed to support long-term fiscal sustainability.

Samoa's economy continues to recover from the effects of Tropical Cyclone Evan in 2012. Real GDP

is estimated to have grown by 1.7 percent in FY2015 (year ended June), up from 1.2 percent in FY2014. Growth in FY2015 was supported by a series of one-off events, including the UN Small Island Developing States conference in September 2014, and preparations for the 2015 Commonwealth Youth Games and first-ever Samoa–New Zealand Test rugby match at Apia Park. Increases in transport sector activity, in part associated with lower fuel prices, also contributed. Economic growth is projected to continue in the medium term at an average rate of around 2 percent, supported by increases in tourism and agriculture, although the pending exit of a major manufacturer in FY2017 will temporarily lower growth.

Average annual inflation was around 2 percent in FY2015, with declines in the prices of imported goods (particularly fuel and food) offsetting increases in domestic food prices. Inflationary pressures should remain relatively modest in the period ahead as the domestic supply of agricultural products expands. The current account deficit of 8 percent of GDP in FY2014 is expected to have narrowed slightly in FY2015, and should continue to decline in the medium term, as agricultural exports and tourism pick up. The recent construction of a number of major hotel developments may also help boost tourist arrivals in the coming years.

The government ran a fiscal deficit of 4.2 percent of GDP in FY2015, down from 5.4 percent in FY2014, with the less expansionary stance attributable to the winding down of cyclone-related works and the continued economic recovery. Although the budget projects a deficit of 4.7 percent in FY2016, the slight widening is largely attributable to a substantial decline in grants from development partners, with government spending on current expenditures (excluding debt servicing) down by around 4 percent from the previous year. As a result of continued fiscal deficits and only modest economic growth, Samoa's external public debt as a proportion of GDP has increased quite rapidly in recent years, from around 30 percent at end-FY2008 to about 56 percent as of March 2015. Looking ahead, it is important that fiscal consolidation proceeds as planned to ensure overall sustainability and sufficient buffers to respond to future external shocks.

Economic performance in **Tonga** continues to be driven by public investment cycles and natural disasters. Economic growth has been on a downward trend since 2010, as major public investments have drawn to a close. However, reconstruction work to rebuild after a major cyclone hit the Hapai'i group of islands contributed to positive growth in FY2014 of around 2 percent (up from a decline of 3 percent in FY2013), while agriculture also rebounded from a poor harvest in FY2013.

In recent years, prudent fiscal management has become entrenched, and while risks remain, the government budget is increasingly well managed. Despite a big increase in expenditure commitments in FY2015 due to cyclone reconstruction, the government was able to restrict the budget deficit to 2 percent of GDP by mobilizing grants and highly concessional credits. A series of revenue policy and administration measures over the last few years have set the foundations for a strengthening budget position. Improved collections, a simplified corporate tax arrangement for small businesses, and a series of measures to tighten taxes on the most unhealthy of foods, tobacco, and alcohol, have contributed to an increase in revenue of more than 2 percent of GDP over the three years to FY2015, and further gains are expected this year. However, large fiscal risks remain on the horizon, including the commencement of repayment of two large external loans, financing of the 2019 South Pacific Games, and periodic large public servant wage demands.

Inflation reached a low of 0.2 percent yoy in 2014, and entered negative territory in 2015, standing at negative 1.6 percent yoy as of May 2015. While local demand pressure has been muted, the bulk of this fall in prices has been driven by big drops in energy and transport prices, with the subindex of transportation prices falling by 14 percent over the year to May 2015. The current account deficit narrowed to 5.5 percent of GDP in FY2013, with

declining imports associated with the completion of infrastructure projects. Foreign exchange reserves remain ample, at almost eight months of import cover.

Economic performance in **Tuvalu** continues to be affected by public investment cycles and natural disasters. Tropical Cyclone Pam (TC Pam) landed on Tuvalu in March 2015 and affected around 40 percent of the population. The effects of TC Pam were most heavily felt by those living on the outer islands, where poverty is more concentrated. Reconstruction efforts together with planned investments are expected to offset losses from the cyclone and boost growth to over 3 percent in 2015. Inflation is similarly expected to pick up to around 4.7 percent in 2015, reflecting growing government expenditure and a potential shortage of essential items due to cyclone-related disruptions in transportation and domestic supply of agricultural products.

The 2015 budget saw a marked increase in capital and related expenditures, but restraint on recurrent spending. TC Pam will increase capital expenditure further due to recovery and reconstruction needs. However, the depreciation of the Australian dollar (which is used as the domestic currency) against the US dollar is expected to increase the local currency value of key US-dollar-denominated revenue sources such as fishing license fees. Overall, the fiscal deficit is forecast to reach 7.7 percent of GDP in 2015, from near balance in 2014.

Despite the structural trade deficit, reserves are expected to remain strong, at around 7 months of imports of goods and services. Increased imports associated with the planned increase in capital projects and the impact from TC Pam are expected to be largely funded through rising income and capital grants. Tuvalu is at high risk of debt distress, and the local currency value of debt stock and debt servicing may rise due to the depreciation of the Australian dollar.

In **Vanuatu**, Tropical Cyclone Pam will have a substantial impact on the economic outlook. As revealed by the Post-Disaster Needs Assessment, 11 lives were lost and around 75,000 people needed emergency shelter. TC Pam inflicted widespread damage to Vanuatu's capital stock, including infrastructure, livestock, and household assets, with damage and losses equivalent to almost two-thirds of GDP. Because of cyclone damage, tourism and agricultural output are expected to decline sharply in 2015, although reconstruction activity and the commencement of several large infrastructure projects should provide a partial offset. In the 2015 calendar year, GDP will therefore likely be flat or increase only slightly, compared with the pre-cyclone forecast of 4.3 percent growth.

As a result of TC Pam, the forecast for inflation in 2015 has been revised upward to close to 4 percent, reflecting cyclone-induced shortages and increases in the prices of materials to be used in reconstruction activities. Exports are likely to decline relative to the pre-cyclone forecast, because there has been some damage to cash crops, including kava and copra. Imports will be boosted by emergency response, recovery, and reconstruction needs. Tourism earnings are expected to be dramatically affected, with a number of major hotels closing their doors until later in the year. The net effect is projected to be a 2015 current account deficit of close to a quarter of GDP, with the impact of the deterioration in the trade balance partially offset by insurance receipts and external assistance.

Supporting the vulnerable population and restoring public facilities and infrastructure will necessitate a considerable expansion in government expenditures, even though revenues are likely to decline with the weak economy. The government also intends to proceed with its pre-cyclone plans to scale-up public investment in roads, seaports, and airports. If undertaken efficiently, these investments should help foster future growth in Vanuatu, and the government's conservative fiscal stance in recent years allows it some scope to take on moderate levels of concessional debt.

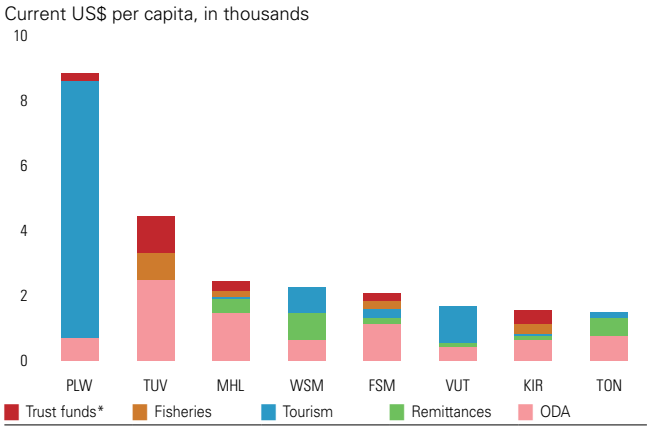
Outlook

Overall, medium-term growth prospects for most of the Small Pacific Island Countries remain modest. In some countries, such as Samoa, Tonga, and Kiribati, the outlook is dependent on the extent to which tapering infrastructure investment is replaced by other sources of growth. In Vanuatu and Tuvalu, economic activity over the next one to two years will be supported by TC-Pam-related reconstruction, which, if well-executed and targeted at productive sectors, should also help boost the potential growth rate over the longer term. Since they are heavily dependent on imported food and fuel, the Small Pacific Island Countries will continue to benefit from low global commodity prices, and the outlook for inflation generally remains benign.

Challenges

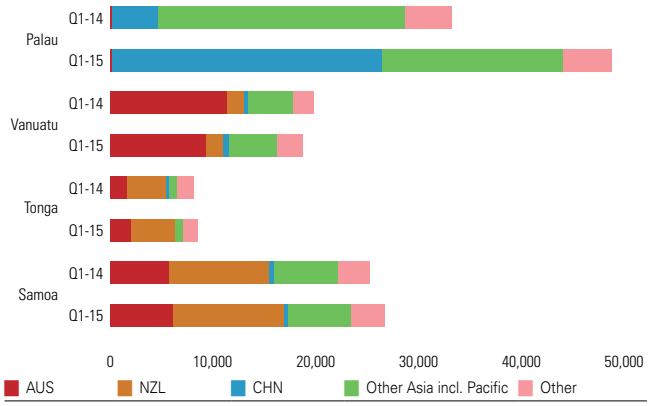
Risks to fiscal sustainability remain a pressing issue in these countries, and the building of fiscal buffers is a key priority. Signs of slowing growth in the region are also a concern, although China accounts for only a relatively minor share of Small Pacific Island Country exports (with the exception of Palau, which relies heavily on Chinese tourism). But any ensuing decline in demand from Australia and New Zealand may have more widespread effects, including through a slowdown in tourist flows from these countries. At the same time, the Small Pacific Island Countries are likely to remain relatively well insulated from recent financial market volatility. Most of these countries rely very little on private capital inflows, while important sources of foreign exchange such as grants and soft loans, remittances, and fishing license revenues are all less likely to be substantially affected.

Figure 1. Selected sources of foreign income, 2012



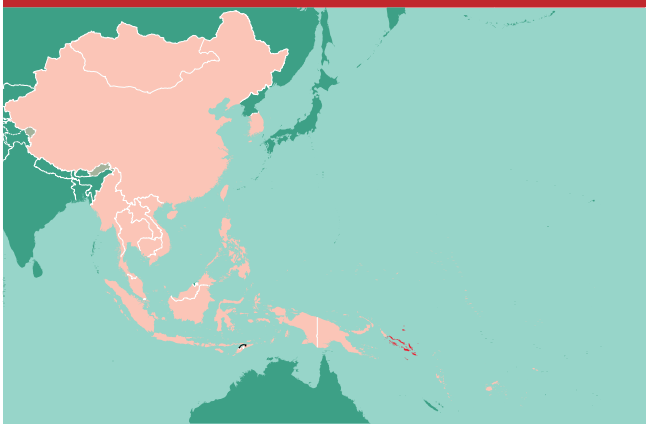
Sources: World Development Indicators; World Bank staff estimates.
Note: *Trust fund earnings are average 2011–13.

Figure 2. Tourist arrivals by source market



Source: South Pacific Tourism Organisation.

THE SOLOMON ISLANDS



	2014
Population, million	0.63
GDP, US$ billion	1.26
GDP per capita, US$	2,146
GDP per capita, US$ PPP	1,877
Gini coefficient	0.36
Life expectancy	68
School enrollment rate, primary (%)	83.3

Sources: Solomon Islands National Statistics Office; IMF 2014 World Economic Outlook; World Development Indicators 2014; UNICEF.

Summary

Given the considerable downside risks to economic growth over the medium term, improvements in living standards will depend on strong and coordinated government action to broaden the economic base and promote inclusive economic growth. This is particularly relevant in the context of a post-conflict setting with high population growth, a high percentage of youth unemployment, and ever-increasing migration to urban centers.

Recent Economic Developments

As one of the poorest countries in the Pacific, the Solomon Islands remains dependent on foreign aid flows and natural resource extraction, and is heavily exposed to external shocks. Since "the tension" period in the early 2000s, economic growth has primarily been driven by logging and Official Development Assistance.

The first half of 2015 has seen production of logs and palm kernel oil surpassing 2014 output for the same period by 15 percent and 12 percent, respectively. Production of other key export commodities remains below that of the previous year, reflecting the continued weakening of international prices.

Employment indicators from the Solomon Islands National Provident Fund exhibited moderate growth in 2014, despite a large redundancy in the mineral sector following the closure of the Gold Ridge mine in Q1 2014. The average number of active superannuation contributors rose by 12 percent year-on-year in 2014, and by a further 7 percent in the first half of 2015 to 57,404 people.

The latest poverty rate, estimated by the government in 2006, was measured at 22.7 percent, while income inequality is estimated to have been lower than most countries at similar levels of income (Gini coefficient of 0.36). Income inequality was estimated to be slightly higher in rural areas (Gini of 0.32) compared to urban areas (Gini of 0.29).

In 2015, the Solomon Islands government has pursued an expansionary fiscal policy, budgeting for a deficit equivalent to 8 percent of GDP, to be financed through the government's cash reserves and loans. This increase in planned spending was driven almost entirely by a large increase in the development budget. Preliminary evidence suggests a lower than usual budget execution rate, partly due to the late passage of the budget coupled with a historically low capital budget execution rate. This implies that the budgeted deficit is unlikely to fully materialize. This is reflected in rising cash reserves, currently equivalent to over twice the planned year-end reserves.

As of Q2 2015, the total official debt (domestic and external) fell by 5 percent against 2014 levels, and the Solomon Islands continues to enjoy one of the lowest debt-to-GDP ratios in the region at an estimated 11 percent. According to the most recent Debt Sustainability Analysis, the Solomon Islands faces a moderate risk of debt distress, with its debt

path vulnerable to shocks to net non-debt-creating flows and financing terms. International reserves stood at US$609 million in Q2 2015, amounting to around 11 months of imports of goods and services. Despite low oil prices, the current account deficit is projected to widen to 8.4 percent of GDP in 2015, following the cessation of gold production (which represented around 20 percent of net exports) and lower cash crop exports, and reflecting a generally weaker external environment. Lower expected log production in future years poses a medium-term risk to the current account; however, low oil and food prices should soften some of the pressure.

The Honiara Consumer Price Index (period average) is expected to further decline from 4.8 percent in January to 0.2 percent by year-end due to lower oil and food prices, which account for 60 percent of the consumption basket.

Outlook

The Solomon Islands economy is projected to grow on average by 3.3 percent over the medium term. This baseline scenario is based on (a) foreign direct investment of above 9 percent of GDP in the next two years, up from an average of 4.8 percent during 2012–14 (b) a resumption of gold-mining activity, and (c) infrastructure investment.

The unsustainable use of forest stocks has proceeded at pace, with logging estimated to have accounted for 17 percent of GDP and export duties and 14 percent of domestically sourced government revenues in 2014. With accessible logging sources expected to be fully depleted in the long run and uncertainty around the exploitation of the country's mining potential, the Solomon Islands faces the challenge of developing new sources of growth.

In 2016, domestically sourced revenue is projected to increase by 3 percent over 2015 levels, driven by taxes on income and profit, and on goods and services. Taxes on trade are expected to increase by 4 percent, and nontax revenue is projected to increase by 5 percent.

Overall, planned government spending in 2016 is anticipated to increase marginally over 2015 budget levels, driven by a further increase in development expenditures (with recurrent spending expected to remain around the same levels as in 2015).

The Honiara Consumer Price Index (period average) is expected to remain on average around 5 percent over the medium term. The current account deficit is expected to widen by a further 2.4 percentage points in 2016 to 10.8 percent of GDP, reflecting the underlying long-run decline in logging exports and an overall increase in capital imports as major infrastructure projects commence.

Challenges

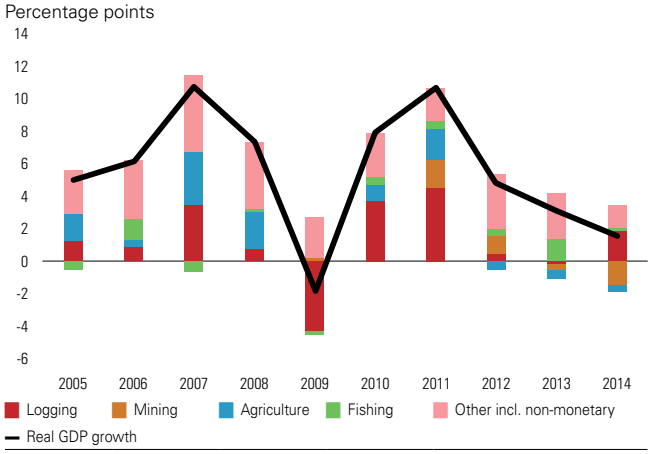
This outlook is subject to considerable downside risk, especially in relation to mining, in that future developments hinge on the development of a legal and regulatory framework conducive to mining, and on clear procedures for the acquisition of land for the exploration and exploitation of natural resources. Fisheries offer the potential to contribute to growth and government revenue over the medium term if they are sustainably managed.

Increasing productivity in the agricultural sector (and in particular cocoa and coconut products), which accounts for 16 percent of economic output and employs over 75 percent of the population, has strong potential to improve living standards. Expected investments in energy and ICT infrastructure have been subject to delay, and the impacts of improved ICT infrastructure on overall growth are not well understood in small, dispersed island contexts such as the Solomon Islands.

Tourism, which is projected to increase by 5 to 6 percent per year in the Pacific region until 2020, could also make an important contribution to broad-based growth, although at this stage it is not very

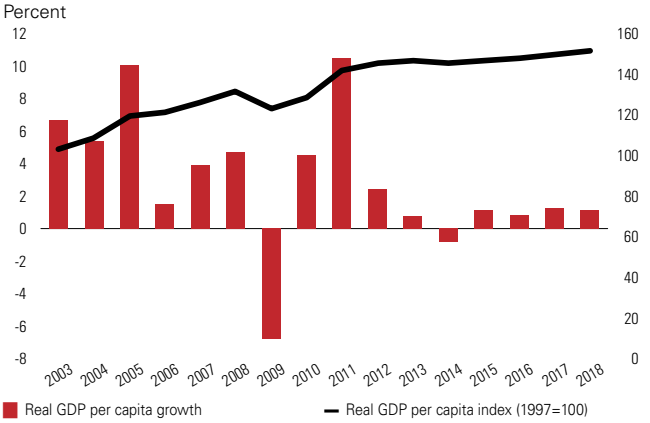
developed. Should economic opportunities remain concentrated in the capital, this could exacerbate challenges associated with urbanization and the growth of urban squatter settlements.

Figure 1. Sectoral contribution to real GDP growth



Sources: World Bank, Central Bank of Solomon Island.

Figure 2. Real GDP growth, per capita

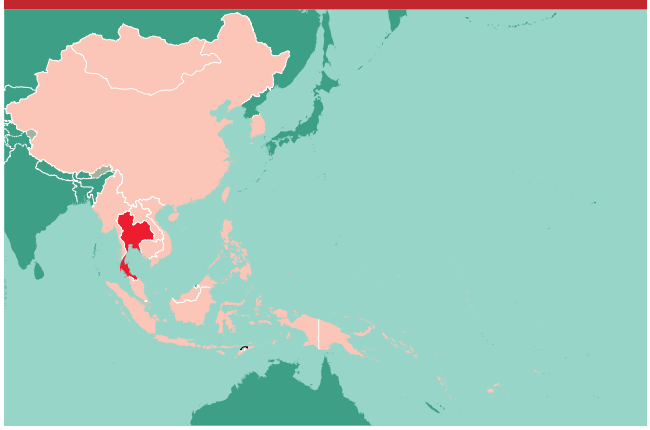


Sources: World Bank, IMF.

Solomon Islands Selected Indicators

	2012	2013	2014	2015 e	2016 f	2017 f
Real economy						
Real GDP	4.7	3.0	1.5	3.3	3.0	3.5
Per capita GDP	2.4	0.7	-0.8	1.1	0.8	1.3
GDP deflator	6.4	-0.4	8.8	3.8	5.4	3.9
CPI (eop, %)	5.1	2.5	4.0	0.2	6.7	4.2
Fiscal accounts (% of GDP)						
Expenditures	50.6	49.9	44.2	48.3	46.0	44.8
Revenues	54.4	54.3	46.1	46.2	44.4	44.5
General government balance	3.8	4.4	1.9	-2.1	-1.6	-0.3
Balance of payments (% of GDP)						
Current account balance	1.5	-4.5	-6.0	-8.4	-12.6	-10.3
Imports (goods and services)	45.1	43.8	39.6	37.4	37.3	37.4
Exports (goods and services)	49.8	42.3	39.1	35.1	32.5	33.5
Foreign direct investment	7.6	3.7	3.0	5.2	5.6	4.6
Gross reserves (eop, US$ million)	499.6	527.7	496.9	539.8	530.8	535.7
In months of next year's imports	8.4	9.1	8.5	8.5	8.0	7.7
External debt	12.7	11.8	10.3	10.8	11.8	13.0
Exchange rate to US$ (average)	7.3	7.3	7.4			
Nominal GDP (US$ million)	1,025	1,060	1,155	1,206	1,309	1,408

THAILAND



	2014
Population, million	68.6
GDP, US$ billion	371.9
GDP per capita, US$	3,438
GDP per capita, US$ PPP (2011)	13,932
Gini coefficient consumption (2012)	0.39
Life expectancy (2012)	74
School enrollment primary, gross (2013)	93

Source: Thailand Government Authorities; World Development Indicators 2014.

Summary

The Thai economy is expected to expand by 2.5 percent in 2015, compared to 0.9 percent in 2014. Government consumption and investment will be the main contributors to growth, given that private consumption weakened in the second quarter of 2015. Tourism and foreign direct investment, in contrast, rebounded in the first half of the year. Lower interest rates and a more competitive baht should be supportive of growth. Poverty rates are expected to fall at a slower rate, with poor households concentrated in rural areas affected by falling agricultural prices.

Recent Economic Developments

Economic growth accelerated to 2.9 percent in the first half of 2015. The main contributors to growth on the demand side were public investment and government consumption, which together amounted to 2.6 and 2.3 percentage points of GDP in Q1 and Q2 2015, respectively. A decline in private demand was observed during April–June 2015. Net exports modestly supported growth in the second quarter of the year.

On the production side, construction and hotels and restaurants were the fastest-growing sectors in the first two quarters of 2015 (at 20.4 and 16.1 percent, respectively). In contrast, agriculture and mining contracted. Manufacturing production grew by 2.3 percent yoy in the first quarter of 2015, led by the production of integrated circuits and semiconductors and apparel, but stagnated again in the second quarter. This was accompanied by a drop in exports.

At the same time, the sharp decline in global energy prices resulted in a fall in total imports (-8.6 percent). Travel receipts strongly expanded in the same period (26.2 percent), helped by improved political stability. This also supported stronger FDI inflows, whereas portfolio investment remained largely negative, due to global uncertainty. The current account surplus remained positive, reaching US$12.3 billion in the first half of the year.

As of July 2015, the baht had depreciated by 5.1 percent, and the real effective exchange rate by 3.1 percent to March 2015; this entails a modest recovery in external competitiveness, in decline since January 2014. In a context of slow growth with deflation, the policy rate was reduced by 0.25 percentage points in February and again in April, to 1.5 percent; nonetheless, headline inflation in August remained at -1.2 percent yoy; in turn, food inflation, affecting the welfare of the poor, remained positive at 1.3 percent.

On the fiscal side, revenue collection would have improved to 21.3 percent of GDP during the first half of 2015, compared to 19.4 percent in the same period of 2014. Expenditures would also have expanded, from 18.1 percent to 19.5 percent of GDP, accompanied by a mild increase in central government debt.

The weak performance of the manufacturing sector is likely to directly impact the incomes of poor

households, and in particular poorer urban and peri-urban households, who work disproportionately as low-skilled workers in manufacturing and labor-intensive nonagricultural sectors. As a consequence, urban poverty is expected to decline at a slower rate than in earlier periods. Slower global growth is likely to affect the poorer rural households dependent on remittances. Over half of the rural poor work as small-scale farmers, and are affected by lower commodity prices (including rice and rubber); in particular, two-thirds of poor agricultural households in Thailand farm rice as their primary crop. Since many of these households crop for own production, this will dampen the pass-through effect. In 2013, 10.9 percent of the population was living under the national poverty line.

Outlook

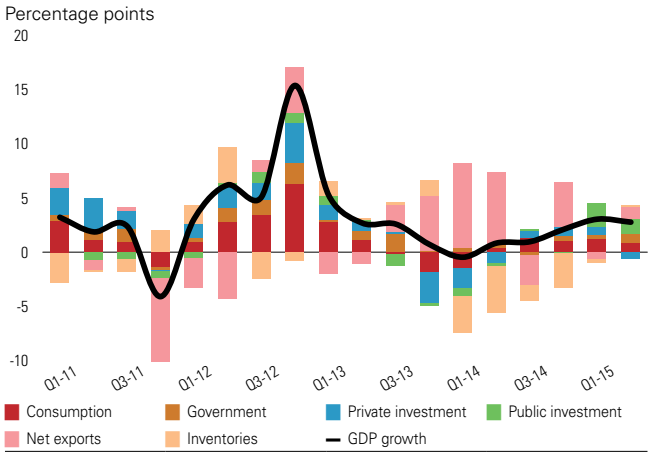
In 2015, real GDP growth is projected at 2.5 percent. While household consumption and private investment are expected to recover only modestly from last year, public spending will contribute to almost half of growth this year. Tourist receipts were expected to record a healthy growth, in a context of enhanced political stability, although prospects may be hampered by the attack on the Erawan Shrine in August. Exports of goods will remain subdued, growing by less than 1 percent in US dollar terms as key export prices fall and demand from China and ASEAN weaken. Imports of goods will continue to contract as prices of fuel imports, around a fifth of total imports, remain low. With the deceleration in imports, the current account balance will remain positive, probably above 4 percent of GDP. Capital flows will continue to be volatile, with a risk of experiencing potentially larger outflows should there be an increase in interest rates in the United States. Growth in 2016 and 2017 would remain sluggish in a context of a slowdown in China and other emerging economies. The timely implementation of public infrastructure projects (dual-track rail and rail upgrading) in 2016 would help contribute to a more positive outlook.

Challenges

The main challenges to the outlook continue to be the uncertain global environment affecting Thai exports, and internal stability.

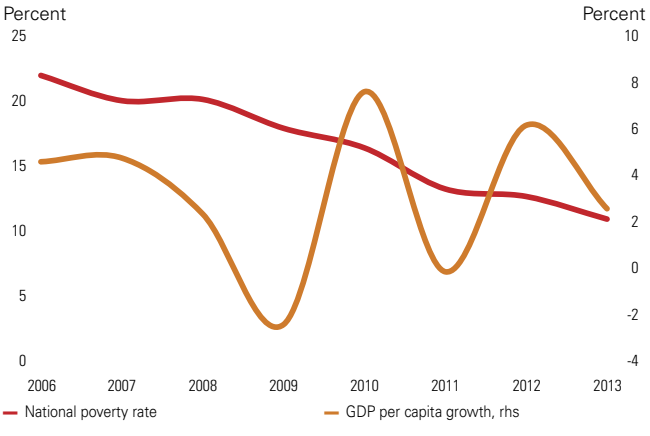
In the case of a sharper than expected slowdown of the Chinese economy, accompanied by global financial volatility, Thailand would be mostly affected through the trade and expectations channel (China represents 12 percent of total exports and 8 percent of total FDI inflows), which would hamper economic recovery. Nonetheless, authorities still have monetary and fiscal space to react to these eventualities.

Figure 1. Contributions to annual GDP growth



Sources: Bank of Thailand; World Bank estimates.

Figure 2. Poverty rate and GDP per capita growth



Sources: World Bank; National Economic and Social Development Board.

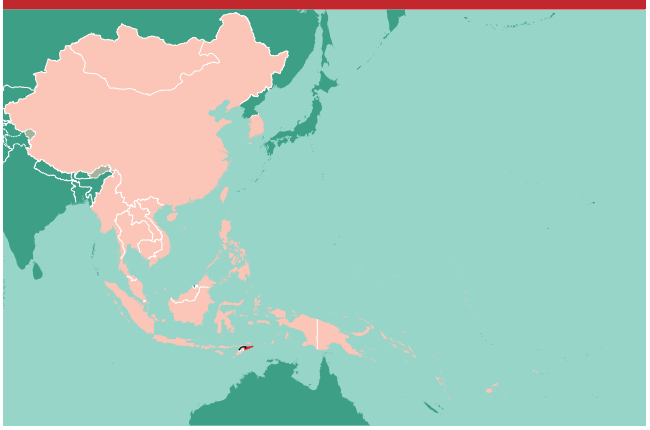
Inequality remains a major challenge in Thailand, differentiating the country regionally and across rural and urban areas. Although key inequality statistics have declined in recent years, inequality in Thailand remains high by international benchmarks. Poverty has become increasingly concentrated among those whose demographic and asset profile implies that they are unable to support themselves through productive means, such as elderly households with few individuals of working age. These households tend to rely heavily on familial transfers; government transfers, including the elderly social pension; and community support.

Thailand Selected Indicators

	2011	2012	2013	2014e	2015f	2016f	2017f
Real gross domestic product	0.8	7.3	2.8	0.9	2.5	2.0	2.4
Private consumption	1.8	6.3	0.8	0.6	1.2	1.4	1.5
Government consumption	3.4	7.5	4.7	1.7	3.5	3.0	3.0
Gross fixed capital investment	4.9	10.2	-0.8	-2.6	2.7	0.8	3.3
Exports, goods & services	9.2	5.1	2.8	0.0	0.8	1.8	1.3
Imports, goods & services	12.4	6.0	1.4	-5.4	0.1	1.3	1.2
GDP, at market prices	0.8	7.3	2.8	0.9	2.5	2.0	2.4
Agriculture	6.3	3.4	0.4	0.3	0.6	2.7	2.7
Industry	-4.1	7.4	1.3	-0.6	1.9	2.3	2.3
Services	3.8	8.4	4.5	2.0	3.0	1.8	2.5
Consumer price index, (average, %)	3.8	3.0	2.2	1.9	-0.5	1.8	2.2
Current account balance (% of GDP)	2.4	-0.4	-0.9	3.3	4.6	4.6	4.4
Fiscal balance (% of GDP)	-0.6	-1.8	-0.2	-1.8	-1.9	-2.2	-2.1

Sources: Central Bank of Thailand; IMF; World Bank staff estimates.
Notes: Figures for 2014 are tentative and may vary from official estimates.

TIMOR-LESTE



	2014
Population, million	1.2
GDP, US$ billion	1.4
GDP per capita, current US$	1,170
Life expectancy /1	68
School enrollment rate, net primary /2	91

Source: National authorities; World Bank estimates.
1/ Data as of 2013.
2/ Data as of 2011.

Summary

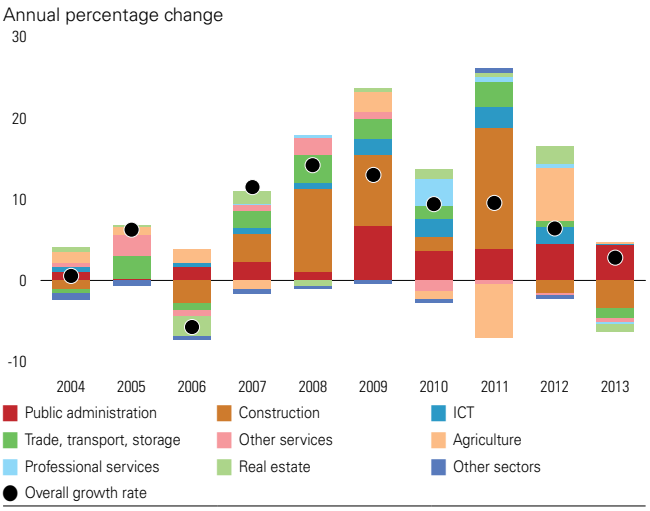
Economic growth dropped in 2013 due to a weakening in petroleum markets and associated lower government expenditure, although it likely rebounded in 2014. Timor-Leste's Petroleum Fund is doing its job of buffering the budget and, through that, the nonoil economy, from the recent volatility in oil prices. But the government will nevertheless need to carefully balance competing development priorities in light of tighter fiscal constraints.

Recent developments

Economic growth from the oil sector has been hit by declining international prices, with double-digit growth in 2011 falling to 5 percent over 2012, and a decline in 2013 of 18.7 percent. Growth in the nonoil sector has also been decreasing, from 9.5 percent in 2011 to 6.4 percent in 2012 and to just 2.8 percent in 2013. The decline in nonoil growth reflects its sensitivity to public spending growth, which fell by 10 percent in 2013. GDP estimates are not yet available for 2014, but GDP is likely to rebound given a strong increase in government-led investment.

Consumer price inflation, which had been running at above 10 percent in 2012 and 2013, dropped precipitously in 2014 to just 0.4 percent on average as a stronger dollar brought down prices of imported goods, especially foodstuffs, alcohol, and tobacco. Refinements to the weights of the CPI series have also led to some volatility in the estimates.

Figure 1. Industry contributions to non-oil real GDP growth



Source: Ministry of Finance.

The approved 2015 Government Budget of US$1.57 billion marked a continued expansionary fiscal policy, 5 percent higher than the 2014 Budget and 20 percent higher than the ceiling that was initially set for the 2015 Budget. The 2015 Budget reflects an adjustment toward recurrent spending—11 percent higher—while capital spending was 22 percent lower. The Rectification Budget following a Cabinet reshuffle part way through 2015 maintained the same level of budget expenditure, despite a dramatic fall in oil prices. As a result, growth in the Petroleum Fund is on course to fall below the estimated sustainable income for the first time since petroleum exports came on stream.

Poor execution hampered government expenditure plans in 2012 and 2013. An execution rate of

66 percent in 2013 meant that actual expenditure declined by 10 percent year-on-year, but execution improved sharply in 2014 to almost 90 percent and, as a result, actual expenditure in 2014 rebounded by 24 percent. Compared to 2012 and 2013, when less than half of budgeted capital works were completed, the equivalent figure in 2014 was 88 percent. This improvement was related to an amendment to the Budget Law that relaxed certain payment procedures passed late in 2014. Indications for 2015 are that execution rates are now improving year-round, with execution rates to May 2015 double what they were at the same time the year before.

Petroleum production is a nonresident activity so is not considered part of exports. The trade deficit in goods and services widened by 20 percent to US$1.34 billion in 2014, due for the most part to an increase in imports driven by a growing public works program.

The Petroleum Fund, Timor-Leste's sovereign wealth fund, reached a value of US$16.86 billion at end-June 2015, more than 10 times nonoil GDP. After growing rapidly in previous years, balances in the Petroleum Fund have been largely static for a year (a small increase from US$16.6 billion in June 2014) due to the anticipated slowdown in petroleum production from current fields, low oil prices, and persistently high levels of withdrawals to fund the government budget. The Central Bank also holds substantial foreign reserves, enough to cover hundreds of months of imports.

Timor-Leste uses the US dollar as its official currency. The real effective exchange rate (REER) has appreciated since 2013 due to an appreciation of the US dollar. However, the appreciation of the REER has slowed as inflation has fallen in Timor-Leste.

Outlook

Global oil prices, domestic oil production, and public spending dominate the outlook for Timor-Leste, one of the world's most petroleum-dependent economies. The government budget is the main linkage between the domestic economy and the much larger petroleum sector (which constitutes 80 percent of GDP). Petroleum revenues dominate public finances—comprising 93 percent of total government revenues. The contractionary impacts of recent falls in oil prices will mean that public spending is likely to need to remain at currently targeted levels or drop slightly if the Petroleum Fund is to be preserved. Growth is expected to remain lower than seen in previous years as government expenditure plateaus.

Challenges

Fiscal sustainability continues to present a challenge. Estimated sustainable income from the Petroleum Fund is currently projected at US$639 million, which, combined with domestic revenue, allows for approximately US$800 million of government expenditure each year that could be maintained for future generations. The 2015 budget was 20 percent higher than the budget ceiling of US$1.3 billion set to be consistent with a sustainable fiscal path. The 2016 budget ceiling has been set at the same level, with an indicative ceiling in 2017 of US$1.2 billion, which indicates the downward moderation in public expenditure that is still required to maintain sustainable Petroleum Fund asset levels in light of lower oil prices.

Timor-Leste has experienced high rates of growth and has a middle-income level of economic activity, yet a large proportion of the population still lives in extreme poverty and lacks the basics to seek a better life. Only half of the children aged 5 to 7 are enrolled in school, much of the population lack basic literacy, and almost half of the children are stunted due to poor nutrition. While Timor-Leste's domestic economy has grown at more than 10 percent a year for the last 8 years, two-thirds of people still work in the very low-productivity agricultural sector. The challenge remains to make use of limited fiscal resources to prioritize interventions that will support increased access for the poorest to the human

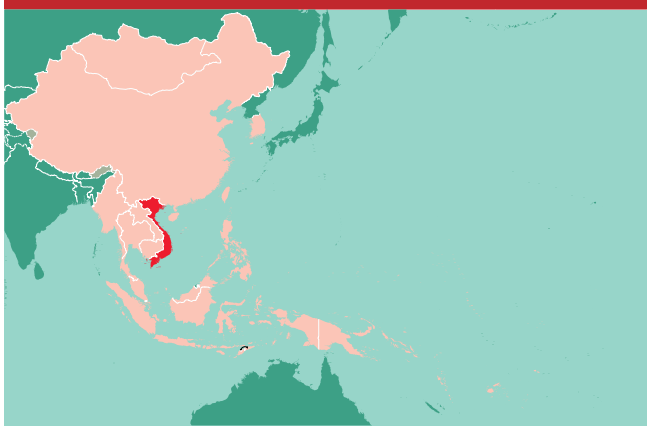
and physical capital essential to move into more productive sectors or to improve their livelihoods in agriculture.

Timor-Leste Selected Indicators

Annual percentage change, unless stated	2013	2014	2015	2016	2017
Real gross domestic product (non-oil)	2.8	7.0	6.8	6.9	7.0
Exports, goods & services, US$ million	61.0	89.5	89.0	105.0	126.0
Imports, goods & services, US$ million	1,409	1,280	1,307	1,379	1,439
CPI inflation (average, %)	11.3	0.4	4.0	3.7	3.9
Current account balance (% of GDP)	49.1	24.0	30.2	32.2	28.1
Fiscal balance (% of GDP)	40.3	23.9	13.8	17.1	11.7

Sources: Statistics Time Leste; Timor Leste Ministry of Finance; Banco Central Timor Leste; World Bank staff estimates.

VIETNAM



	2014
Population, million	90.7
GDP, US$ billion	186.2
GDP per capita, US$	2,052
GDP per capita, US$ PPP	5,629
Poverty rate, US$1.9/day, 2011 PPP /1	2.8
Poverty rate, US$3.1/day, 2011 PPP /1	12.3
Gini coefficient, consumption /2	0.36
Life expectancy /2	76
School enrollment rate, primary /2	105

Sources: Vietnam Government Authorities; World Development Indicators.
/1 2012.
/2 2013.

Summary

Economic activity has remained buoyant in 2015, driven by strong private demand. While extreme poverty continued to fall to less than 3 percent in 2014, poverty remains high among ethnic minorities. Medium-term challenges include containing public debt while implementing structural reforms (especially in the areas of the banking sector and state-owned enterprises [SOEs]) and creating an environment more conducive to private-sector-led growth. Vietnam's continued international economic integration is expected to further boost trade and investment.

Recent Economic Developments

Economic activity continued to firm up in 2015, driven by strengthening domestic demand. GDP accelerated to 6.3 percent during the first half of 2015, the fastest first-half-of-the-year growth rate in the last five years. The recovery was driven by strong activity in manufacturing and construction, which together contributed nearly half of overall GDP growth. Despite the pickup in retail activity, overall services (which account for nearly 40 percent of GDP) rose modestly at 5.9 percent in the first half of 2015. On the demand side, stronger growth was supported by investment (spurred by strong FDI inflows) and improved private consumption. However, the contribution of net exports turned negative as sluggish external demand weighed on export growth, while strengthened domestic activity continued to fuel import growth.

With ongoing strong growth, poverty has continued to decline. Preliminary analysis of new data from the 2014 Vietnam Household Living Standards Survey confirms that poverty for the country is dropping, and extreme poverty using the new US$1.90 2011 PPP line is below 3 percent. Concerns about poverty are increasingly focused on the 15 percent of the population who are members of ethnic minority groups. Ethnic minorities now account for more than half the poor, and progress on ethnic minority poverty reduction has slowed.

A low inflation environment has enabled the State Bank of Vietnam (SBV) to loosen its monetary policy stance. The consumer price index rose only 0.6 percent year-on-year in August 2015, down from 4.3 percent a year earlier. Interest rate cuts were aided by macroprudential measures, including relaxation of limits on short-term deposits, and risk weights for certain lending activities. This allowed banks to maintain lower lending rates than in the past, thereby stimulating credit growth to an estimated 7.9 percent (year-to-date) in June 2015, consistent with the SBV's target range for the whole year.

In response to a universally firmer US dollar, and to keep pace with exchange rate movements in Vietnam's main trading partners, the SBV devalued the dong three times—in January, May, and August 2015—by a cumulative 3 percent, and widened the trading band from +/-1 percent to +/-3 percent

in August 2015, in order to promote foreign exchange market stability and preserve external competitiveness.

Persistent fiscal imbalances are a concern against the backdrop of rising public debt. Budget outturns thus far in 2015 indicate persistent fiscal pressures, with an estimated deficit (including principal payment) of 5.6 percent of GDP in the first half of 2015, reflecting weak revenue outturn and increased current and capital spending.

Total public and publicly guaranteed debt increased further to an estimated 59.6 percent in 2014 (up from 54.5 percent in 2013). While public debt levels are still within the bounds of sustainability, debt servicing costs are beginning to cut into fiscal space and risk crowding out more productive spending.

The external trade balance weakened, causing the current account to move into deficit in Q1 of 2015. A trade deficit of US$3.5 billion was recorded in the first seven months of 2015 (compared to a surplus of US$2.1 billion in entire 2014). The outturn reflected a slowdown in export growth and stronger growth in imports, especially of intermediate and capital goods.

Progress on structural reforms has been mixed, especially with regard to SOE and banking sector reforms. An acceleration of these reforms is deemed necessary—by both policy makers and private analysts—to carry growth closer to the 7 percent mark and meet Vietnam's longer-term aspirations to become a modern, industrialized nation. SOE equitization (divestiture of state assets) has slowed in 2015. Consolidation of the banking sector (mergers and acquisitions of commercial banks) accelerated during the first half of 2015, but resolution of bad debts remains a concern

Lack of financial sources, weak professional capacity, and absence of an adequate enabling legal framework continue to hamper efforts of the Vietnam Asset Management Company to resolve the bad debt.

Outlook

The medium-term outlook for Vietnam is positive on balance but subject to significant downside risks. Growth is expected to be over 6 percent in 2015, underpinned by further recovery in domestic demand, in turn reflecting more robust private consumption and investment growth. Despite the expansionary monetary policy stance, inflation would remain low due to subdued global conditions and low global energy and food prices. The fiscal deficit is expected to start adjusting through consolidation efforts to avoid further increases in public debt. The trade balance is projected to turn into a deficit in 2015 due to softer export growth and sustained strong import growth stoked by stronger domestic economic activity. However, robust remittances will keep the current account in surplus, albeit at a much lower level than last year.

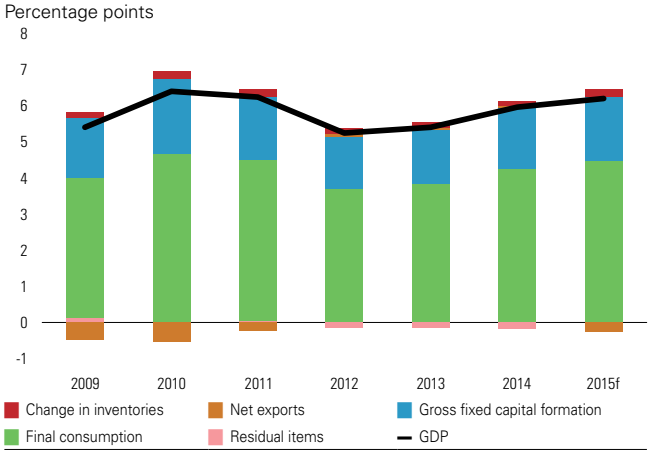
Poverty is expected to continue to decline. Extreme poverty (US$1.90 a day, 2011 PPP) is expected to decline from 2.8 percent in 2012 to 1 percent in 2017, while the percentage of the population living below US$3.10 a day would fall from 12.3 percent in 2012 to 6.7 percent in 2017. While the strengthening recovery combined with stable macroeconomic conditions is expected to help sustain positive poverty trends, slower agricultural growth may dampen rural income growth and widen the rural-urban income gap. It is also expected that ethnic minorities will account for a growing share of the poor.

Challenges

The baseline assessment is subject to downside risks, both external and domestic. On the external front, as described, global growth remains sluggish and subject to much uncertainty, with important implications for Vietnam through its significant trade linkages. Furthermore, weak global prices of rice and other agricultural products may adversely affect rural household income and consumption. On the domestic side, a credible medium-term fiscal consolidation plan together with comprehensive

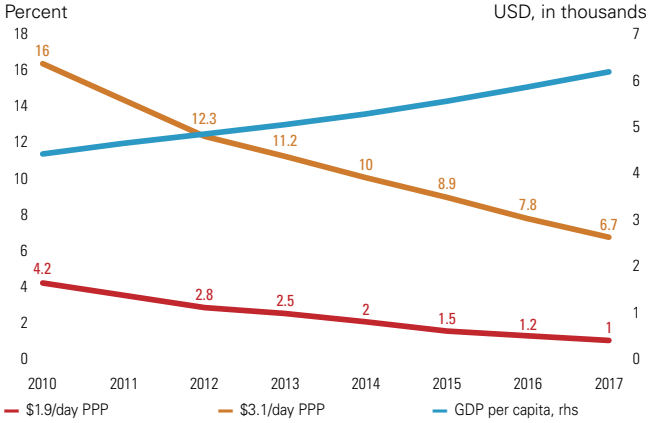
structural reforms to strengthen the finances of the SOEs and the state-owned banking sector would remain crucial to ward off pressures on public debt and boost private sector confidence.

Figure 1. Contribution to annual GDP growth



Source: Vietnam government authorities.

Figure 2. Poverty rates and GDP per capita 2010–17



Source: WB staff estimates based on survey data (2010–12).
Note: Projections based on neutral distribution with GDP per capita at constant 2011 PPP.

Vietnam Selected Indicators

	2012	2013	2014	2015	2016	2017
Real GDP growth, at constant market prices	5.3	5.4	6.0	6.2	6.3	6.3
Private consumption	4.7	5.2	6.1	7.2	7.0	7.0
Government consumption	7.2	7.3	7.0	7.0	6.9	6.8
Gross fixed capital investment	2.0	5.0	8.9	9.0	8.7	6.3
Exports, goods and services	15.7	17.4	11.6	10.0	11.2	11.5
Imports, goods and services	9.5	17.1	12.7	14.6	12.2	11.7
Real GDP growth, at constant factor prices	5.2	5.4	6.0	6.2	6.3	6.3
Agriculture	2.7	2.6	3.5	2.6	2.7	2.7
Industry	5.8	5.4	7.1	8.6	8.4	8.2
Services	5.9	6.6	6.0	5.6	5.8	6.0
Inflation (consumer price index)	9.1	6.6	4.1	1.5	3.0	3.2
Current account balance (% of GDP)	6.0	5.5	4.8	0.2	0.0	-0.3
Fiscal balance (% of GDP)	-6.7	-6.9	-6.0	-5.4	-5.0	-4.8
Poverty rate [a, b, c]						
Poverty rate ($1.9/day 2011 PPP terms)	2.8	2.5	2.0	1.5	1.2	1.0
Poverty rate ($3.1/day 2011 PPP terms)	12.3	11.2	10.0	8.9	7.8	6.7

(a) Calculations based on 2010-VHLSS Survey, 2012-VHLSS survey.
(b) Projection using neutral distribution (2012) with pass-through = 0.87 based on GDP per capita constant PPP.
(c) Actual data: 2012. Projections are from 2013 to 2014.

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Staying the Course

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