



Adjusting to a Changing World



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Adjusting to a Changing World

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LIST OF ABBREVIATIONS (continued)

Countries (continued)

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

Currency Units

B	Thai bhat
CR	Cambodian riel
D	Vietnamese dong
F\$	Fiji dollar
K	Myanmar kyat
K	Papua New Guinea kina

LIST OF ABBREVIATIONS (continued)

Currency Units (continued)

Kip	Lao PDR
₱	Philippine peso
RM	Malaysian ringgit
RMB	Chinese renminbi
Rp	Indonesian rupiah
SIS	Solomon Island 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 work 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; the Republic of Korea; 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 March 27 inclusive.

EXECUTIVE SUMMARY

In the six months since the previous East Asia and Pacific Economic Update, the regional economic landscape has been dominated by two key developments in the global economy. First, there has been a sustained decline in world oil prices. This is already exerting, and will likely continue to exert, a differential impact on the performance and prospects of countries, depending on whether they are fuel importers or exporters. Second, there has been a rapid dollar appreciation against the euro and the yen. Most regional currencies have depreciated to only a limited extent against the dollar, implying significant appreciations in real, trade-weighted terms.

Growth in developing East Asia and Pacific moderated from 7.2 percent in 2013 to 6.9 percent in 2014, reflecting slowdowns in China and some ASEAN-4 economies. Nonetheless, the region still accounted for more than one-third of global growth, twice the combined contribution of all other developing regions. In China, growth decelerated by 0.3 percentage points, as attempts to contain credit growth and reduce overcapacity were partly offset by measures to avoid a sharp slowdown. In the rest of the region, growth fell by 0.6 percentage points. Within the ASEAN-4, growth dropped most sharply in Thailand, to 0.7 percent, as a result of prolonged political turmoil; the economy began to recover only in late 2014. Indonesia was affected by weakness in its terms of trade and commodity exports, and by the continued impact of policy tightening aimed at addressing external financing constraints. Growth remained generally robust in the region's smaller economies, including Cambodia, Lao PDR, and Myanmar.

Most countries continued to rebuild the fiscal buffers eroded by stimulus spending in the wake of the global financial crisis, but challenges remain. Fiscal balances broadly continued to improve, particularly in Malaysia and the Philippines. Indonesia, Malaysia, Thailand, and Vietnam further rationalized fuel subsidies or raised fuel taxes. However, in Mongolia and to a lesser extent Lao PDR, both deficit and debt levels remain elevated; in Myanmar, a sizable deficit has emerged; in Vietnam, public debt continues to rise; and Malaysia's public debt remains high.

Central banks responded to inflationary pressures in mid-2014, but have since refocused on growth concerns. Indonesia, Malaysia, and the Philippines raised policy rates in mid- to late-2014. Since then, China, Indonesia, and Thailand have eased monetary policy. Falling world oil and food prices helped reduce headline inflation in most regional economies; core inflation remained broadly stable.

Most regional currencies appreciated in trade-weighted terms in 2014. They depreciated against the U.S. dollar, but appreciated against the euro and yen. Malaysia was the only country to experience real, trade-weighted depreciation. The strengthening U.S. dollar poses particular challenges to trade competitiveness in the region's most dollarized economies, Cambodia and Timor-Leste. FDI inflows remained generally robust, rising in all countries except Malaysia and Mongolia.

Looking ahead, global growth is expected to pick up moderately, from an average 2.5 percent in 2012–14 to 3.1 percent in 2015–17. Growth in high-income economies will continue to increase, from 1.7 percent in 2014 to an average 2.2 percent in 2015–17. In the **United States**, growth will rise to an average 3 percent in 2015–16, returning to near-potential growth of about 2.5 percent in 2017. The recovery will be led by consumption, assisted by improved housing and labor market conditions, although the strong U.S. dollar will dampen net exports. In the **euro area**, low energy prices, a weak euro, and favorable financing conditions will support the

recovery, although the legacies of the financial crisis (impaired balance sheets, high unemployment, and debt overhang) will continue to weigh on medium-term prospects. Growth will strengthen to an average 1.6 percent in 2015–16. In **Japan**, low oil prices, a weak yen, and a range of product and labor market reforms announced since June 2014 will help raise growth to an average 1.4 percent in 2015–16, following stagnation in 2014.

These projections assume that world fuel prices will remain low for a considerable period. Oil prices are projected to be 45 percent lower on average in 2015, and to rise only moderately through 2017, reflecting the impact of unconventional oil supplies and OPEC's attempts to maintain market share. Relatedly, prices of liquefied natural gas for delivery in Japan are projected to be 30 percent lower in 2015, and to remain constant thereafter.

The gradual strengthening of activity in high-income economies, combined with the sustained fuel price decline, will help developing East Asia and Pacific (EAP) maintain its growth performance. Growth in the region as a whole will ease slightly in 2015, from 6.9 percent to 6.7 percent, and then stabilize. In developing EAP excluding China, growth will rise by half a percentage point in 2015, and a further 0.3 percentage points by 2017, driven by the large ASEAN economies.

In China, growth will moderate further, to 7.1 percent in 2015 and 6.9 percent in 2017, reflecting continued policy efforts to address financial vulnerabilities and gradually shift the economy to a more sustainable growth path. Continued measures to contain local government debt, contain shadow banking, reduce excess capacity, curb energy demand, and control pollution will reduce investment and manufacturing growth. However, targeted stimulus is expected to continue to mitigate the impact on short-term growth, should this show signs of slowing considerably below the government's indicative target of about 7 percent.

In the rest of developing EAP, growth will pick up, reflecting a recovery in both investment and consumption, partly driven by lower fuel prices, although export growth will be constrained by the ongoing real appreciations. Low fuel prices will benefit developing EAP as a whole, but their impact will vary across countries, reflecting the magnitude of net fuel imports, energy intensity in production, and the share of oil and gas in total energy consumption. Cambodia, Lao PDR, the Philippines, Thailand, and the Pacific Island Countries will all gain significantly. Conversely, Malaysia and Papua New Guinea will experience small GDP losses. In Indonesia, the net impact will hinge on the extent to which the prices of coal and gas exports track oil prices.

Given the uncertainties facing the global economy, the outlook for developing EAP is subject to significant risks. A downturn in the euro area and Japan would weaken global trade, and impair the region's export performance. Higher U.S. interest rates and an appreciating U.S. dollar, associated with monetary policy divergence across the advanced economies, may raise borrowing costs, generate financial volatility, and reduce capital inflows more sharply than anticipated. A significant slowdown in China, though unlikely, would exert significant spillovers, particularly on commodity exporters.

Addressing fiscal challenges, and basing public budgets on prudent medium-term fiscal plans, will help manage the risks associated with an uncertain global outlook. In most large economies, some combination of bolstering revenue and rationalizing expenditure will help create fiscal space for both productivity-enhancing investments and targeted social protection and insurance programs. In the major fuel exporters, lower fuel prices will erode fiscal revenues over time, creating a need for consolidation. Among the smaller economies, fiscal consolidation is urgently required to rebuild fiscal buffers in Mongolia, and to a lesser extent Lao PDR and

Myanmar; in addition, fiscal institutions need to be strengthened. The Pacific Island Countries continue to face significant short- and medium-term fiscal sustainability issues.

The prospect of low world fuel prices means there is a unique opportunity to both remove fuel subsidies and raise energy taxes more broadly; this will reduce inefficiencies and help address fiscal challenges. Fuel subsidies and related tax expenditures have strained public finances and weakened current accounts in many fuel exporters and importers in the region. Recent steps to reduce these distortions have established a positive momentum, which now needs to be sustained.

China faces a delicate balancing act; reforms to restructure the economy and reduce local government debt need to be sustained, but the likelihood of sharp contractions minimized. Efforts to cut excess capacity in heavy industry, reduce supply mismatches in residential property, dampen unproductive risk taking in shadow banking, and harden budget constraints on local governments will help make investment more efficient and realign growth over the medium term. However, such reforms will depress activity in the short term. It is critical that any offsetting stimulus measures be designed so as not to undermine restructuring efforts; in particular, any fiscal stimulus program will need to avoid unsustainable increases in local government debt.

Over the medium term, developing human capital and physical infrastructure is a key priority, including in fuel exporters striving for diversification. In fuel importers, lower fuel prices boost growth and relax fiscal constraints to expanding productivity-enhancing investments, including in education, health care, and infrastructure. In fuel exporters, the decline in fuel prices underscores the need to remove barriers to economic diversification, including by developing fiscal and monetary institutions to better manage volatility in natural-resource rents; providing high-quality education and appropriate infrastructure; and creating a competition regime that levels the playing field for enterprises.

Countries in the region—both low- and middle-income—face significant long-term fiscal challenges, as demographic trends and social pressures lead to rising social security expenditure. EAP is aging faster than any region in history, driven primarily by a rapid decline in fertility, but also increased longevity. This will affect growth prospects. Combined with growing pressures to expand pension coverage, it will also raise the costs of pensions. The policy response should be twofold, first, sustaining productivity growth, boosting the labor-force participation of women and older urban people, and in some cases increasing immigration; and second, reforming social security financing so as to expand the revenue base.

In a similar vein, demographic trends and social pressures will lead to sharp increases in health expenditures. The fiscal costs of health care and long-term care will be affected by both rapid aging, and pressures to expand health care coverage through universal enrollment, a greater degree of financial protection, and access to higher-quality health services. These welcome expansions in coverage need to be accomplished in a fiscally sustainable manner. The revenue base for health care should therefore be expanded. In addition, costs must be contained, including by reforming the mechanisms for paying health-care providers, purchasing pharmaceuticals, and adopting new health care technologies.

Whether lower-income economies in developing EAP benefit from China's move into higher value-added sectors depends partly on the extent to which Chinese labor-intensive manufacturing relocates *within* China. As China's economy matures, its labor-intensive manufacturing will face pressures to move to lower-cost economies across the region. However, such international relocation has so far proved limited. Rather, as

costs have risen in China's manufacturing hub on the eastern coast, industry has moved to lower-cost areas within the country, both within the eastern coastal region, and in other regions in China. Underlying factors include China's significant advantages in terms of labor productivity, a favorable investment climate, robust logistics, and superior infrastructure. For developing EAP, making progress in these areas will prove critical to developing their industrial sectors.

Increasing competitiveness in services through further regional integration will be necessary for ASEAN economies to sustain growth in the long run. Services such as finance, education, health care, transportation, and telecommunications are critical to modern economies, including as key drivers of productivity in high value-added manufacturing. Recognizing this, the ASEAN members have committed to liberalizing and integrating their services markets, in the context of the formation of the ASEAN Economic Community at end-2015. However, de facto progress has been modest so far, and ASEAN remains among the most restrictive regions in the world with respect to trade in services. Correcting this will require a focus on promoting regulatory cooperation and coordination through harmonization or mutual recognition, together with the development of regulatory capacity.

Part I. Recent Developments and Outlook

I.A. Recent Developments

In the six months since the previous East Asia and Pacific Economic Update, the regional economic landscape has been dominated by two key developments in the global economy. First, there has been a sustained decline in world oil prices. This is already exerting, and will likely continue to exert, a differential impact on the performance and prospects of countries, depending on whether they are fuel importers or exporters. Second, there has been a rapid dollar appreciation against the euro and the yen. Most regional currencies have depreciated to only a limited extent against the dollar, implying significant appreciations in real, trade-weighted terms.

Growth in developing East Asia and Pacific (EAP) moderated from 7.2 percent in 2013 to 6.9 percent in 2014, reflecting slowdowns in China and some ASEAN-4 economies. In China, growth decelerated by 0.3 percentage points, to 7.4 percent, as attempts to contain credit growth and reduce overcapacity were partly offset by measures to avoid a sharp slowdown (figure I.A.1). In the rest of the region, growth fell by 0.6 percentage points, to 4.6 percent. Within the ASEAN-4, growth dropped most sharply in Thailand, to 0.7 percent, as a result of prolonged political turmoil; the economy began to recover only in late 2014. Indonesia was affected by weakness in its terms of trade and commodity exports, and by the continued impact of policy tightening aimed at addressing external financing constraints. Growth also fell in the Philippines, as public expenditure decelerated. In contrast, growth accelerated in Malaysia, reflecting a pickup in exports and private consumption. Buoyant manufacturing exports and investment also boosted growth in Vietnam.

Figure I.A.1. GDP growth

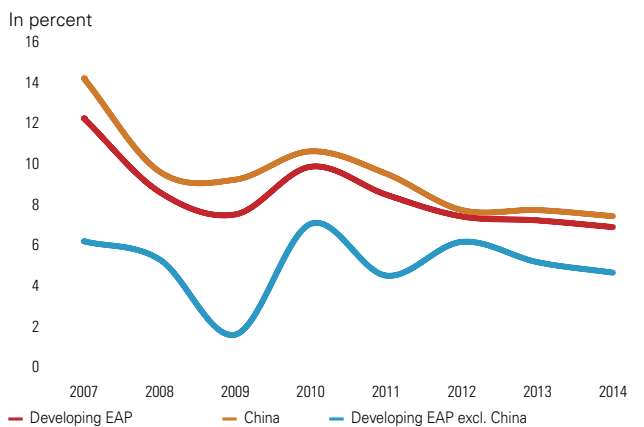
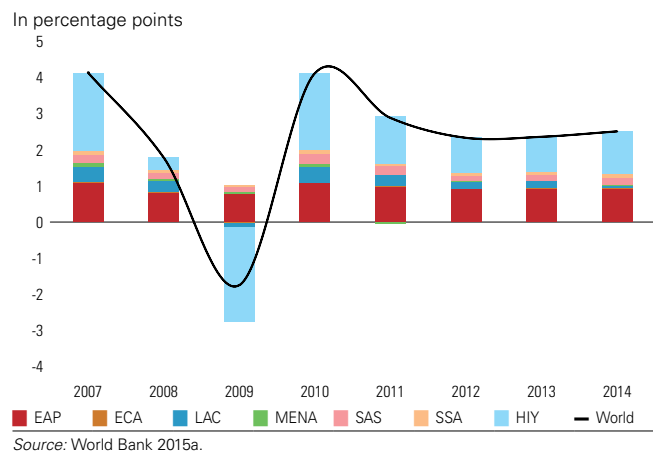


Figure I.A.2. Regional contribution to global GDP growth



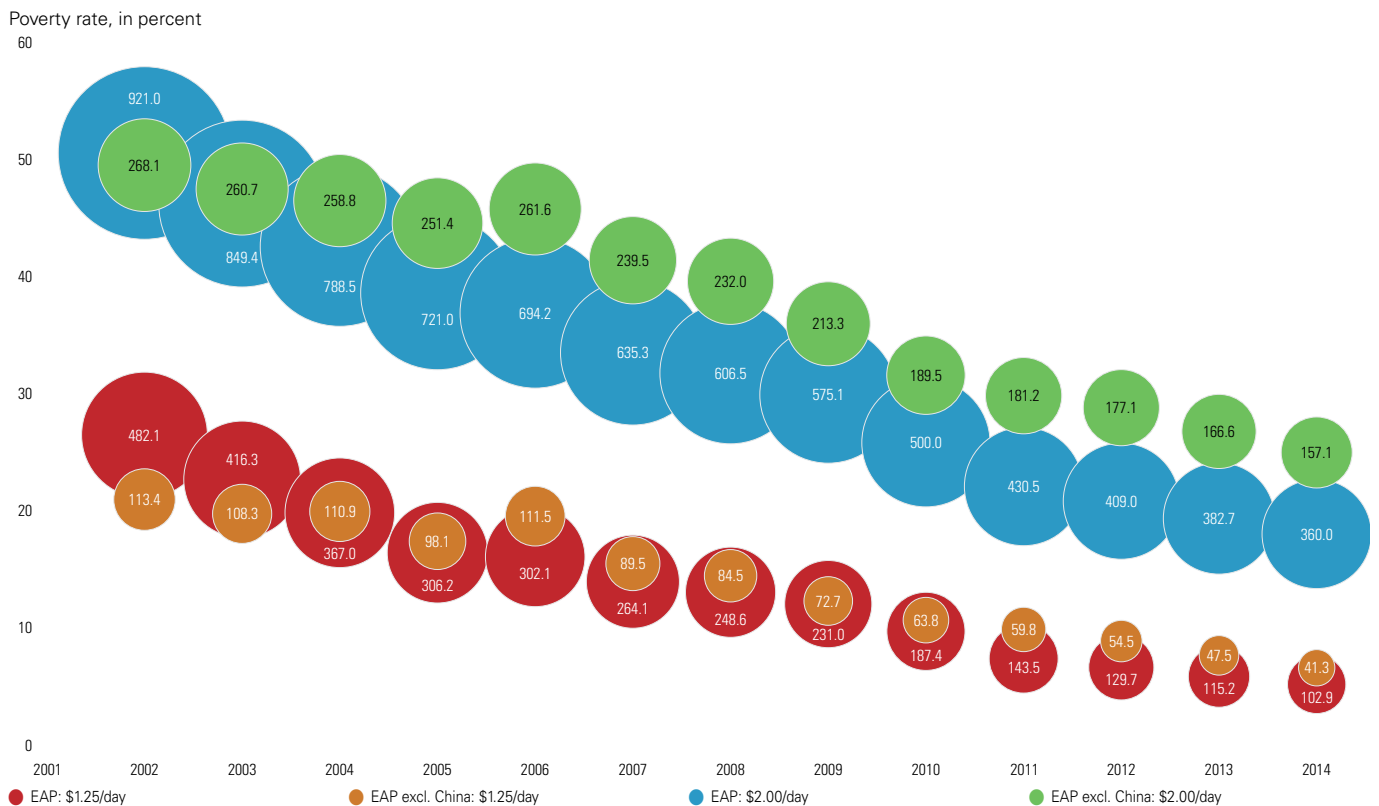
Growth remained generally robust in the region's smaller economies, including Cambodia, Lao PDR, and Myanmar. In Cambodia, garment exports, construction, and finance underpinned the expansion. In Lao PDR, FDI remains buoyant, particularly in the power sector, which is benefiting from sustained regional demand. In Myanmar, economic activity continues to rebound after a long period of isolation, as reforms encourage domestic and foreign investment. In Mongolia, growth fell sharply; the mining slowdown and previous highly expansive policies have resulted in large fiscal, financial, and external imbalances. Most Pacific Island Countries

saw moderate growth, driven by stimulus from donor-financed aid projects and recovery from recent natural disasters.

Growth in both China and the rest of the region was the weakest since the recovery from the global financial crisis began in 2010. Nonetheless, in the context of a slow global recovery (box I.A.1), the region still accounted for almost two-fifths of global growth, twice the combined contribution of all other developing regions, and approximately the same share as in 2012 and 2013 (figure I.A.2).

Oil prices fell by 40 percent between June and December 2014, the sharpest decline in six years, with differential effects on the external and fiscal accounts of fuel importers versus exporters (box I.B.2). Indonesia reduced fuel subsidies in November, and Malaysia eliminated blanket gasoline subsidies in December. Lower world oil prices cushioned the impact of these decisions on domestic prices and consumers. Continued low fuel prices, however, will adversely affect the budgets in both countries, since they rely heavily on fuel-related fiscal revenues.

Figure I.A.3. The region has seen a continuous and substantial decline in poverty over the last decade



Source: World Bank East Asia and Pacific Poverty Portal.

Note: Estimates are derived from (a) household survey data directly, (b) interpolations between existing surveys, or (c) extrapolations based on per capita GDP growth and historical estimates of the growth elasticity of poverty. All estimates are subject to revision.

The region faced more volatile exchange rates toward the end of 2014, as monetary policy increasingly diverged among the world's major central banks; most regional currencies experienced significant trade-weighted appreciation. Commitments by central banks in the euro area and Japan to more aggressive stimulus measures, and expectations of movements in the opposite direction by central banks in the United States and the United Kingdom, led to significant appreciation of the U.S. dollar against the euro and the

yen, and currency volatility. Most regional currencies depreciated only slightly against the dollar, resulting in significant appreciation in real, trade-weighted terms.

Taking a longer-term view, the region has seen a continuous and substantial decline in poverty over the last decade—a trend that will likely be sustained with favorable economic prospects. Between 2002 and 2014, the regional extreme poverty rate (defined as the share of the population living on less than \$1.25 a day PPP) fell from 27 percent to 5.1 percent (figure I.A.3).¹ If a higher poverty line (\$2.00 a day PPP) is used, the poverty rate fell from 51 percent to 18 percent. Even excluding China, the rate was halved, to 25 percent. Nevertheless, there are still 360 million poor in the region. Further, large shares of the population remain vulnerable to being pushed into poverty by shocks, including economic downturns, natural calamities, or increases in the cost of living.²

Box I.A.1. Recent Global Developments

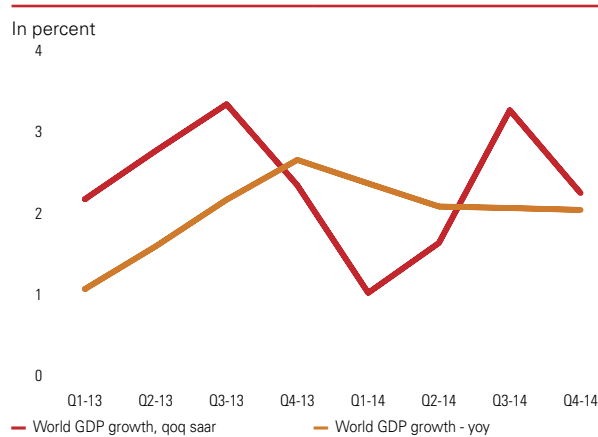
Global growth is still weak. Global growth in Q4 2014 is estimated at 2.6 percent (annualized quarter-on-quarter), down from 3.5 percent in Q3 2014 (figure I.A.1.1). This largely reflects developments in several large economies, including a leveling off in the United States, an ongoing slowdown in China, a deepening recession in Russia, and contraction in Brazil. Since the start of 2015, the impact of sharply lower oil prices on the global economy has been increasingly visible, with a significant pickup in retail sales and falling inflation across major oil-importing economies (including many high-income economies, China, and India), increasing headwinds facing oil exporters (including Nigeria and Russia), and heightened volatility in bond and equity markets.

Growth in high-income countries has seen some broadening. In the **United States**, growth decelerated to 2.2 percent in Q4 2014, after an exceptionally strong third quarter. Consumption picked up sharply, reflecting tailwinds from declining oil prices and strong labor market conditions. In contrast, dollar appreciation has led to a significant slowdown in exports. In the **euro area**, growth picked up to a still modest 1.4 percent in Q4 2014. The expansion was led by Germany, and benefited from a significant contribution from consumption and net exports. In **Japan**, a technical recession ended in the fourth quarter, with growth bouncing back to 1.5 percent, supported by a recovery in both consumption and exports. However, the strength of the rebound disappointed, and investment continued to stagnate. In **Australia**, growth rose to 2.7 percent for 2014 as a whole, but has decelerated sharply since Q1 2014. Declining prices for key export commodities, including mineral fuels and iron ore, have depressed mining investment.

Oil prices are low and stable. Crude oil prices fell by 56 percent between July 2014 and January 2015, reaching a six-year low. They have since stabilized, reflecting prospects of capacity adjustments in U.S. oil supply (the number of oil rigs, a measure of future crude oil supplies, halved between October 2014 and March 2015), the announcement of sharp cutbacks in investment plans by major oil companies, some pressure from members of the Organization of the Petroleum Exporting Countries (OPEC) for the cartel to reconsider its November 2014 decision not to curtail production, and the recent escalation of geopolitical turmoil in the Middle East.

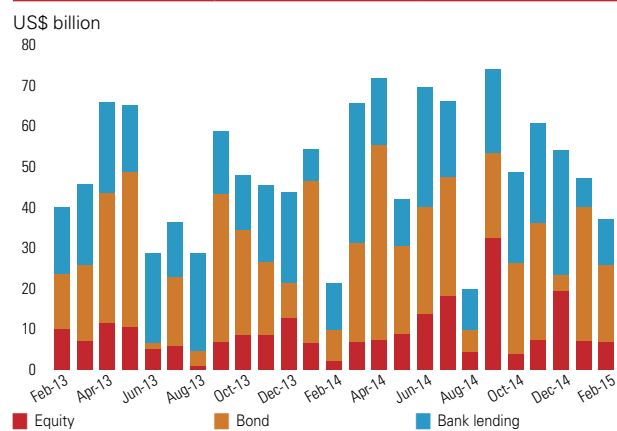
¹ The absolute number of extreme poor fell from 482 million to 103 million—a decrease of almost four-fifths. The share living in China fell from over three-quarters to approximately three-fifths.

² See, for instance, World Bank (2014a).

Figure I.A.1.1. Global growth

Sources: World Bank and Haver Analytics.

Note: qoq = quarter-over-quarter; saar = seasonally adjusted annual rate; yoy = year-over-year.

Figure I.A.1.2. Gross capital flows to developing countries

Source: Bloomberg.

Monetary policy reflects different stances. The euro area, concerned that deflationary pressures could be aggravated by falling oil prices, aggressively moved to ease monetary policy. The U.S. Federal Reserve, however, is still expected to gradually start tightening in the second half of the year.³ Among large oil-importing developing countries, the combined effect of inflation moving toward policy targets, declining current account deficits, and soft growth has allowed several central banks to cut interest rates since the start of the year, including in Egypt, India, Indonesia, Pakistan, and Turkey. In oil-exporting countries, however, central banks must balance the need to support growth against maintaining stable inflation and investor confidence in the face of currency pressures, and in several cases have raised interest rates.

Emerging market currencies are volatile and under pressure. Divergence in monetary policy between the major reserve currencies, together with sharply lower oil prices, has induced greater volatility in emerging market currencies, and in several cases intensified pressures. Since mid-2014, depreciation against the U.S. dollar has been pronounced and broad-based. In trade-weighted terms, most emerging market currencies have proved more stable. However, in both oil exporters, and countries with a particularly significant foreign investor presence, real effective exchange rates have fallen below long-term averages.

Capital flows to emerging markets are still robust. Gross capital flows (including international bond issuance, equity placements, and cross-border syndicated bank loans) to developing countries in the first two months of 2015, at US\$84 billion, were 12 percent higher than in the same period the previous year (figure I.A.1.2). In particular, international bond issuance and equity flows remained buoyant, especially in Asia. This reflects the continued demand for high-yield debt; issuer interest in taking advantage of historically low bond yields, including in the euro area;⁴ and a number of large public offerings in China and other East Asian countries. In contrast, bank lending has declined sharply relative to Q4 2014.

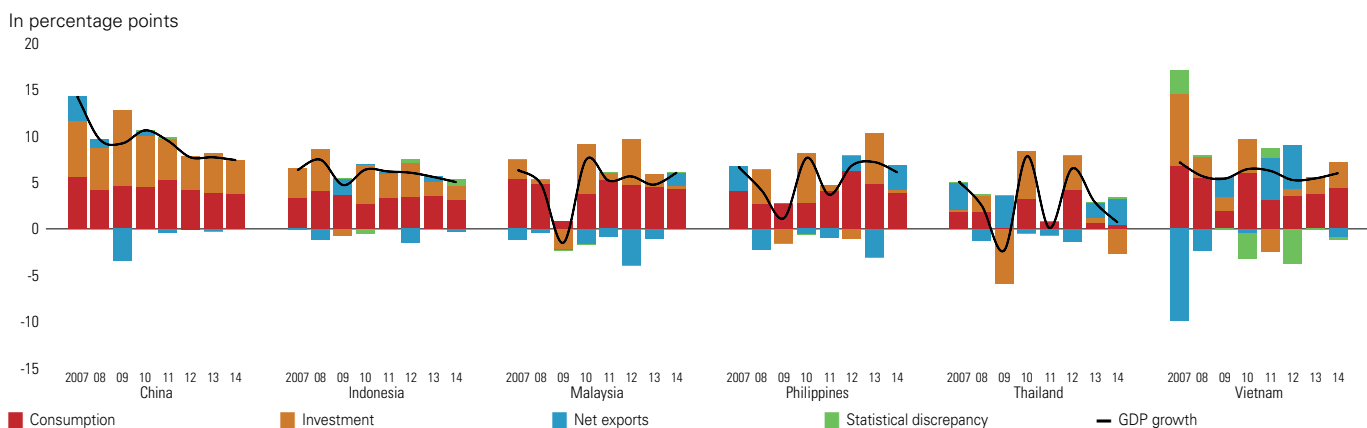
3 It indicated on March 18, 2015, that “an increase in the target range for the federal funds rate remains unlikely at the April FOMC [Federal Open Market Committee] meeting. [It] anticipates that it will be appropriate to raise the target range for the federal funds rate when it has seen further improvement in the labor market and is reasonably confident that inflation will move back to its 2 percent objective over the medium term.”

4 Chinese companies already issued US\$2.9 billion in euro-denominated debt in January and February 2015, compared with US\$3.3 billion for the whole of 2014.

Consumption remained resilient, while investment weakened, and manufactures exports boosted growth

In 2014, domestic demand, and in particular consumption, was the main driver of growth in most of the region's major economies. China started to gradually rebalance toward a more consumption- and services-oriented growth model. Consumption contributed more than investment to growth (figure I.A.4); relatedly, growth in the services sector proved particularly robust. In Indonesia, private consumption also remained the main driver of growth, supported by election-related spending. In Malaysia, buoyant private consumption was supported by stable employment and growing household income, despite the implementation of macroprudential measures aimed at reining in household debt (over 87 percent of GDP at end-2014). In the Philippines, private consumption was supported by stronger job creation (unemployment fell to 6 percent in October 2014, its lowest level in 10 years) and sustained growth in remittances. In contrast, in Thailand, private consumption softened, weighed down by tighter credit conditions and high household debt (84 percent of GDP at end-2014 Q2).

Figure I.A.4. Contributions to growth



Investment provided a significantly smaller boost to growth in 2014 than in 2013, particularly in the ASEAN-4. In China, investment accounted for less than half of total growth, owing to overcapacity in key heavy industries, policy tightening in energy-intensive sectors, a slump in real estate sales and construction, regulatory curbs on shadow banking, and central government restraints on local government debt. In Indonesia, investment remained relatively subdued in the face of weak commodity terms of trade. In Malaysia, public investment slumped, reflecting slower disbursements from the development budget, and the near completion or deferral of major projects by public enterprises. Private investment in machinery and equipment contracted,⁵ although private construction expanded. In the Philippines, private fixed investment was supported by a significant increase in FDI. However, public infrastructure investment fell sharply, owing to bottlenecks in budget execution, slow disbursements for reconstruction from typhoon Yolanda, and the negative effects of a Supreme Court decision finding provisions of the government's Disbursement Acceleration Program unconstitutional. In Thailand, private investment was hampered by political uncertainty, weak external demand, and low capacity utilization. The large planned public-transport infrastructure investments are still in the preparatory stages.

⁵ This partly reflects a slowdown in equipment-intensive oil and gas investments, some of which are nearing completion or have been delayed owing to the fuel-price decline.

Manufactures exports grew rapidly in China, Malaysia, the Philippines, and Vietnam in 2014 (figure I.A.5). China also incurred a significant deficit in services trade. Malaysia saw 9 percent real export growth, despite the sharp decline in oil prices; the highly diversified manufacturing sector accounts for 60 percent of total gross exports. In the Philippines, electronics exports (47 percent of total exports) grew robustly, as did exports of labor-intensive manufactures, including garments and textiles, and capital-intensive manufactures, including machinery and transport equipment. However, manufacturing output fell in the second half of the year, as shipments of raw materials were delayed by port and road congestion. In Vietnam, real exports grew by 14 percent, and real imports grew even more vigorously.

Figure I.A.5. Exports grew in China, Malaysia, the Philippines, and Vietnam

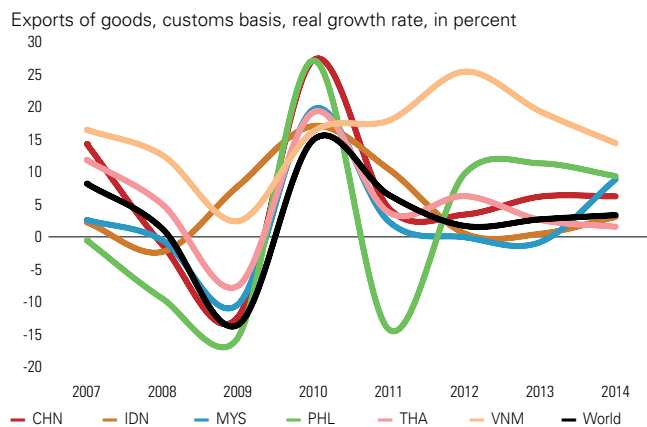
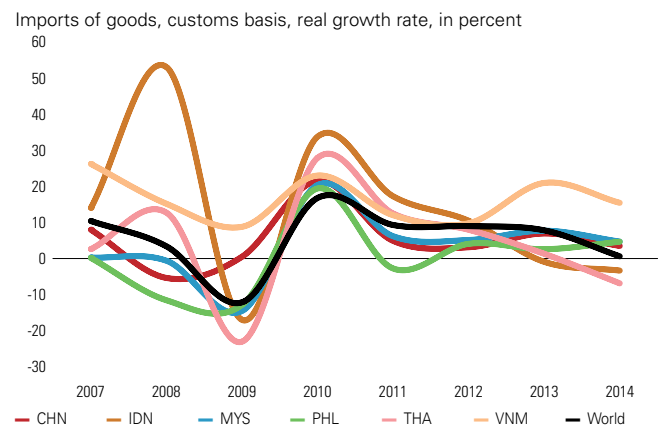


Figure I.A.6. Imports fell sharply in Indonesia and Thailand



In Indonesia and Thailand, exports and imports proved stagnant or contracted. In Indonesia, real exports grew by only 1 percent. Falling world commodity prices, together with policy restrictions on exports of raw commodities early in 2014, discouraged commodity exports, which account for 63 percent of total exports. In Thailand, where exports stagnated, imports contracted sharply, in line with the steep drop in growth (figure I.A.6).

Supply-side developments in the smaller economies

In 2014, construction remained generally upbeat in most small economies. In Cambodia, construction was helped by the restoration of domestic political stability and the revival of investor confidence. In Lao PDR, the real estate sector continued to expand, although less rapidly than in the last few years. In most Pacific Island Countries, construction contributed strongly to growth, led by reconstruction from recent cyclones in Samoa and Tonga, and the implementation of donor-funded airport and road upgrading projects in Tuvalu. In Micronesia, however, construction ceased to be a source of growth, since U.S.-funded airport improvement projects were completed, but other donor-funded infrastructure projects were delayed.

Agriculture also proved robust in most small economies. In Lao PDR, non-rice crops and forestry benefited from demand from China. In Mongolia, favorable weather led to 14 percent growth in agriculture. Micronesia and the Marshall Islands reported increased fishery output. In Samoa, agriculture has gradually recovered from the effects of cyclone Evan in 2012. In Tonga, harvests remained robust in the islands not affected by cyclone Ian. In Vanuatu, coconut production rose, as competitors in the Philippines were affected by typhoon Haiyan. In contrast, in Cambodia, agriculture remained sluggish, owing to slow yield improvements and depressed agricultural commodity prices.

In many small economies, tourism is a critical service sector, but its contribution to growth varied widely. In Vanuatu, cruise tourism fell by 15 percent and air arrivals by 2 percent. In Cambodia, growth in tourist arrivals slowed from 18 percent in 2013 to 6.9 percent in 2014. Palau, particularly reliant on tourism, reported an unexpected rise in arrivals from China.

Mining sector performance was mixed. In Mongolia, overall mining production rose 24 percent.⁶ Coal production, however, fell by 16 percent, owing to weakening demand and increased competition from China. In Lao PDR, lower gold prices and depleted reserves in an important mine slowed gold production.

Inflation remained generally subdued, reflecting weak commodity prices

Falling world oil and food prices helped reduce headline inflation in most regional economies, both large and small. In China, inflation fell to 2 percent in 2014, well below the 3.5 percent upper limit of the inflation target (figure I.A.7). In the Philippines, inflation started moderating in September, reflecting also a stabilization of the rice supply and tightening monetary policy. In Thailand, inflation fell to a five-year low of 1.3 percent in November 2014, reflecting also weak domestic demand, government price controls, and consumer subsidies. In Vietnam, inflation stabilized in 2014 at 4.1 percent, the lowest level since 2003 (figure I.A.8). In Cambodia, inflation fell to 1.2 percent at end-2014. In Mongolia, inflation peaked at 15 percent last July, but monetary tightening has since reduced it to 9.3 percent in February. In Lao PDR, inflation decreased more than 2 percentage points in 2014, to 4.2 percent, again also reflecting some policy tightening.

In Indonesia and Malaysia, cuts in fuel subsidies led to temporary spikes in inflation. In Indonesia, inflation rose to 8.4 percent last December, after the fuel subsidy cuts, but has since decelerated to 7 percent in January. Likewise, in Malaysia, inflation rose to 3 percent last October, after the second round of fuel subsidy cuts, but has since dropped to 1 percent in January.

In the Pacific Island Countries, weak commodity prices also kept inflation subdued. In Tonga, lower energy costs, and the induced decrease in transport prices, kept inflation at 0.8 percent in September. In Samoa, consumer prices fell by 0.4 percent in 2014, reflecting a reversal in the cyclone-related spike in food and beverage prices. In Timor-Leste, the collapse in inflation, from 12 percent in Q4 2013 to an average 0.4 percent in 2014, largely reflects measurement issues (the weight of food in the CPI basket was increased to 64 percent).

⁶ Copper concentrate production increased 34 percent, as the new Oyu Tolgoi mine entered its first full year of production. Crude oil production rose 44 percent, and gold production 29 percent.

Kiribati represented an exception: inflation increased from -1.5 percent in 2013 to 3.4 percent in 2014, owing to a new value-added tax and depreciation against the Australian dollar.

Figure I.A.7. In Indonesia and Malaysia, spikes in inflation following fuel-subsidy cuts proved temporary

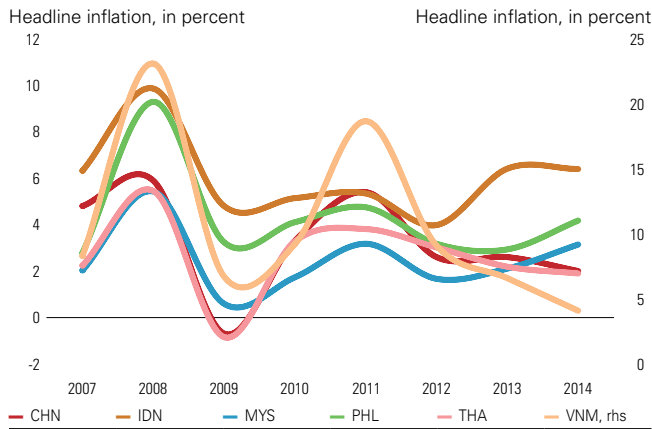
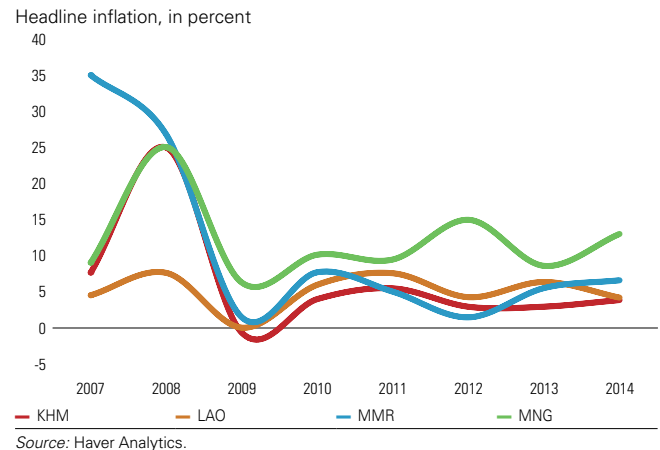


Figure I.A.8. In Mongolia, inflation remains high, but has been decreasing following policy tightening



Moderate regional food prices reflected falling world prices, but also abundant regional crops and lower energy prices. Ample crop supplies encouraged greater intraregional imports; lower oil prices reduced the cost of energy-intensive agricultural production. In Malaysia, domestic food prices decelerated through 2014, in line with declining global prices (figure I.A.9). In the Philippines, food prices started decelerating in October, as the largest rice imports in four years helped stabilize domestic rice prices. In Indonesia, food price inflation declined significantly between January and August 2014; the subsequent rise mainly reflects a likely transitory tripling in the price of chilies. Rice imports again helped stabilize rice prices, which had increased owing to the dry conditions caused by El Nino.

Figure I.A.9. Food price inflation has decelerated in the Philippines and Indonesia, helped by rice imports

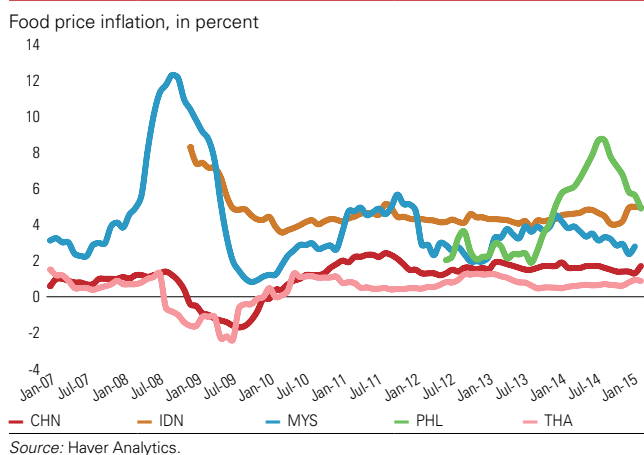
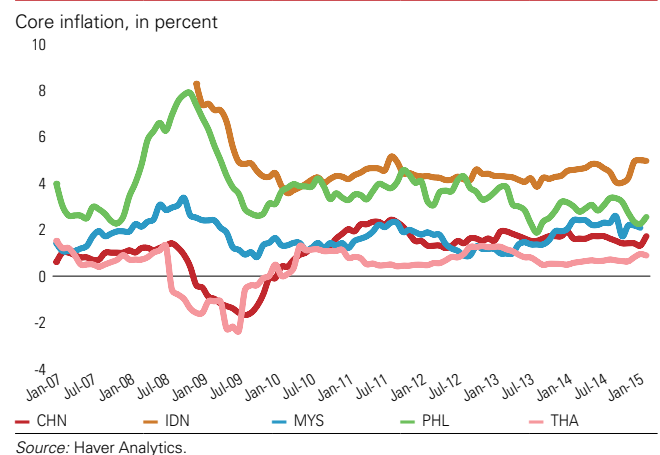


Figure I.A.10. Core inflation remains stable in all of the large economies in the region



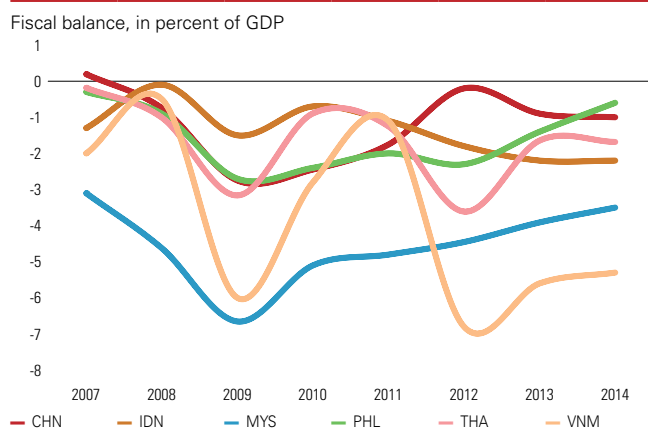
Core inflation remained broadly stable. Core inflation, which excludes the more volatile categories of energy and food prices, was contained at 5 percent in Indonesia: the electricity tariff increase phased in starting last

July has had a limited impact on consumer prices so far (figure I.A.10). In Malaysia, core inflation increased only slightly in the first 10 months of 2014. In the Philippines, core inflation decelerated from a peak last September. In Thailand, the only country in the region to target core inflation, this remained stable. In China, producer prices declined for the third consecutive year, reflecting both falling world commodity prices, in particular for coal and oil, and persistent overcapacity in several heavy industries, including steel, cement, and plate glass.

Most countries made further progress in deficit reduction, including by rationalizing fuel subsidies, but public debt remains a concern

Fiscal balances broadly continued to improve, particularly in Malaysia and the Philippines; however, Malaysia's public debt remains high. Most of the larger countries continued to rebuild the fiscal buffers eroded by stimulus spending in the wake of the global financial crisis (figure I.A.11). In Malaysia, the deficit has steadily declined from 6.7 percent of GDP in 2009 to 3.5 percent in 2014. Last year, corporate income tax collections, including dividends from the national oil company, proved buoyant. In addition to the cuts in fuel subsidies, current expenditures, including emoluments, pensions, and gratuities, were compressed. However, public debt remains high compared to other large EAP economies (figure I.A.13). In the Philippines, the deficit has narrowed from 2.7 percent of GDP in 2009 to 0.6 percent in 2014. Customs revenues increased by 18 percent and internal revenues by 11 percent yoy through Q3 2014, reflecting economic growth and improved tax administration. In addition, public expenditure decelerated sharply; growth in government consumption fell to 2.6 percent, and infrastructure spending decreased by 1.5 percent.

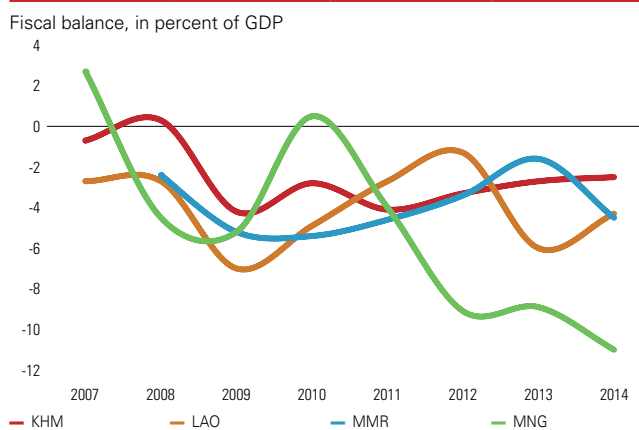
Figure I.A.11. Developing EAP has made progress rebuilding fiscal buffers, eroded from deficit spending during the 2009 crisis



Source: Staff estimates.

Note: Central government for China, Indonesia, Malaysia (federal government), the Philippines, and Thailand (cash balance of central government before financing).

Figure I.A.12. Off-budget expenditures account for a substantial share of Mongolia's consolidated fiscal deficit



Source: Staff estimates.

Note: In Vietnam, includes off-budget expenditures. In Mongolia, includes off-budget spending by the Development Bank of Mongolia.

In Vietnam, public debt continues to rise; Thailand recently approved a significant stimulus package. In Vietnam, the fiscal deficit stands at an elevated 5.3 percent of GDP, reflecting poor revenue collections and high recurrent spending. Public debt has increased to 61 percent of GDP, from 47 percent in 2009, with short-term domestic debt rising particularly rapidly. In Thailand, the fiscal deficit was roughly unchanged, at 2.2 percent

of GDP. Public debt has progressively 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. A fiscal stimulus package of 2.8 percent of GDP was approved last October, focused on the renovation of roads, schools, hospitals, and administrative buildings, with some support to rice farmers adversely affected by low commodity prices; implementation of the investment plans has been slow.

Figure I.A.13. Public debt has been rising fast in Vietnam, remains high in Malaysia...

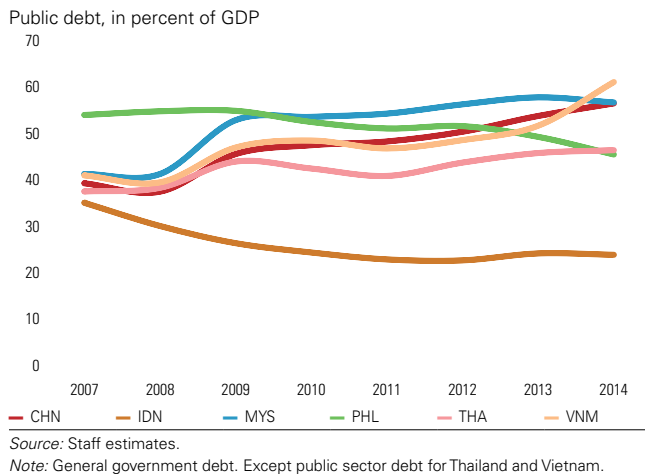
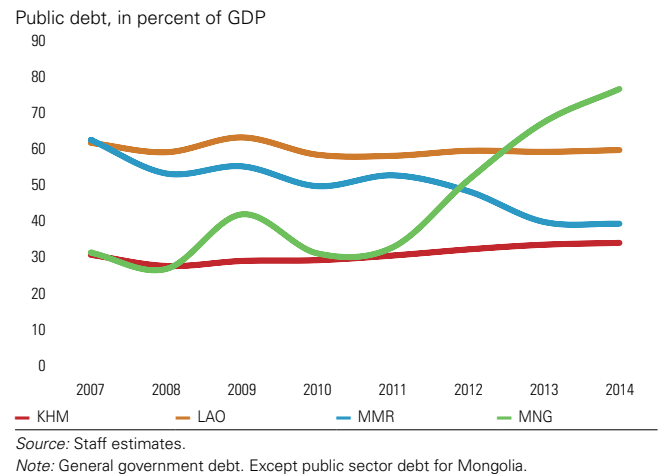


Figure I.A.14. ...and is a particular concern in Mongolia, and to a lesser extent Lao PDR



In Indonesia, the deficit rose slightly. Revenue growth remained weak, even though nominal depreciation boosted exchange-rate-sensitive revenues.⁷ Current expenditures increased, but capital expenditures declined by 18 percent, reflecting the substantial midyear budget tightening, land acquisition problems, and the transition to a new government.

Indonesia, Malaysia, Thailand, and Vietnam further rationalized fuel subsidies or raised fuel taxes. In Indonesia, gasoline and diesel prices were raised by 34 percent last November; in January, gasoline subsidies were eliminated, and diesel subsidies were capped at a low level. Malaysia abolished subsidies for midgrade gasoline and diesel last December, and introduced a managed float mechanism linking retail prices to world prices. Thailand ended its seven-year subsidy for liquefied petroleum gas last December. It also revised the domestic fuel-pricing mechanism last August, raising taxes on diesel but reducing them on gasoline. Vietnam tripled the environmental tax on fuel consumption, effective May 2015. It also raised tariffs on fuel imports from 18 percent (in May 2013) to 27 percent (in December 2014) and 35 percent (in January 2015).

China's overall fiscal position remains solid. The fiscal deficit stands at just 1 percent of GDP; the slowdown in real estate translated into slower revenue growth, but expenditures increased in line with budget plans. Public debt remains moderate at 56 percent of GDP, although it has grown by 20 percentage points since 2008.

In Mongolia, and to a lesser extent Lao PDR, both deficit and debt levels remain elevated; in Myanmar, a sizable deficit has emerged; Cambodia is making progress with fiscal consolidation, despite dwindling

⁷ On average, a 10 percent depreciation leads to a 16 percent increase in oil- and gas-related revenues, which currently account for 20 percent of total fiscal revenues. Import duties also respond, but are relatively small.

grants. In Mongolia, in the face of revenue shortfalls, the Ministry of Finance has tried to control expenditures; however, substantial spending remains outside the budget.⁸ In 2014, the consolidated fiscal deficit, including off-budget expenditures, stood at 11 percent of GDP (figure I.A.12), and public debt at 77 percent of GDP, compared to 32 percent in 2011 (figure I.A.14). In Lao PDR, the fiscal deficit narrowed to a still high 4.3 percent of GDP, as higher value-added and excise taxes and import duties compensated for lower mining revenues and grants. In Cambodia, the deficit fell slightly to 2.5 percent of GDP; improved revenue collection and increased efficiency of spending, reflecting a public financial management reform program, were largely offset by lower grants. The government raised its deposit balance by US\$400 million in 2014, to help increase its financial buffers against shocks. In Myanmar, a sizable deficit has emerged (4.5 percent of GDP in 2014), reflecting both a significant increase in spending, particularly on social programs, and the historically narrow tax base.

In the Pacific Island Countries, fiscal positions generally improved. Kiribati, the Federated States of Micronesia, and the Marshall Islands posted fiscal surpluses, reflecting strong revenues from fishing licenses. Palau benefited from taxes on tourism, and Tonga and Tuvalu from donor grants to fund infrastructure projects.

Central banks responded to inflationary pressures in mid-2014, but have since refocused on growth concerns

Malaysia, the Philippines, and Indonesia tightened monetary policy in mid- to late-2014 to contain inflationary pressures and expectations. Malaysia tightened monetary policy for the first time in three years last July, raising the overnight policy rate by 25 basis points, citing the need to mitigate financial imbalances. The Philippines raised its overnight reverse repo rate by 25 basis points in both July and September 2014, and lowered its inflation target to 3 to 4 percent in January. Indonesia raised its policy rate by 25 basis points last November, as the cut in fuel subsidies led to a spike in headline inflation, although the deposit facility interest rate was not changed.

Since then, China, Indonesia, and Thailand have eased monetary policy on concerns over growth. Indonesia in February reversed its earlier rate increase, in the face of limited inflationary pressures (figure I.A.15). China cut the prime lending rate by 40 basis points last November, after growth slipped to 7.3 percent yoy in Q3 2014, the slowest pace since Q1 2009; a further 25-basis-point cut followed in March. Also, in February, the required reserve ratio was reduced by 50 basis points across the board (figure I.A.16). Previous efforts to ease reserve requirements had been more narrowly targeted, including the 25-basis-point reduction last June for lending to small enterprises and rural businesses. Thailand cut the benchmark interest rate in March by 25 basis points, to 1.75 percent.

⁸ The Development Bank of Mongolia (DBM) has been using funds raised through government and government-guaranteed borrowing to finance mainly budgetary projects implemented by government agencies, as well as some commercial projects. All such projects should be treated as off-budget public expenditures; financing to budgetary projects is to be repaid by the budget, and in any case, DBM financing almost fully relies on public guarantees.

Figure I.A.15. Indonesia raised its benchmark rate in November 2014 as headline inflation spiked, then cut it in February 2015 as inflationary pressures dampened

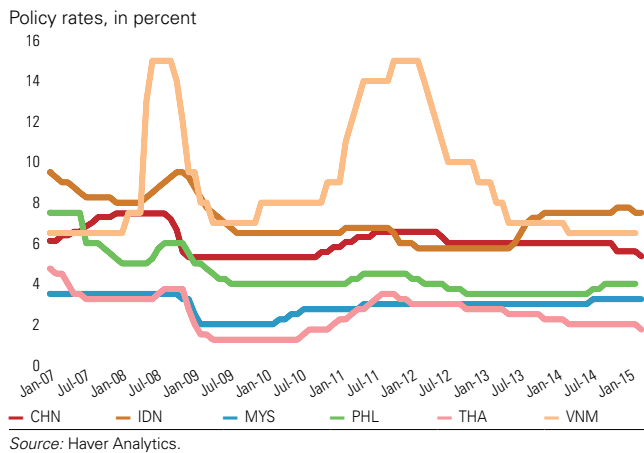
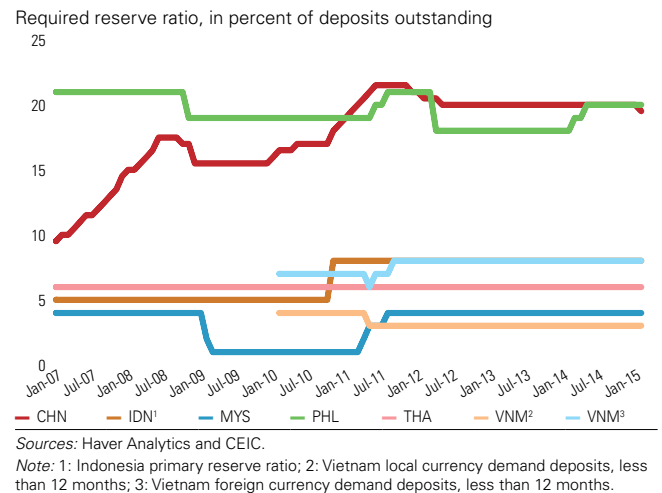


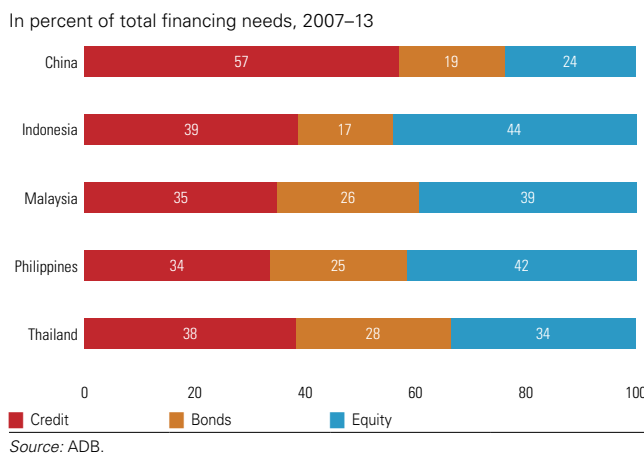
Figure I.A.16. China reduced its required reserve ratio by 50 basis points in February 2015, for the first time since 2012



Credit growth decelerated throughout the region in 2014, on tighter monetary policy in some countries, and slower growth in others

Domestic credit funds a large portion of the region's financing needs. Bank and nonbank credit accounts for 60 percent of financing needs in China, and 35 to 40 percent in ASEAN countries (figure I.A.17). As a result, slower domestic credit growth, reflecting tighter monetary policy, significantly affects economic activity.

Figure I.A.17. Domestic financing profile



Bank credit growth decelerated in Indonesia and Thailand in 2014 (figure I.A.18). In Indonesia, banks faced funding constraints, as demand and saving deposits increased at less than half the 2013 growth rate. Also, nonperforming loans rose to over 2.5 percent of all loans outstanding at end-November 2014, compared to 1.9 percent at end-2013, discouraging credit. In response, the authorities introduced a temporary cap on deposit rates to lower bank's funding costs, incentives for lending to small and medium enterprises, and an easing of loan-to-deposit caps. In Thailand, bank credit increased by less than 4 percent, about one-third the rate in 2013. Household debt now exceeds 80 percent of GDP, a burden reflected in the high

number of vehicle repossessions. In Vietnam, lending remains constrained by banks' impaired balance sheets, concerns over the financial health of borrowers, the property-market slump, and weak credit demand by households and corporates.

Figure I.A.18. Domestic bank credit growth decelerated in the larger ASEAN countries

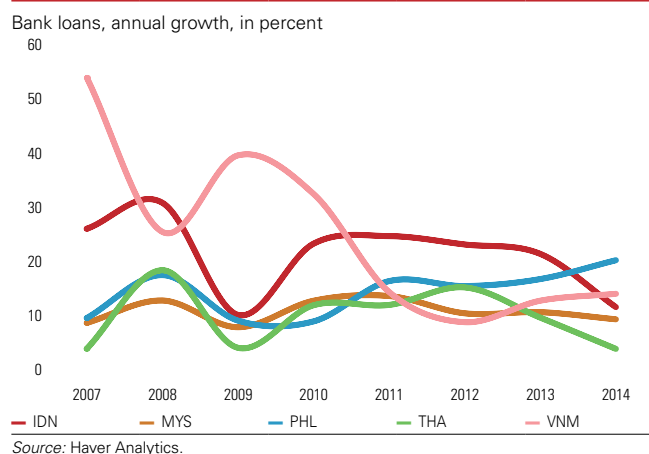
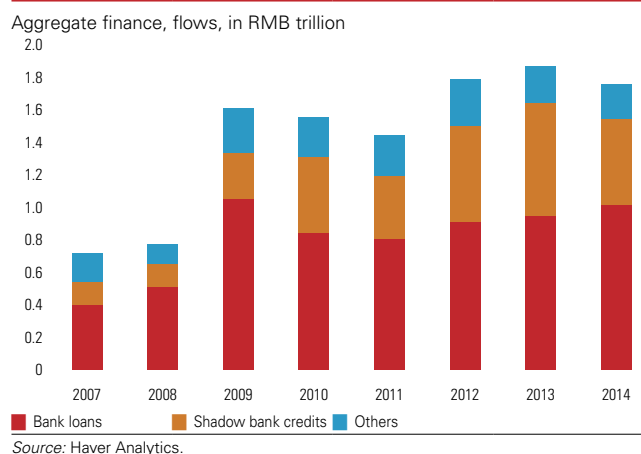


Figure I.A.19. In China, more bank loans did not offset fewer shadow credits in 2014



Credit growth also moderated in China. Total social financing (TSF), the country’s broadest measure of credit, amounted to RMB 1.6 trillion in new credits in 2014, slightly less than in 2013 (figure I.A.19). New shadow-banking credits contracted by a quarter, as the government tightened trust and interbank asset regulations, and investors gained greater awareness of risks in nonbank products. But new bank loans rose by 7 percent, as the central bank eased liquidity conditions using an array of policy tools, including relending facilities, open market operations, foreign exchange market intervention, targeted required reserve ratio cuts, and a benchmark rate reduction.

Figure I.A.20. New issuance of local currency bonds declined in 2014

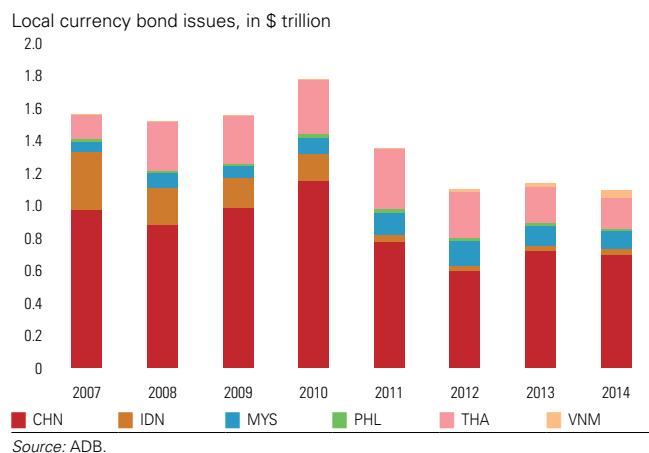
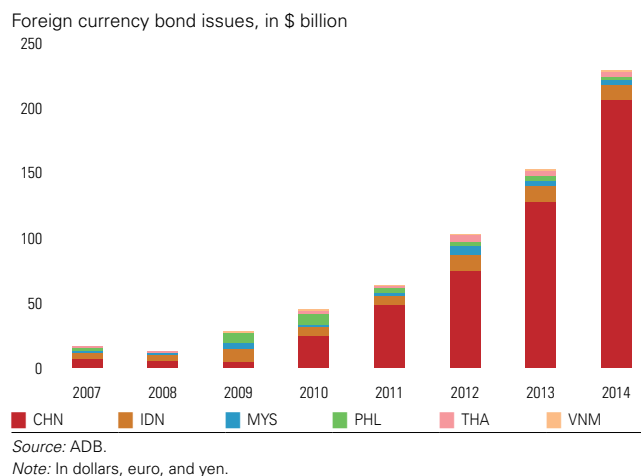


Figure I.A.21. China turned to foreign currency bond issues in 2014



Bank lending similarly slowed in 2014 in the smaller economies, except Cambodia. In Mongolia, credit growth more than halved, to 23 percent, as the central bank phased out some of its quasi-fiscal lending programs. In Lao PDR, credit growth slowed to 14 percent last December, from 35 percent a year earlier, as limits on lending in foreign exchange were enforced more strictly, and restrictions were introduced on financing public investment projects. In Timor-Leste, credit growth contracted in Q2 2014 and Q3 2014. In Cambodia, credit growth decelerated in the first half of 2014, but recovered in the second half, supported by record foreign currency deposits.

Funding conditions also tightened in the region's capital markets in 2014. Issuance of local currency bonds declined in practically all countries (figure I.A.20). An exception was Vietnam, where, however, the volume remains comparatively small. Particularly in China, issuance of foreign currency bonds helped compensate for tighter domestic conditions (figure I.A.21).

Current account balances broadly improved, reflecting a combination of strong exports, weak demand compressing imports, and robust remittances

The large economies, except for Indonesia, posted current account surpluses in 2014. In China, the surplus stabilized at 2.2 percent of GDP (figure I.A.22). Thailand moved into surplus, as imports contracted sharply, owing to depressed domestic demand and lower oil prices. Malaysia's surplus increased slightly, as the goods trade surplus offset both a deficit in services trade, stemming from weak construction and insurance exports, and large income payments on inbound FDI. The Philippines continued running a current account surplus, supported by remittance inflows of about a 10th of GDP; so did Vietnam, amid buoyant exports and robust remittance inflows.

Figure I.A.22. Indonesia ran a current account deficit for the third consecutive year in 2014

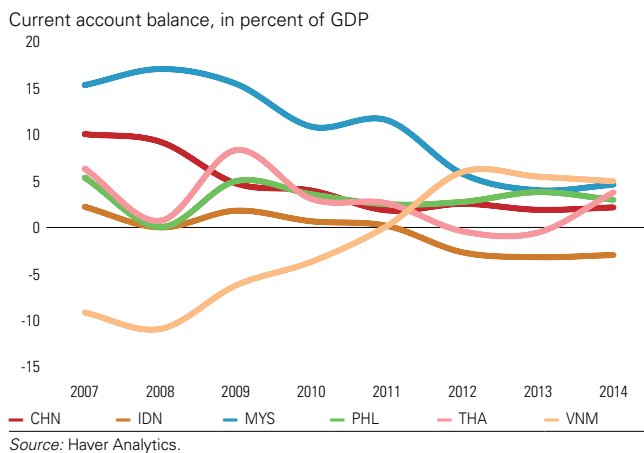
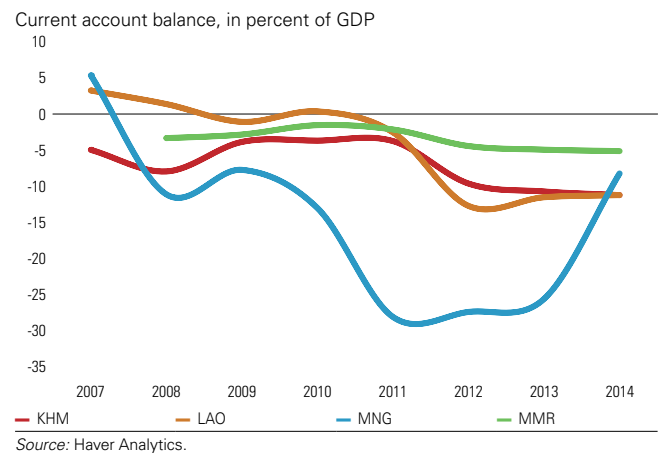


Figure I.A.23. Mongolia's current account deficit narrowed, as imports fell



Indonesia ran a current account deficit for the third consecutive year. Exports were dragged down by weak international prices for key commodity exports, including coal, natural gas, palm oil, rubber, copper, and nickel (figure I.A.24). Imports were reduced by subdued domestic demand and falling oil prices; the country is a net oil importer. Overall, the terms of trade have deteriorated by 15 percent since before the crisis (figure I.A.25).

Among the smaller economies, Mongolia, Cambodia, and Lao PDR ran large current account deficits. Mongolia's deficit narrowed to 8.2 percent of GDP, from 25 percent in 2013 (figure I.A.23). The country ran a large trade surplus; exports rose 35 percent, as rising copper concentrate and crude oil exports offset lower coal exports, and imports fell 15 percent, reflecting lower industrial machinery and transport equipment imports. In Cambodia, the current account deficit widened to 12 percent of GDP (excluding official transfers). Both exports and imports were weak. In Lao PDR, the current account deficit fell marginally, to 11 percent of GDP. Lower

mining exports were partly offset by strong timber exports to China and Vietnam. Imports remained high, partly reflecting FDI-related investments.

Figure I.A.24. Global commodity prices

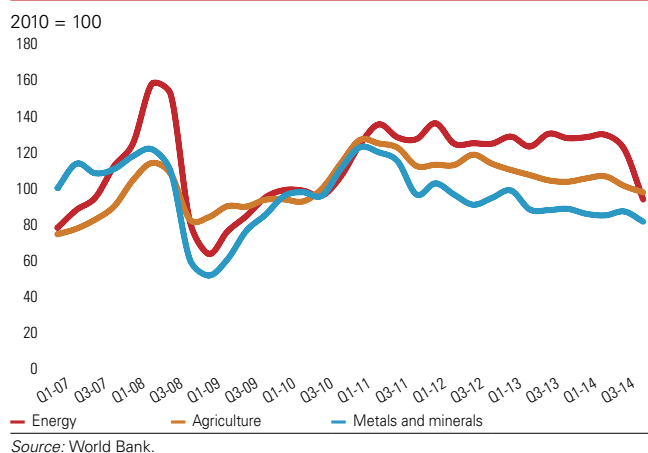
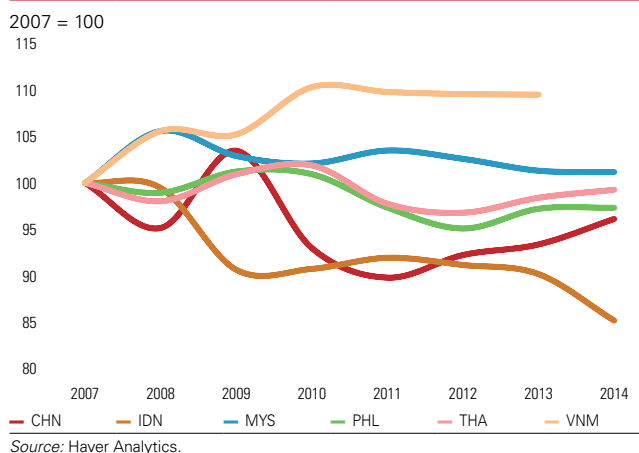


Figure I.A.25. Terms of trade



FDI remained robust

FDI inflows remained generally robust in 2014. The region received almost one-third of all FDI to developing regions in 2013, up from one-quarter in 2007. Last year, FDI inflows rose in all countries except Malaysia and Mongolia (figure I.A.26). In Indonesia, FDI inflows amounted to US\$15 billion (2.9 percent of GDP), the highest level since the global financial crisis. The Philippines also recorded its highest FDI inflows in decades, both in dollar terms and relative to GDP; however, it still lags behind the rest of the ASEAN-5. Vietnam enjoyed sustained FDI inflows, mostly directed at labor-intensive manufacturing, although the share of technology-intensive sectors has been rising quickly. In Cambodia, FDI remains concentrated in construction, garment manufacturing, and tourism; in Lao PDR, in hydropower projects.

FDI flows to Mongolia fell sharply. FDI into the mining sector, which averaged less than 9 percent of GDP before 2009, ballooned to around 50 percent of GDP in 2011–12, at the height of Mongolia’s mining boom. Since then, it has dropped eightfold. This reflects both the completion of initial investments in new copper and gold mines, and weakening investor sentiment amidst uncertainty over major mining projects and the investment regime.

China and Malaysia engaged in significant outward FDI. In China, FDI outflows averaged 5 percent of GDP during 2012–14 (figure I.A.27), and have exceeded FDI inflows since 2008. China has emerged as the world’s third-largest source of FDI, after the United States and Japan. Over four-fifths of its outbound FDI involves energy and metals projects in Sub-Saharan Africa, Australia, East Asia, and Central Asia (China Global Investment Tracker dataset). In Malaysia, FDI outflows also recovered to 5 percent of GDP last year.

Figure I.A.26. FDI into the region's large economies generally strengthened in 2014

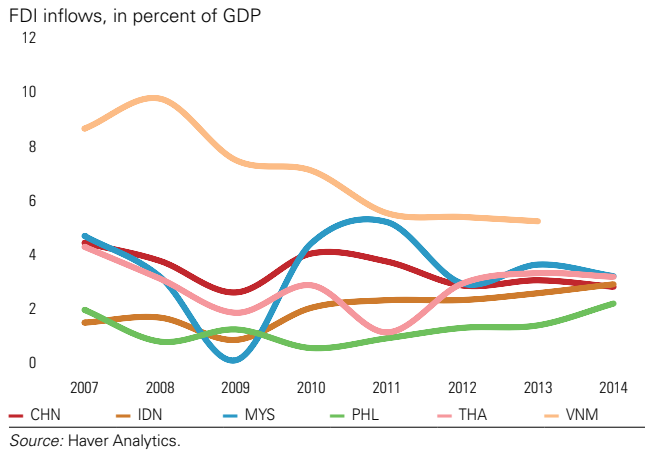
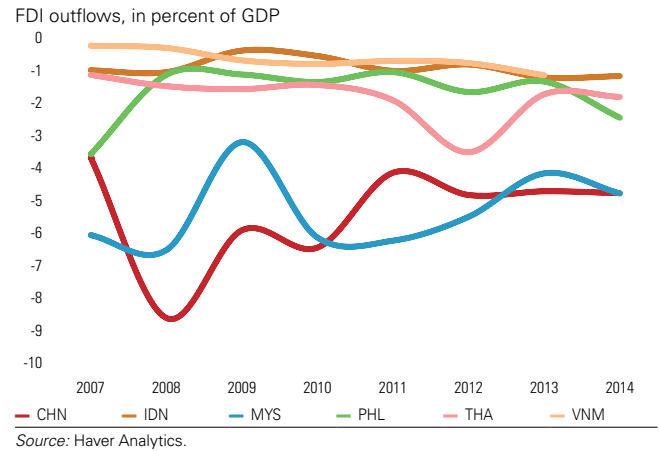


Figure I.A.27. China and Malaysia engaged in significant outbound FDI



Portfolio flows to China, and to a lesser extent Indonesia, increased markedly in 2014 (figure I.A.28). Indonesia was viewed by foreign investors as a potential reform story. Conversely, portfolio flows to Malaysia reversed, as foreign investors repatriated their capital. Meanwhile, Malaysian and Thai residents, active portfolio investors overseas for the last several years, continued their purchases of foreign securities (figure I.A.29).

Figure I.A.28. Foreign portfolio investors favored China and Indonesia in 2014

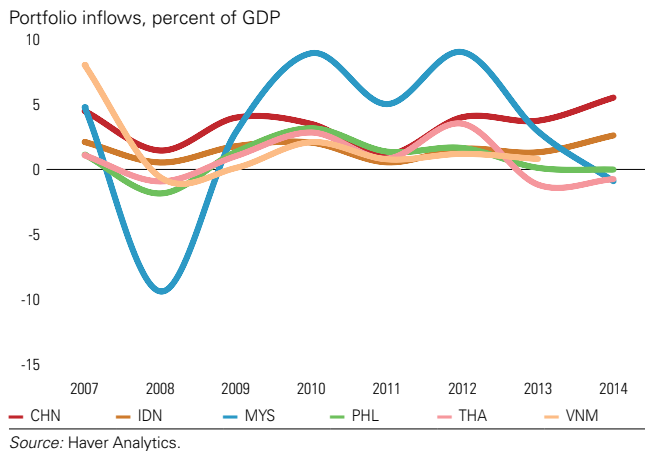
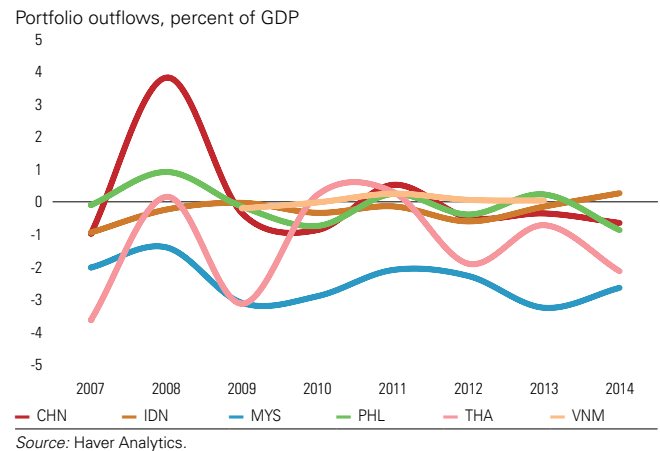


Figure I.A.29. Malaysian and Thai residents remained active portfolio investors last year

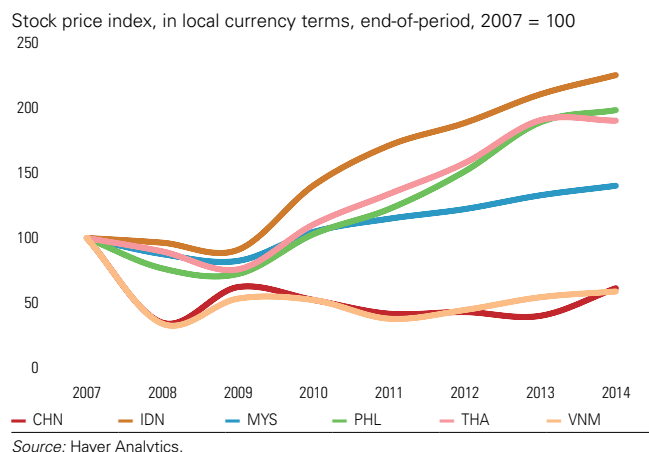


Portfolio inflows helped lift stock and bond markets

Portfolio flows into equities helped lift regional stock markets in 2014. Share prices gained the most in China, rising more than 50 percent, although they still stand 40 percent lower than their precrisis valuation (figure I.A.30). Stock valuations have become more conservative in recent years in China; the market price-earnings (P/E) ratio averaged 11 in 2014, down from 52 in 2007, and lower than the historical average of 16 for

all emerging markets during 1997–2014 (figure I.A.31). Elsewhere in the region, share price gains were comparatively more modest, and valuations stabilized around the historical average P/E ratio for all emerging markets.

Figure I.A.30. The region's emerging markets advanced further in 2014



Similarly, portfolio inflows into bonds helped support regional bond markets. Regional bond returns were uniformly positive in 2014—8 percent in Indonesia, and 4 percent in the Philippines and Thailand (figure I.A.32). In Indonesia, foreign ownership of local currency government bonds topped 38 percent of issues outstanding, up from 31 percent in 2013. In Thailand, it increased marginally, to 18 percent.

Figure I.A.31. Valuations in China have corrected from their exceptionally high precrisis level

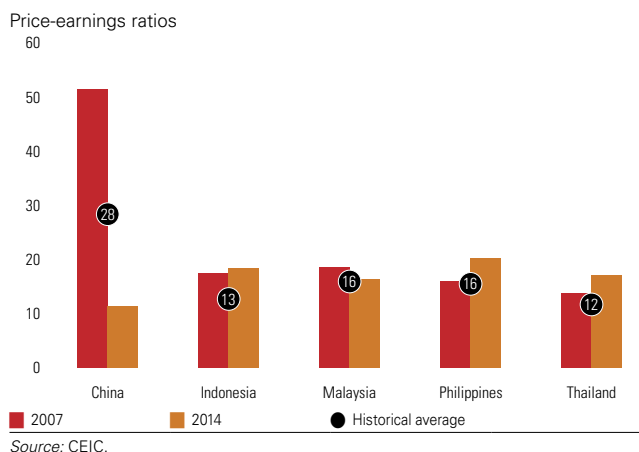
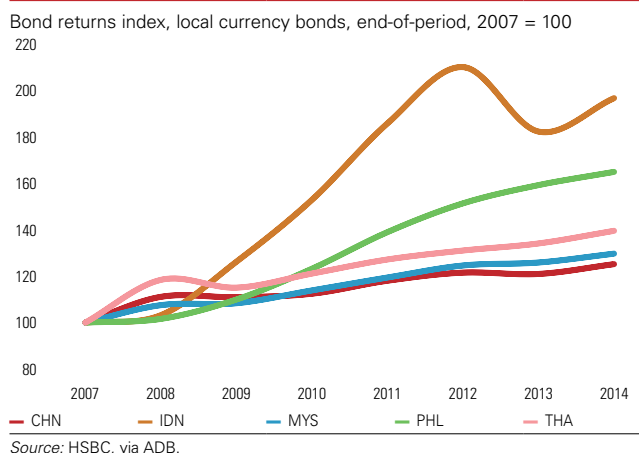


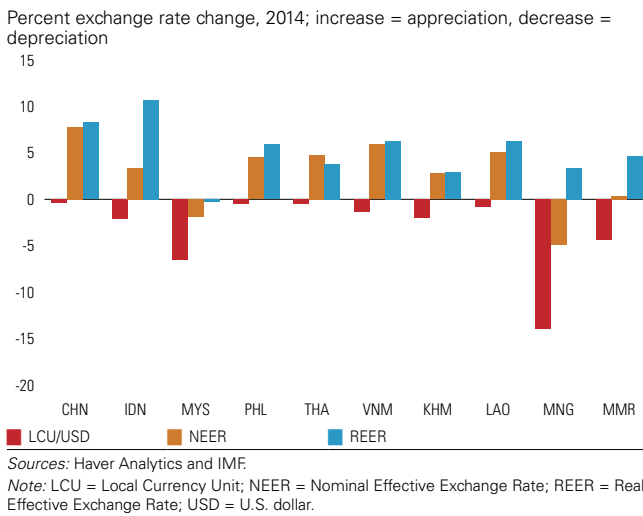
Figure I.A.32. Total bond returns



Regional currencies broadly appreciated in real, trade-weighted terms in 2014

Regional currencies depreciated against the U.S. dollar last year. The dollar gained against most global currencies, as the U.S. economy strengthened, and U.S. monetary policy appeared set to tighten relative to the euro area and Japan. Within the region, Indonesia, Malaysia, Mongolia, and Myanmar depreciated most against the dollar, reflecting increased external vulnerabilities, either from difficult economic restructuring or from lower commodity prices (figure I.A.33). Indeed, Malaysia's currency reached its lowest level against the U.S. dollar since early 2010, partly reflecting increased FDI and portfolio outflows by Malaysian residents, as well as portfolio outflows by nonresidents.

Figure I.A.33. The region’s currencies depreciated against the dollar, but appreciated in nominal and real effective terms in 2014



Most regional currencies appreciated in trade-weighted terms. All major currencies, except Malaysia’s and Mongolia’s, appreciated in nominal effective terms, reflecting the relative weakness of the euro and yen. And all major currencies, except for Malaysia, appreciated in real effective terms (figure I.A.33). The internationalization of China’s currency continued; the renminbi currently ranks second among all currencies in international trade financing, and ninth in foreign exchange trading volume.

The strengthening U.S. dollar poses particular challenges for the region’s most dollarized economies, Cambodia and Timor-Leste. In Cambodia, widespread use of the dollar supports price stability. But, as the dollar has strengthened, Cambodia’s competitiveness has eroded. In Timor-Leste, where the dollar is the official currency, there

has been significant appreciation against the major trading partners, Australia and Indonesia. In Lao PDR, the tightly managed dollar exchange rate has resulted in continued real effective appreciation.

Taking a longer perspective, much of the region has experienced significant real appreciation since the global financial crisis (figure I.A.34 and figure I.A.35). This partly reflects the swift and strong postcrisis rebound of capital flows to developing EAP, particularly portfolio and bank flows.

Figure I.A.34. Real effective exchange rate

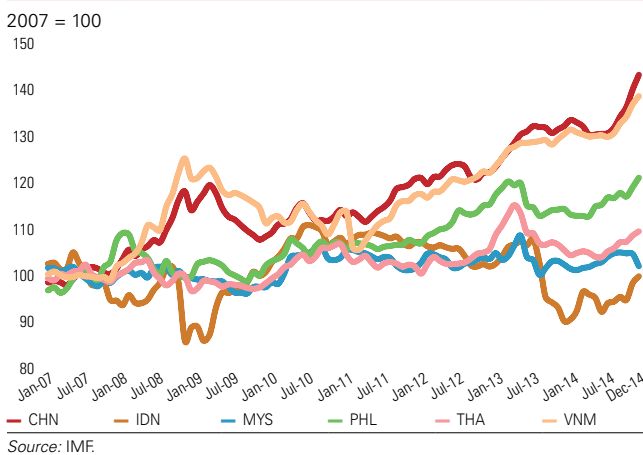
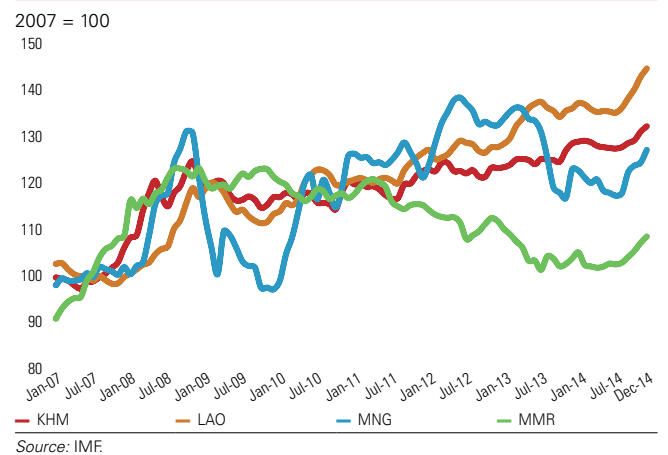


Figure I.A.35. Real effective exchange rate



Reserve coverage of imports and short-term debt remains adequate in the large economies, even as reserve accumulation has moderated

The pace of reserve accumulation in the region has moderated in recent years. China added only US\$20 billion to reserves in 2014 (figure I.A.36). Reserves declined in Malaysia, the Philippines, and Thailand (figure I.A.37), amid net capital outflows. Meanwhile, reserves increased in Indonesia, which received large capital inflows, and Vietnam, which ran a large current account surplus.

Figure I.A.36. International reserves, China

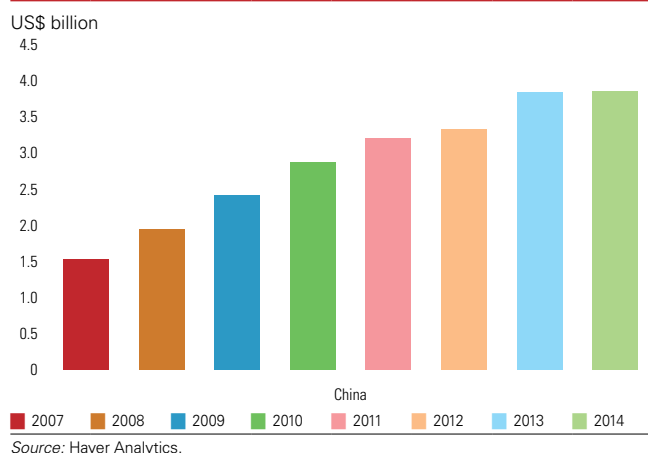


Figure I.A.37. International reserves, ASEAN-5

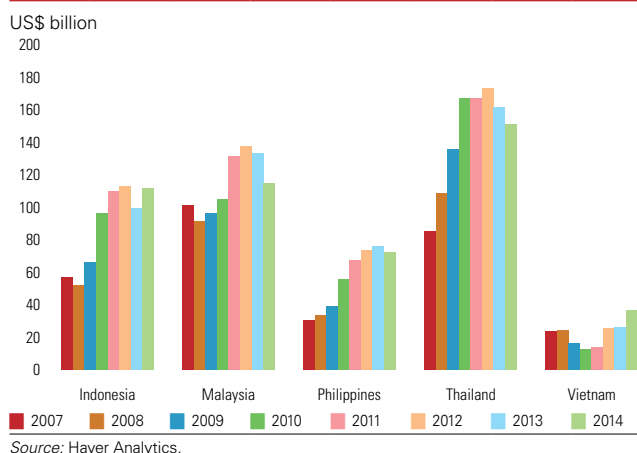


Figure I.A.38. Vietnam's reserves rose to 3 months of imports...

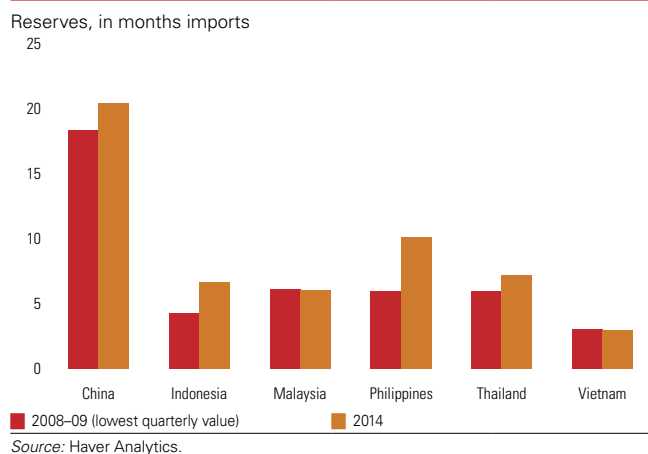
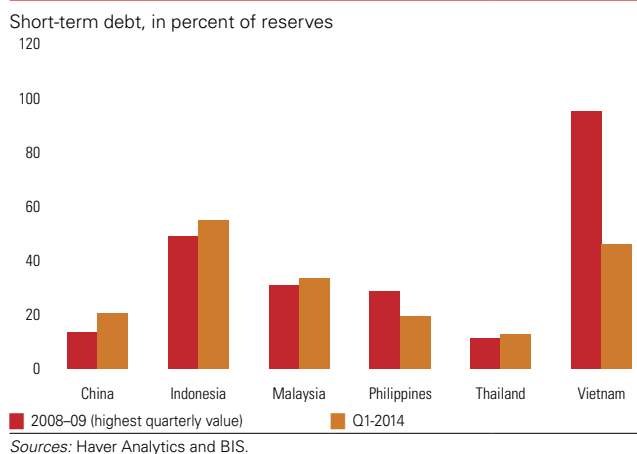


Figure I.A.39. ...and more than twice its short-term debt



Regional reserve adequacy ratios are generally adequate, particularly for the large economies. Reserve coverage has typically increased from the levels during the global financial crisis, in terms of both imports and short-term debt (figure I.A.38 and figure I.A.39). Vietnam's reserves rose to three months of imports at end-2014, up from 2.4 months at end-2013, and to more than twice its short-term debt at end-2014 Q1. In some smaller economies, however, reserve adequacy ratios are less encouraging. In Lao PDR, reserves have increased, but still equal less than two months of imports, and only 28 percent of foreign currency deposits in

the financial system. In Mongolia, reserves have declined to three months of imports and 80 percent of short-term external debt. However, a bilateral currency swap line with China provides an additional buffer.

I.B. Outlook and Risks

Global growth is expected to pick up moderately, and world fuel prices to remain low for a considerable period. This will help developing East Asia and Pacific sustain its growth performance. In China, growth will moderate further, reflecting continued policy efforts to address financial vulnerabilities and gradually shift the economy to a more sustainable growth path. In the rest of the region, growth will pick up, reflecting a recovery in both investment and consumption, although export growth will be constrained by the ongoing real appreciations. Given the uncertainties facing the global economy, the regional outlook is subject to significant risks. The most significant of these include a downturn in the euro area, Japan, or China; and the potential impact of higher U.S. interest rates and an appreciating U.S. dollar, associated with monetary policy divergence across the advanced economies, on borrowing costs, financial volatility, and capital inflows.

Regional growth will ease slightly

Growth in developing EAP is projected to ease slightly, from 6.9 percent in 2014 to 6.7 percent in 2015–16. In China, further progress with structural reforms, aimed at transitioning to more sustainable growth, will dampen investment and reduce short-term growth by half a percentage point, to 6.9 percent by 2017 (table I.B.1). Excluding China, growth will pick up by half a percentage point in 2015, and a further 0.3 percentage points by 2017, driven by the large ASEAN economies.

These projections assume a moderate pickup in growth in high-income countries, along with a modest tightening of global financial conditions (box I.B.1). In particular, the global recovery will support some pickup in international trade. Capital flows to emerging markets are assumed to moderate, but to do so smoothly over the 2015–17 projection period.

The projections also assume that world fuel prices will remain low for a considerable period, with a positive impact on growth in the region taken as a whole. Plentiful U.S. shale oil production, and OPEC's desire to maintain market share, are projected to result in low oil and gas prices through at least 2017. The region is a net fuel importer, is relatively energy intensive, and relies on oil and gas for a significant share of its total energy consumption. As a result, the decline in fuel prices will likely raise regional output by 0.3 percent in 2015 (box I.B.2). Nevertheless, future trends in oil prices and their impacts remain highly uncertain.

The impact of lower fuel prices will vary across countries, reflecting the magnitude of net fuel imports, energy intensity in production, the share of oil and gas in total energy consumption, and the share of the oil and gas sector in total output. The Pacific Island Countries, Cambodia, the Philippines, and Thailand, will all gain significantly. Conversely, Malaysia and Papua New Guinea will experience small GDP losses. In Indonesia, the net impact will hinge on the extent to which the prices of coal and gas exports track oil prices.

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

	2013	2014	Projections			Change from Oct-14 ^a (percentage points)		
			2015	2016	2017	2014	2015	2016
East Asia and Pacific	6.1	6.0	6.0	6.0	6.0	0.0	-0.1	-0.1
Developing East Asia and Pacific	7.2	6.9	6.7	6.7	6.6	0.0	-0.2	-0.1
China	7.7	7.4	7.1	7.0	6.9	0.0	-0.1	-0.1
Indonesia	5.6	5.0	5.2	5.5	5.5	-0.2	-0.4	-0.1
Malaysia	4.7	6.0	4.7	5.0	5.1	0.3	-0.2	0.0
Philippines	7.2	6.1	6.5	6.5	6.3	-0.3	-0.2	0.0
Thailand	2.9	0.7	3.5	4.0	4.0	-0.8	0.0	0.0
Vietnam	5.5	6.0	6.0	6.2	6.5	0.6	0.5	0.4
Cambodia	7.4	7.0	6.9	6.9	6.8	-0.2	-0.6	-0.3
Lao PDR	8.5	7.5	6.4	7.0	7.0	0.0	0.0	0.0
Myanmar	8.3	8.5	8.5	8.2	8.0	0.0	0.0	0.0
Mongolia	11.6	7.8	4.4	4.2	3.9	1.5	-1.8	-1.9
Fiji	4.6	3.8	2.5	2.4	2.6	0.1	0.0	-0.1
Papua New Guinea	5.5	7.5	16.0	5.0	2.4	1.9	-4.0	1.0
Solomon Islands	3.0	0.1	3.5	3.5	3.5	0.0	0.0	0.0
Timor-Leste ^b	5.4	6.6	6.8	6.9	7.0	-1.4	-0.9	-1.7
Memo: Developing East Asia and Pacific excl. China	5.2	4.6	5.1	5.4	5.4	-0.2	-0.2	0.1
Memo: ASEAN	5.0	4.4	4.9	5.1	5.2	-0.1	-0.1	0.0
Assumptions about the external environment:								
World	2.5	2.6	2.9	3.2	3.2	0.0	-0.3	-0.1
High-income countries	1.4	1.7	2.1	2.4	2.2	0.0	-0.2	0.0
Developing countries	5.1	4.6	4.5	5.1	5.4	0.1	-0.5	-0.2

Sources: World Bank data and staff estimates.

Notes: a. World Bank, *East Asia and Pacific Economic Update*, October 2014; b. Nonoil GDP.

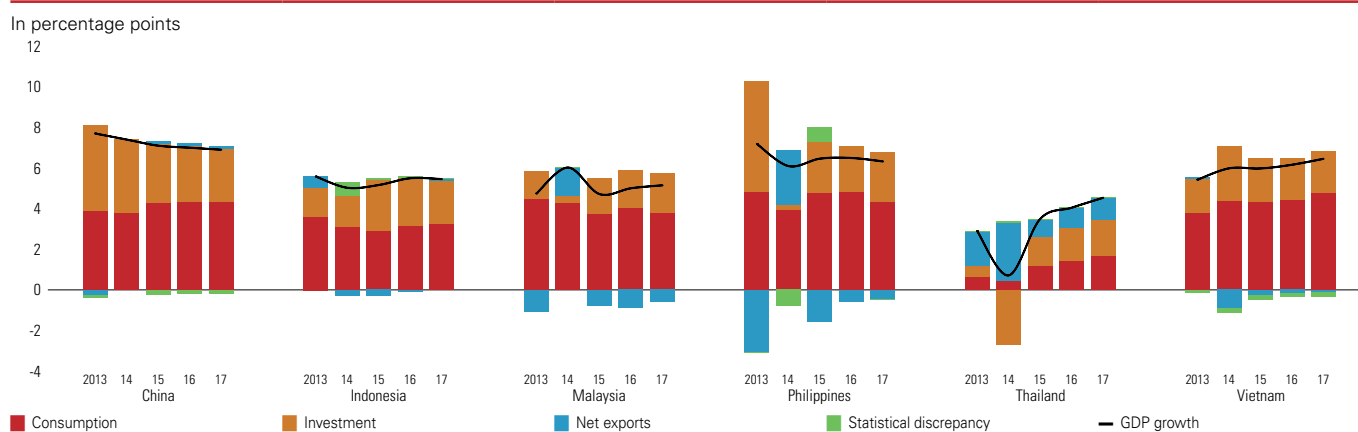
In China, engineering a gradual shift to a more sustainable growth path will continue to pose challenges for policy makers, given real sector weaknesses and financial system vulnerabilities. Efforts to cut excess capacity in heavy industry, reduce supply mismatches in residential property, dampen unproductive risk taking in shadow banking, and harden budget constraints on local governments will help make investment more efficient and realign growth over the medium term. However, such reforms will depress activity in the short term. Conversely, stimulus measures aimed at supporting short-term growth may conflict with efforts to increase the sustainability of medium-term growth. A narrowly targeted stimulus may ameliorate the tradeoff, but will also prove more challenging to implement. The projected gradual deceleration assumes a firm commitment to structural reforms and to reducing vulnerabilities; at the same time, targeted stimulus is expected to continue to mitigate the impact on short-term growth,¹ should this show signs of slowing considerably below the government's indicative target of about 7 percent.

Growth is expected to pick up in 2015 in most of the larger ASEAN economies, excluding Malaysia, reflecting a recovery in both investment and consumption; export growth will be constrained by the ongoing real appreciations. In Indonesia, growth will rise by 0.5 percentage points by 2016–17, assuming successful implementation of the new government's ambitious capital spending plan (figure I.B.1). In the Philippines, growth will rise by 0.4 percentage points in 2015–16, assuming implementation of the Typhoon Yolanda reconstruction plan and other public spending plans, including public-private partnerships. Upbeat

¹ For instance, to boost the housing market, the authorities announced at end-March a reduction in down-payment requirements, and a waiver of the property transaction tax on homes owned over 2 years.

consumer sentiment, falling oil prices, and higher incomes will support consumption in 2015, while election-related spending and transfers will provide a transitory boost in 2016. In Thailand, growth will rebound to 3.5 percent in 2015 and 4.5 percent in 2017. Greater political stability will encourage consumer spending (consumer sentiment reached an 18-month high last December). Investment will recover as stalled infrastructure projects, including from last October's stimulus program, are restarted. In Vietnam, growth will stabilize at 6 percent, reflecting continued strength in manufacturing, trade, and foreign investment. In contrast, in Malaysia, the region's largest oil-exporter, growth will fall by 1.3 percentage points in 2015. Low oil prices will affect capital expenditures in the oil and gas sector, a key driver of the last three years' investment boom; private consumption will moderate as the government implements the goods and services tax (GST, a value-added tax) in April. After 2015, investment is projected to stabilize, and the impact of the GST to dissipate.

Figure I.B.1. Growth projections



Source: Staff estimates.

Growth will decelerate in several smaller economies. In Mongolia, weak world prices for copper and coal will affect mining; many other sectors will remain under pressure from rising production costs and weakening demand. The projections assume only limited policy tightening in the face of accumulated vulnerabilities, including large balance-of-payment pressures. In Cambodia, growth will remain below 7 percent in 2015–17. Construction is vibrant, but agriculture will be affected by weak commodity prices and slow improvements in crop yields; garment exports will be constrained by real appreciation and competition from new entrants; and a return to rapid growth in tourism is far from certain. In Lao PDR, growth will drop by 1 percentage point in 2015, with limited recovery thereafter. Flat mining output, a slowdown in wood exports from last year's unusually high levels, and a deceleration in credit growth will outweigh the impact of large power investments.

Growth in the Pacific Island Countries will be supported by rising trade, tourism, and remittances, and generally positive country-specific developments. In Papua New Guinea, growth will temporarily spike to 16 percent in 2015, as liquefied natural gas (LNG) exports, which began in May 2014, increase rapidly, more than offsetting the completion of LNG-related construction work.² In the Solomon Islands, reconstruction in the wake of the April 2014 flooding will boost activity. However, in Timor-Leste, flat government spending is

² Projected 2015 growth has been revised downward by 4 percentage points since October 2014, for two reasons: LNG production is now expected to peak in 2016 rather than 2015; and LNG prices, which have decreased significantly in the last few months, are expected to remain subdued (see box I.B.2).

expected to keep nonoil growth constant at 7 percent.³ And in Fiji, growth will fall by 1.2 percentage points, reflecting the fiscal consolidation needed to contain a further buildup of debt and contingent liabilities.

The region will consolidate its gains in poverty reduction

Poverty in developing EAP is projected to continue decreasing. Between 2014 and 2017, the regional extreme poverty rate (based on \$1.25 a day PPP) will fall by more than a quarter, to 3.7 percent, or 4.3 percent excluding China (table I.B.2). Similarly, if a higher poverty line (\$2.00 a day PPP) is used, the poverty rate will fall by more than one-sixth, to 14.8 percent, or 21 percent excluding China.⁴ That said, the pace of poverty reduction for developing EAP as a whole will be slower than during 2012–14, and even slower than in the 2000s, largely reflecting the expected slowing of China’s economic growth. And in 2017, there will still be 75 million extreme poor and more than 300 million poor in the region.

Table I.B.2. East Asia and Pacific: Poverty projections

	2013	2014	Projections		
			2015	2016	2017
Poverty (\$1.25 a day PPP)					
Developing EAP (percent)	5.8	5.1	4.6	4.1	3.7
Developing EAP excl. China (percent)	7.6	6.6	5.7	5.0	4.3
Developing EAP (millions of poor)	115.2	102.9	92.7	83.5	75.3
Developing EAP excl. China (millions of poor)	47.5	41.3	36.5	32.0	28.2
Poverty (\$2.00 a day PPP)					
Developing EAP (percent)	19.3	18.0	16.9	15.8	14.8
Developing EAP excl. China (percent)	26.8	25.0	23.5	22.1	20.7
Developing EAP (millions of poor)	382.7	360.0	340.1	321.4	303.5
Developing EAP excl. China (millions of poor)	166.6	157.1	149.6	142.0	134.9

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 population-weighted average of country-specific projections.

Several downside risks threaten the positive outlook

Given the uncertainties facing the global economy, the regional outlook is subject to significant risks. A downturn in the euro area and Japan would weaken global trade and impair the region’s export performance. Higher U.S. interest rates and an appreciating U.S. dollar, associated with monetary policy divergence across the advanced economies, may raise borrowing costs, generate financial volatility, and reduce capital flows to

³ Estimated and projected growth in 2014–16 has been revised downward significantly since October 2014, for two reasons: public expenditure is now expected to stabilize after the big increase in 2014; and there is renewed uncertainty surrounding private investment, for instance, in a cement plant and in the Tibar Bay Port.

⁴ All these estimates depend critically on the estimated responsiveness of poverty to growth, particularly in China, Indonesia, and the Philippines, which together account for more than 90 percent of the total number of poor.

the region more sharply than anticipated. A significant slowdown in China, though unlikely, would exert large spillovers, particularly on commodity exporters.

A downturn in the euro area and Japan would weaken global trade and impair the region's export performance

The euro area or Japan could slip into a prolonged recession (box I.B.1). This could slow the global recovery and weaken global trade, adversely affecting developing EAP's export performance.

The region is particularly at risk from a global downturn, because it is highly open. Its economies are deeply integrated into global supply chains and commodity markets, and are hence particularly sensitive to global growth developments and prospects. The spillovers would be transmitted through trade (figure I.B.2 and figure I.B.3), and potentially also investment channels.

Figure I.B.2. Developing EAP ships 15 percent of its total exports to the euro area...

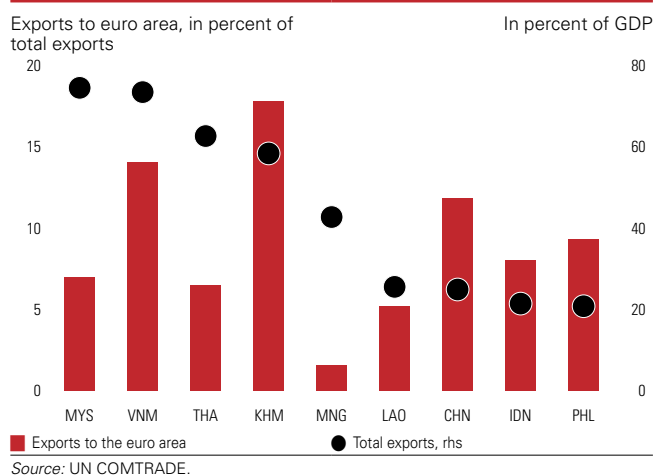
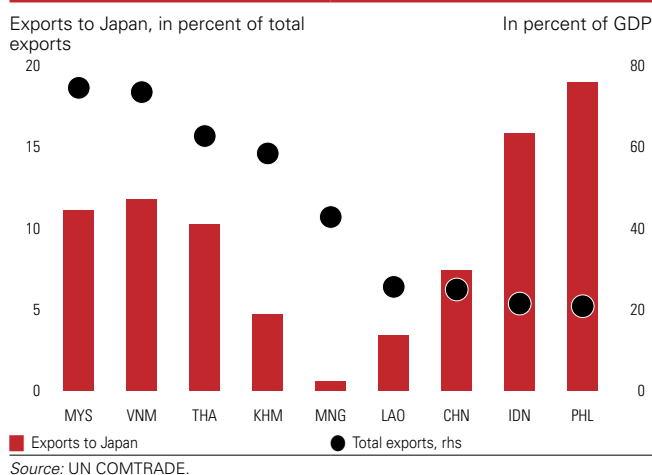


Figure I.B.3. ...and 10 percent to Japan



Higher U.S. interest rates and an appreciating U.S. dollar, associated with monetary policy divergence across the advanced economies, may raise borrowing costs, generate financial volatility, and reduce capital inflows

Monetary policy is increasingly diverging across the advanced economies, and remains subject to significant uncertainties. The United States is expected to begin raising interest rates in the second half of the year, but both the timing and the pace of rate hikes remain uncertain. In contrast, the euro area has committed to a relatively open-ended program of large-scale asset purchases (box I.A.1).

Yields, especially on dollar-denominated assets, may increase more abruptly than anticipated, raising the borrowing costs of governments, corporates, and households. Debt has increased rapidly in the wake of the global financial crisis, reflecting the unprecedented expansion of liquidity and credit, including through the prolonged fixing of policy rates at close to zero. In particular, several EAP countries have accumulated sizable amounts of dollar-denominated debt, benefiting from the prolonged compression in U.S. term- and

credit-risk premia (box I.B.3). In recent years, both cross-border dollar bank loans and especially international dollar bond issuance have grown rapidly. As a result, the region would be sharply affected by rising U.S. rates. Global yields more generally may also rise.

Continued U.S. dollar appreciation would further increase the cost of borrowing in dollar markets. The rapid U.S. dollar appreciation against the euro and yen since mid-2014 may continue. As regional economies seek to limit swings in their overall competitiveness, their currencies may continue depreciating against the U.S. dollar. This would also increase the cost of servicing or rolling over dollar-denominated debt, which accounts for a large majority of foreign-currency debt across the region (box I.B.3). Those sectors characterized by long-term investments and limited hedging opportunities (including real estate, utilities and energy, and transport and infrastructure) will be most affected.

Financial volatility may increase. Divergence in monetary policies and the associated uncertainties create a potential for significant portfolio adjustments, asset repricing, volatility in capital flows, and increases in risk premia. As investors try to shift substantial positions in shallow markets, there is also a risk of market dislocation and asset-price spirals.

Structural developments in financial markets will compound these effects. Liquidity in secondary bond markets has declined since the Global Financial Crisis, particularly in already less liquid markets and securities (Fender and Lewrick 2015). As a result, less selling pressure is required to generate large price adjustments and significant volatility. In addition, risks are shifting from the banking system to the nonbank sector, where authorities have a less direct and complete set of tools to address risks (Financial Stability Board 2013; IMF 2014).

Increased debt burdens and financial volatility may also be associated with a sharp reduction or even reversal of capital flows to emerging markets, including developing EAP. In turn, this would exert considerable pressure on countries with vulnerable external positions. Of particular concern to several countries in the region are (a) the reliance on portfolio flows and short-term borrowing to finance current account deficits or debt rollovers (figure I.B.4), (b) a large external debt load (figure I.B.5), (c) a large share of local-currency debt held abroad (figure I.B.6), and (d) elevated household debt (figure I.B.7).

Figure I.B.4. In Indonesia, FDI inflows have been insufficient to finance current account deficits, generating reliance on volatile portfolio and bank flows

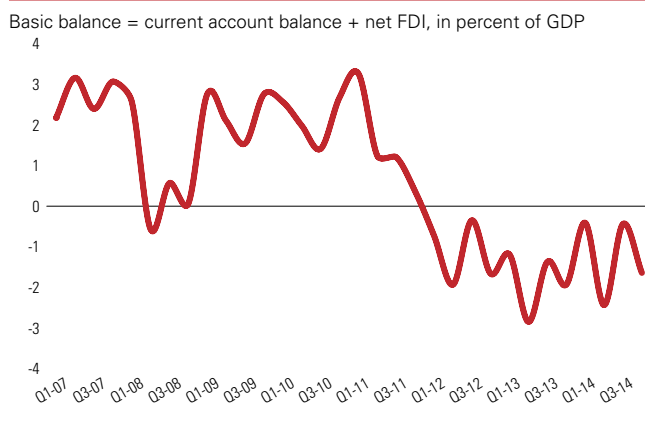


Figure I.B.5. Mongolia and Indonesia use a large share of export receipts to service external debt

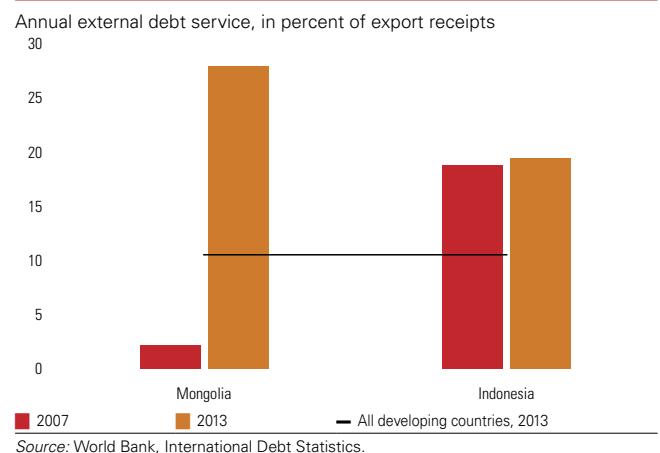
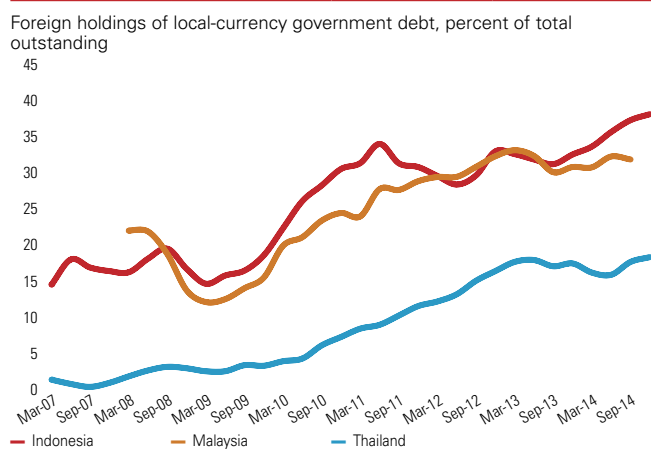
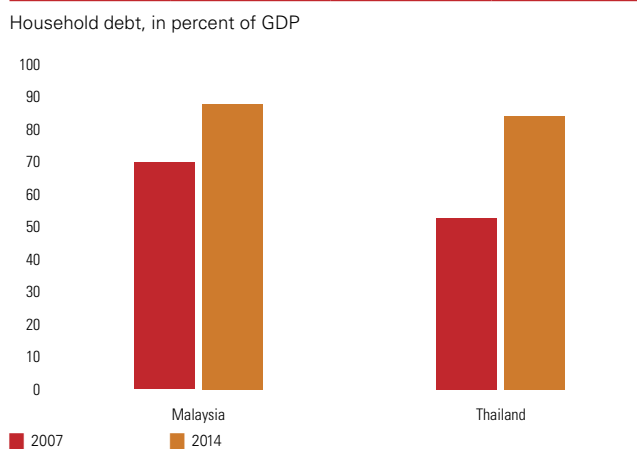


Figure I.B.6. Indonesia and Malaysia may be relatively susceptible to changes in U.S. interest rates, since foreigners hold a large share of local-currency public debt



Source: ADB, Asian Bond Monitor, November 2014.

Figure I.B.7. In Malaysia and Thailand, household debt was relatively high before the crisis, and has surged since



Sources: BIS, IMF, and staff estimates.—Note: Data for Thailand refer to end-Q3 2014, and include credit from depository and nondepository financial institutions.

A significant slowdown in China, though unlikely, would exert large spillovers, particularly on commodity exporters

In China, a disorderly unwinding of real and financial vulnerabilities could trigger a sharp slowdown in investment and output growth. A steep decline in property prices could force developers and banks to deleverage quickly, leading to a sharp contraction in real estate investment. A disorderly unwinding of local government financing could trigger a sharp slowdown in infrastructure investment. A wave of bankruptcies in primary and heavy industries suffering from overcapacity could seriously derail fixed investment in otherwise healthy industrial sectors. And excessive risk taking in the shadow-banking system could eventually force a rapid cutback in liquidity and credit, deeply curtailing investment.

A slowdown of this order remains unlikely, given the substantial policy buffers available. As discussed in the October 2014 *East Asia and Pacific Economic Update*, there are significant fiscal, institutional, and exchange-rate buffers to prevent a disorderly unwinding of debt. Ample fiscal space is available to deploy targeted stimulus or bail out debtors. The savings rate is 50 percent of GDP, financial repression restricts savings outside the banking system, the financial system is still predominantly state owned, and capital controls on bank lending and portfolio investment prevent sharp outflows. Foreign reserves, at US\$3.9 trillion, are by far the largest in the world, and net international assets exceed US\$2 trillion.

However, should a sharp slowdown materialize, it would exert large spillovers across the region. A one-time 1-percentage-point decrease in China's GDP growth relative to the baseline (stemming from a 2-percentage-point decrease in investment growth) would reduce growth in the region by approximately 0.2 percentage points (World Bank 2014). The impact would be relatively larger for commodity exporters, and for economies more tightly integrated into regional supply chains (Ahuja and Nabar 2012). In addition, the significant negative impact on Australia and New Zealand, among the world's largest commodity suppliers, would lead to indirect spillovers on the Pacific Island Countries, given their tight links through trade, investment, and aid.

Box I.B.1. Global growth will pick up gradually, but downside risks prevail

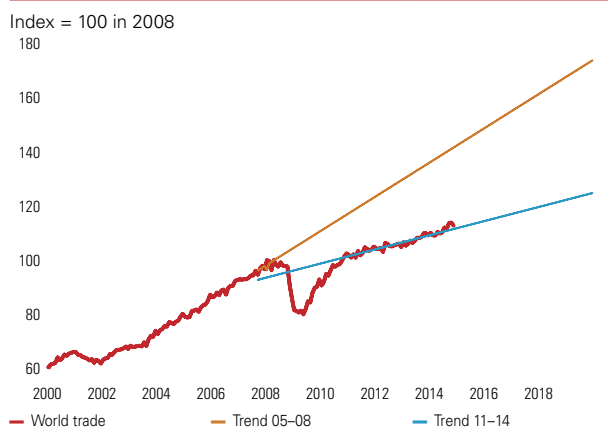
Global growth is expected to pick up moderately, from an average 2.5 percent in 2012–14 to 3.1 percent in 2015–17. This slow recovery will continue to be accompanied by relatively weak trade (figure I.B.1.1).

World oil prices are expected to remain low for a considerable period (box I.B.2). This will:

- Support global activity in the medium term; however, this could be offset in the short term by sharp adjustments in oil exporters, and persistent headwinds facing some large oil importers (including tighter fiscal or macroprudential policies, weak bank balance sheets, political instability or policy uncertainty, a high debt burden, or infrastructure bottlenecks).
- Shift real income from oil exporters to oil importers, improving current accounts in the latter and reducing their vulnerabilities.
- Reduce nonenergy commodity (especially food) prices, and reduce global inflation by around 1 percentage point in 2015 (figure I.B.1.2), providing more room for expansionary monetary policies where country circumstances warrant.

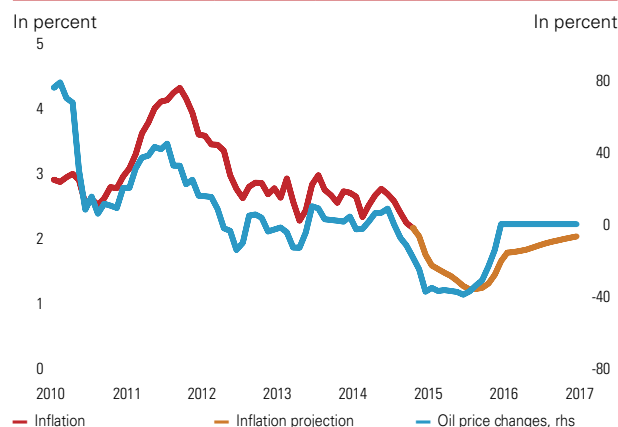
Global financial conditions will tighten gradually. As monetary policy begins to tighten in the United States, while remaining accommodative in other major economies, capital flows to developing countries are set to moderate. They will, however, slow unevenly across countries, with investors focusing more on country-specific vulnerabilities, policies, and growth prospects.

Figure I.B.1.1. Global trade volume



Sources: World Bank 2015a; and CPB Netherlands Bureau for Economic Policy Analysis, *World Trade Monitor*.
Note: Orange line: trend during Q1 2005–Q1 2008; Blue line: trend since Q1 2011.

Figure I.B.1.2. Oil prices and global inflation



Source: World Bank 2015a.
Note: "Inflation" denotes the consumption-weighted average inflation rate of 16 members of the G20 (excluding Argentina and Russia). Projections are simulation results from individual country vector autoregression (VAR) models.

Growth in high-income countries is projected to continue rising, from 1.7 percent in 2014 to an average 2.2 percent in 2015–17, supported by continued recovery in the United States and gradual acceleration in the euro area. In the United States, growth will rise to an average 3 percent in 2015–16, gradually returning to near-potential growth of about 2.5 percent. The recovery will be led by consumption, assisted by improved housing and labor market conditions, although the strong U.S. dollar will dampen net exports. A first interest

rate hike is expected in the second half of 2015, followed by a gradual and protracted tightening cycle. In the **euro area**, growth will strengthen to an average 1.6 percent in 2015–16. Quantitative easing, a weak euro, and low energy prices will assist activity and lift asset prices. However, the legacies of the financial crisis (impaired balance sheets, high unemployment, debt overhang, and ongoing uncertainties surrounding Greece's support program) will continue to limit the expansion. In **Japan**, low oil prices, a weak yen, the impacts of product and labor market reforms announced in June 2014, and the recent additional monetary stimulus will boost consumption and net exports, and raise growth to an average 1.4 percent in 2015–16.

Growth in developing countries will strengthen to an average 5 percent in 2015–17. Developing countries will be helped by the recovery in high-income countries and by sustained low commodity prices. Prospects for large emerging markets are, however, mixed. Major reforms and greater investor confidence have improved growth prospects in India and Mexico. However, commodity exporters, particularly those who face capacity constraints and domestic headwinds, such as Argentina, Brazil, Kazakhstan, and Russia, will continue to experience weak growth, especially in 2015.

There are significant downside risks to this global outlook; the short-term risks are related to oil prices, divergence in monetary policies across advanced economies, and geopolitical tensions. Persistently low oil prices could rapidly erode fiscal and external buffers in oil producers (Baffes et al. 2015). As buffers weaken, episodes of sharp currency depreciation and associated financial stress could intensify, triggering a reassessment of emerging market assets more broadly. In addition, as monetary policy increasingly diverges across major high-income economies, investors may reassess prospects and policies, and the exchange rates for the major currencies may swing abruptly. Although developing-country sovereigns have increasingly borrowed in local currency, corporates have issued significant amounts of foreign-currency–denominated debt. Exchange rate adjustments may cause financial-market strains in countries with large currency mismatches, for instance, between export earnings and corporate borrowing or external liabilities. Also, if geopolitical tensions intensify, they could exert deep economic and financial spillovers. The impact on investor confidence could exceed the actual disruptions to supply chains, trade, and travel, and could trigger a general repricing of emerging and frontier market assets.

The main medium-term risks are associated with possible stagnation in the euro area and Japan. Should inflation expectations fall further below the European Central Bank's target for an extended period, weak consumption, anemic investment, and low inflation could feed on each other in a deflationary spiral. This will be compounded by demographic and structural challenges in the euro area, such as rigidities in labor markets and a nonunified banking sector. Euro area stagnation would have global repercussions since the bloc accounts for one-quarter of world trade and cross-border banking system assets. There is also the risk that Japan could relapse into deflation and stagnation, should its fiscal stimulus and aggressive monetary easing fail to permanently lift inflation expectations and revive growth. Stagnation in Japan would damage growth prospects in East Asian trading partners, in particular.

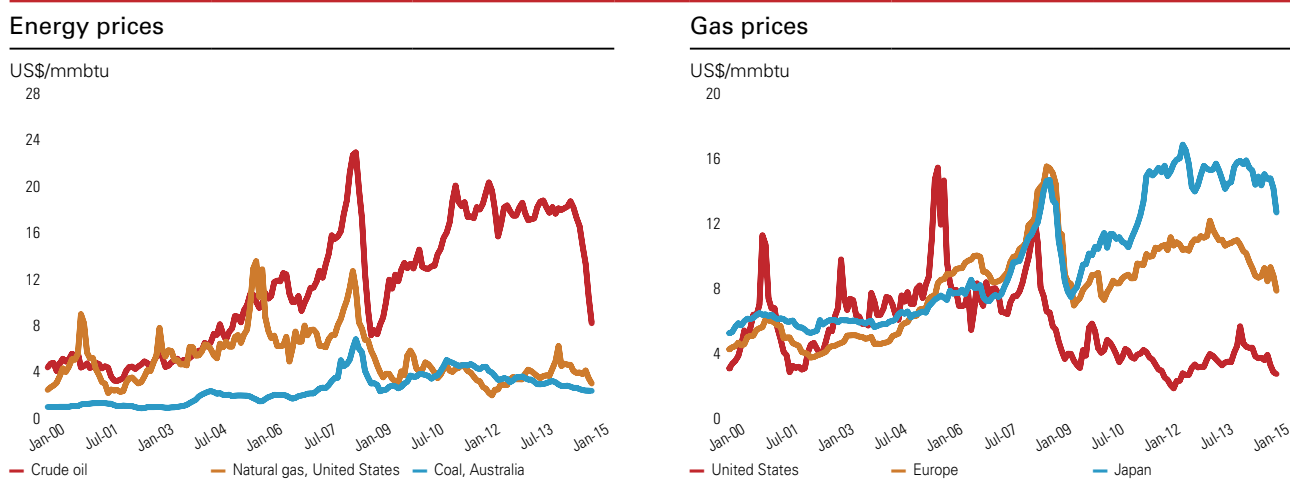
High levels of accumulated debt also pose risks. Government debt in many high-income economies has reached unprecedented highs since the crisis, while private sector debt in emerging markets is rising. Slower growth, combined with falling inflation and rising real interest rates, could weaken the debt repayment capacity of a number of countries. Concerns about debt sustainability would further weigh on growth and increase vulnerability in many emerging markets to stresses such as declining capital inflows.

Box I.B.2. The impact of the decline in fuel prices on East Asia and Pacific⁵

This box discusses the implications of the recent steep drop in world oil prices, and the projected significant decline in natural gas prices. These developments are expected to persist for an extended period, and will therefore have a material impact on the region's prospects. Changes in the prices of other commodities, including coal, are expected to be comparatively minor.

Oil prices have decreased by about 40 percent since June 2014, after four years of relative stability; natural gas prices have also declined, although by smaller amounts (figure I.B.2.1). This reflects above all several years of significant expansion in unconventional oil supplies, together with a shift in OPEC policy away from price support and toward maintenance of market share (World Bank 2015b). Weakening global demand, the unwinding of some geopolitical risks, and U.S. dollar appreciation have played a smaller role.

Figure I.B.2.1. Energy price developments



Source: World Bank *Commodity Markets Outlook*, January 2015.

Note: mmbtu = millions of British Thermal Units, a measure of energy content.

Oil prices are expected to remain low for a considerable period. In the baseline, oil prices will average US\$53 per barrel in 2015, 45 percent lower than in 2014, with only a small recovery in 2016 (table I.B.2.1). This reflects the persistence of the above drivers, and assumes no further deterioration in the global macroeconomic environment, and no further changes to OPEC policy (Baffes et al. 2015).

Weakness in oil prices will extend to other energy markets, especially natural gas in Asia and Europe. Most important for EAP, the Japanese LNG price benchmark is projected to decline 30 percent in 2015. In contrast, coal prices are projected to remain relatively stable.

The decline in fuel prices will affect economies through three key channels. It will lead to a significant real income shift from fuel exporters to fuel importers. In addition, as with any reduction in the cost of intermediate inputs, it will act as a positive productivity shock. Further, it will directly affect prospects for the

⁵ This box was prepared by Ekaterine Vashakmadze, with modeling contributions from Young Il Choi. It draws on Baffes et al. (2015) and World Bank (2015b).

oil and gas sector, and in particular discourage sectoral investment and reduce fiscal revenue from the sector. Overall, fuel importers are likely to benefit through faster growth and improved trade balances. Conversely, fuel exporters are likely to experience slower growth, an external and fiscal deterioration, currency depreciation and, potentially, financing pressures.

Table I.B.2.1. Energy price forecasts

		2014	2015	2016	2017	Percent change		
						2014–15	2015–16	2016–17
US\$								
Coal, Australia	\$/metric ton	70.1	67	69.7	72.6	-4.4	4.0	4.2
Crude oil, avg. spot	\$/barrel	96.2	53.2	56.9	60.8	-44.7	7.0	6.9
Natural gas, Europe	\$/mmbtu	10.1	8.5	8.6	8.8	-15.8	1.2	2.3
Natural gas, United States	\$/mmbtu	4.4	4	4.2	4.5	-9.1	5.0	7.1
Natural gas LNG, Japan	\$/mmbtu	15.8	11	11.1	11.3	-30.4	0.9	1.8

Source: World Bank *Commodity Markets Outlook*, January 2015.

Note: mmbtu = millions of British Thermal Units, a measure of energy content.

A sustained fuel-price decline will benefit developing EAP as a whole. The region is a net fuel importer (for the equivalent of 3 percent of GDP, or 1 percent of GDP excluding China), is relatively energy intensive, and relies on oil and gas for a significant share of its total energy consumption. As a result, the projected decrease in fuel prices will act to raise regional output by 0.3 percent (table I.B.2.2), boost the regional trade balance by more than 1 percent of GDP, and reduce regional inflation by 1 percentage point in 2015. In the medium term, and assuming that the decline in fuel prices is sustained, the cumulative impact on output will be significantly larger (on the order of 0.7 to 0.9 percent). An alternative scenario, with a further decline in oil prices to US\$30 per barrel in 2015, is also possible, although of low probability.⁶ Under this scenario, the above effects would be roughly doubled.

The impact will vary across countries. The Pacific Island Countries, Thailand, the Philippines, Cambodia, and Lao PDR will all gain more than 0.5 percent of GDP under the baseline. Conversely, Malaysia, and Papua New Guinea will experience small GDP losses. These overall effects reflect the interplay of several factors:

- **Net fuel imports.** Most countries are net fuel importers. Imports are highest, as a share of GDP, in the Pacific Island Countries, Thailand, Cambodia, and the Philippines (figure I.B.2.2, panel D). The net fuel exporters are Timor-Leste, the largest exporter of crude oil; Malaysia, an exporter of petroleum products and gas; and Indonesia, a coal and gas exporter, although a net oil importer. Gas exports will also become increasingly important in Papua New Guinea.
- **Energy intensity of production.** This is relatively high in China, Thailand, Indonesia, and Malaysia (figure I.B.2.2, panel A). Vietnam, Cambodia, and the Pacific Island Countries lack comparable data, but they also rely relatively heavily on those sectors most dependent on oil consumption, including transportation, tourism, petrochemicals, and agriculture.

⁶ For instance, fuel producers that are heavily reliant on fuel-related fiscal revenue may further increase production to meet planned budget expenditures. Indeed, some analysts have argued that a further drop in oil prices to US\$20 per barrel is possible (Citigroup, February 9, 2015). Relatedly, a survey of 86 investment specialists found oil price projections for 2015 in the range of US\$35 to US\$80 per barrel (Bloomberg Intelligence). Again, during 1985–86, when conditions in the global oil market were similar to those prevailing today, oil prices declined (in current US\$) from the previous peak of US\$126 per barrel (November 1979) to US\$61 per barrel at a time when OPEC still “managed” supplies (November 1985), and then to less than US\$21 per barrel when OPEC abandoned supply management (July 1986).

Table I.B.2.2. The impact of the fuel price decline on GDP growth and the trade balance^{a,b}

	2015 baseline vs. 2014 fuel prices		2015 lower fuel price scenario vs. 2014 fuel prices	
	Change in GDP growth	Change in trade balance / GDP	Change in GDP growth	Change in trade balance / GDP
EAP	0.3	1.1	0.7	1.9
China	0.3	1.3	0.7	2.1
EAP (excl. China)	0.3	0.1	0.6	0.8
Indonesia	0.2	-0.2	0.4	-0.3
Malaysia	-0.1	-0.3	-0.2	-0.5
Philippines	0.6	0.8	1.1	1.3
Thailand	0.5	2.3	1.4	3.6
Vietnam	0.4	0.2	0.6	0.2
Cambodia	0.5	0.3	0.9	0.5
Lao PDR	0.4	0.4	1.0	0.6
Myanmar	0.4	-0.5	0.8	-0.8
Mongolia	0.2	-0.3	0.4	-0.5
Fiji	0.7	2.0	1.2	3.0
Papua New Guinea	-0.1	-0.2	-0.3	-0.3
Solomon Islands	0.5	0.6	1.2	0.9

Source: Staff estimates.

Notes: a. 2015 baseline refers to oil prices of US\$53 per barrel, and Asia LNG prices of US\$11 per millions of British Thermal Units (mmbtu). 2015 lower fuel price scenario refers to oil prices of US\$30 per barrel, and Asia LNG prices of US\$7.2 per mmbtu. 2014 oil prices were US\$96 per barrel, and Asia LNG prices were US\$15.8 per mmbtu; b. In Timor-Leste, lower oil prices will significantly affect oil sector and total GDP and the trade balance. However, for Timor-Leste, growth projections, and the estimated impact of lower fuel prices, refer by convention to nonoil GDP. In the short run, this will be relatively unaffected; the public sector accounts for almost 90 percent of nonoil GDP; and lower oil prices will not affect public spending in 2015, since the reduction in fiscal revenue is being offset by increased transfers from the country's natural resource fund.

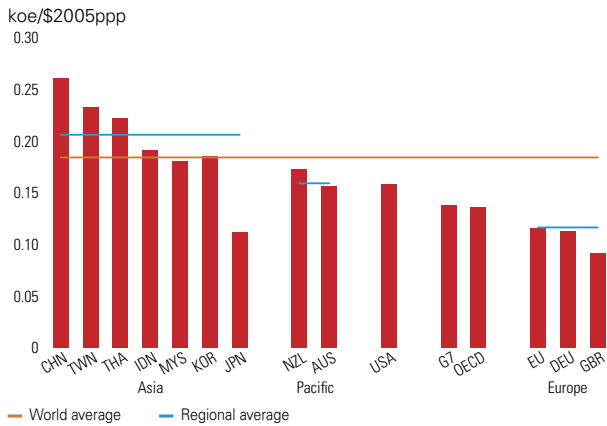
- **The share of oil and gas in total energy consumption.** This is relatively high in Thailand, Malaysia, Indonesia, and the Philippines (figure I.B.2.2, panel B). Conversely, in China, coal accounts for 68 percent of energy consumption, whereas oil and gas account for less than 25 percent. Vietnam also relies relatively more on coal and hydroelectric power.
- **The share of the oil and gas sector in total output.** This is relatively high in Vietnam, Malaysia, and Indonesia (figure I.B.2.2, panel C). Relatedly, these countries also rely significantly on the oil and gas sector for fiscal revenues.

Some of the effects of lower oil prices have already materialized. In the last quarter of 2014, trade balances improved in net fuel importers, such as China, the Philippines, and Thailand, and deteriorated in net fuel exporters, such as Indonesia and Malaysia (figure I.B.2.3). Lower oil prices also acted to reduce inflation across the region (figure I.B.2.4). Indonesia was an exception: here, domestic fuel prices actually increased, but this reflected the reduction in fuel subsidies.

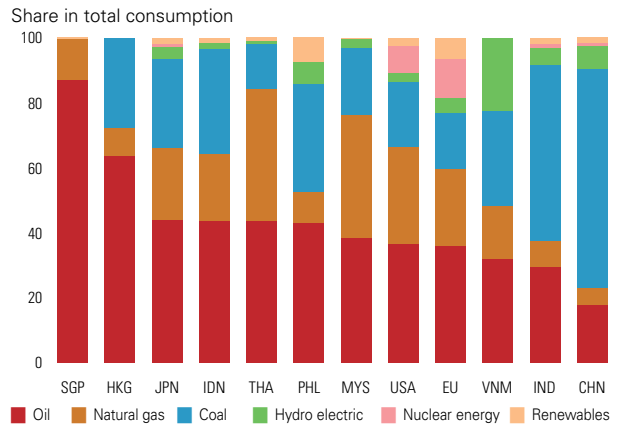
All the above estimates are subject to significant uncertainty. For instance, in Indonesia, the impact on growth, and to a lesser extent the current account, will be significantly influenced also by how the prices of coal and gas exports evolve. For the Philippines, the overall impact on the current account will also depend on whether lower fuel prices translate into lower remittances for Filipino workers in oil-producing Middle East countries. If fuel exporters were to face acute fiscal and external stress, they might have to tighten policy significantly. Relatedly, the positive effects for fuel importers could take time to materialize, whereas the adverse effects for fuel exporters could arise more abruptly, especially if accentuated by financial market pressures.

Figure I.B.2.2. Energy intensity, consumption, production, and trade balance

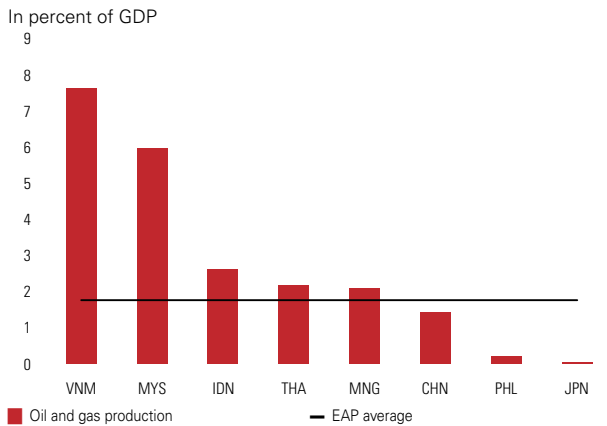
A. Energy intensity of GDP at constant PPP^a



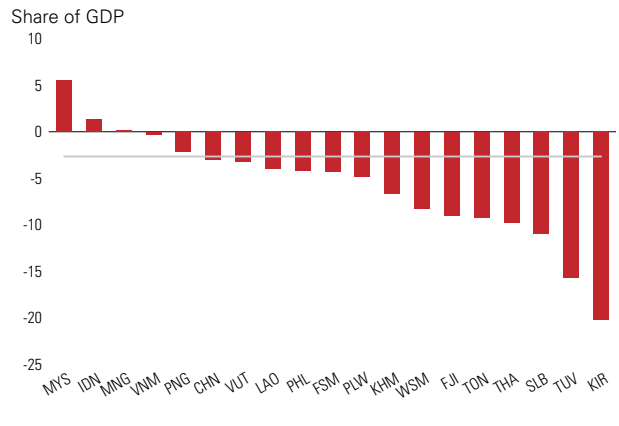
B. Energy consumption by energy type, 2013^a



C. Value of oil and gas production, 2013^b

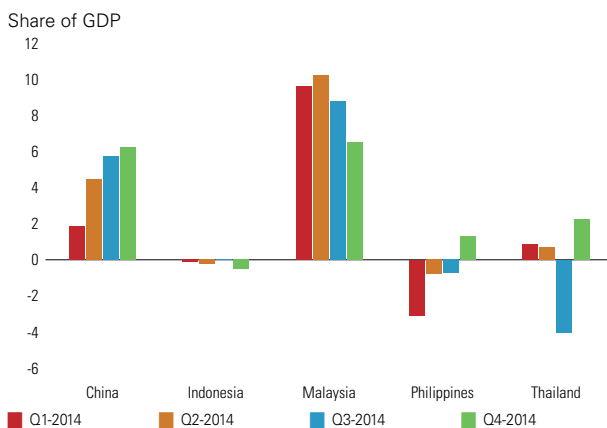


D. Fuel trade balance, 2013



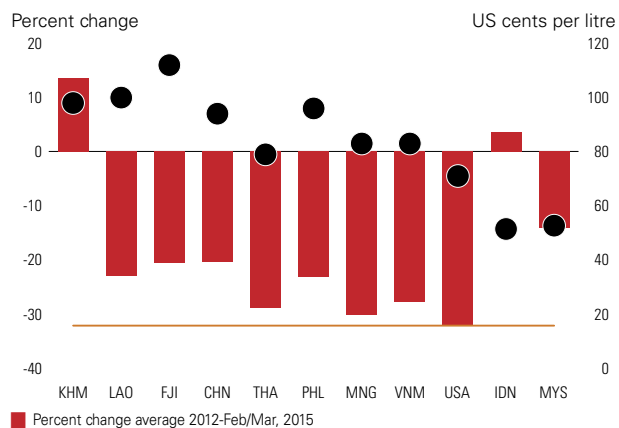
Sources: Enerdata, World Development Indicators, BP Statistical Review, CEIC, U.S. Energy Information Agency, UN COMTRADE, and U.S. Department of Agriculture.
 Note: a. Oil consumption measured in million tons; other fuels in million tons of oil equivalent; b. Value of oil and gas production is estimated as the difference between the value of production at world prices and total production costs (see World Bank 2011).

Figure I.B.2.3. Merchandise Trade Balance



Sources: Haver Analytics and World Bank staff estimates.

Figure I.B.2.4. Change in local gasoline prices (US dollars)

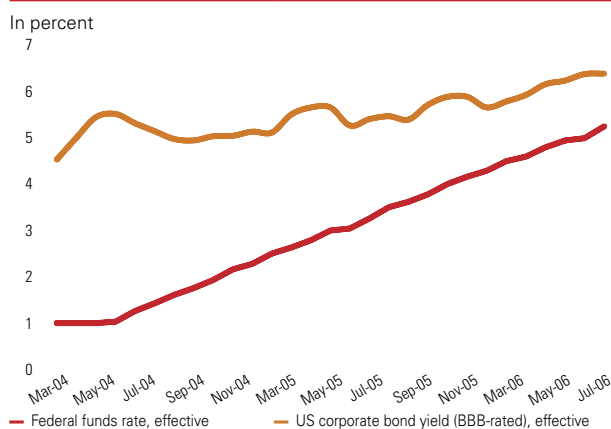


Sources: CEIC, Globalpetrolprices, Bloomberg, Haver, GIZ – International Fuel Prices, Ministry of Domestic Trade, Cooperative and Consumerism, Indonesia, and National Statistical Office, Mongolia.
 Note: Data refer to the retail prices of gasoline 93 in China, RON 88 gasoline in Indonesia, RON 95 gasoline in Malaysia, A1-92 in Mongolia, and Gasohol 95 E20 in Thailand.

Box I.B.3. Higher U.S. interest rates and a stronger U.S. dollar could pose significant debt-servicing challenges for developing EAP⁷

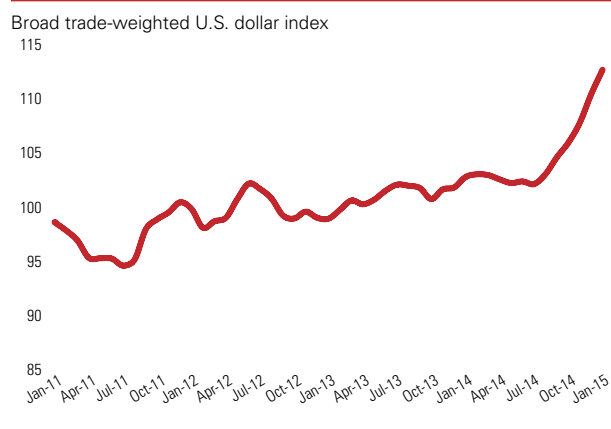
The cost of servicing dollar-denominated debt will likely increase over the coming years. The anticipated normalization of U.S. monetary policy beginning in 2015 is likely to increase interest rates on all dollar debt (figure I.B.3.1). In addition, the rapid U.S. dollar appreciation since mid-2014 may also continue, raising the debt service burden in local currency terms (figure I.B.3.2).

Figure I.B.3.1. When the U.S. Federal Reserve last raised the federal funds rate sharply, from 1 percent to 5.25 percent during 2004–06, U.S. corporate bond yields surged from 4.5 percent to 6.4 percent



Sources: U.S. Federal Reserve Board; Bank of America Merrill Lynch.

Figure I.B.3.2. The U.S. dollar could strengthen further as the U.S. Federal Reserve tightens, while the European Central Bank starts buying sovereign debt, and Japan extends its stimulus



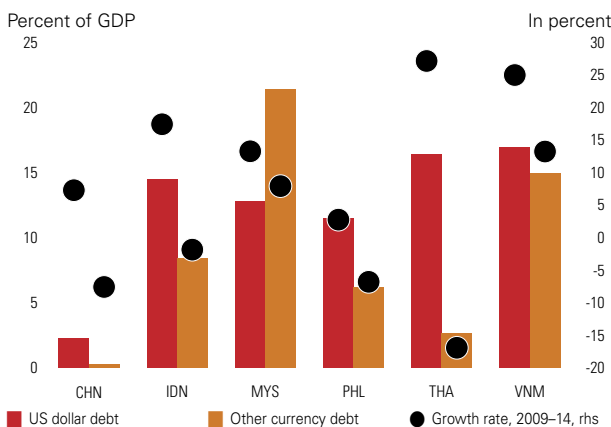
Source: U.S. Federal Reserve Board.

Borrowers outside the United States, including developing East Asia, have accumulated sizable amounts of dollar-denominated debt since 2009.⁸ China accounts for US\$1.1 trillion in dollar debt, 12 percent of the global total. In the ASEAN-5, dollar debt is even larger as a share of GDP, and has been growing rapidly (figure I.B.3.3). Across the region, a large majority of foreign currency debt is denominated in U.S. dollars.

The implied risks to growth in developing EAP are heightened by three developments in dollar credit markets.

First, recent efforts to contain domestic credit growth, in the face of rising financial vulnerabilities, have been blunted by borrowers resorting to cross-border dollar bank loans.

Figure I.B.3.3. External debt (long term) by currency, in percent of GDP, 2014



Source: Staff estimates.

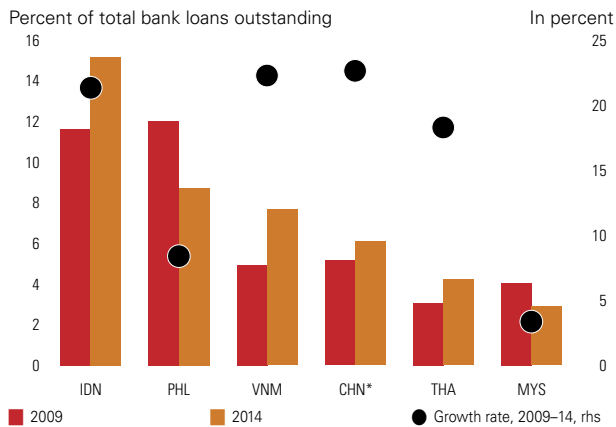
Note: In Malaysia, “other currency debt” denotes almost entirely nonresident holdings of domestic currency debt.

7 This box was prepared by Antonio Ollero.

8 Globally, U.S. dollar debt held by nonbank borrowers outside the United States rose by 50 percent between end-2009 and end-September 2014. It currently exceeds US\$9.2 trillion: US\$4.9 trillion in bank loans, and US\$4.2 trillion in debt securities (BIS). Emerging market borrowers now account for half the dollar credit outside the United States, up from one-third before the global financial crisis.

Cross-border bank loans at end-Q3 2014 accounted for 15 percent of total outstanding bank loans in Indonesia, 9 percent in the Philippines, 8 percent in Vietnam, and 4 percent in Thailand (figure I.B.3.4). In China, and also in Vietnam and Thailand, cross-border bank loans have grown much faster than domestic loans, both since 2009 and more recently.⁹ In addition, in China, there are significant amounts of dollar-denominated domestic bank loans.

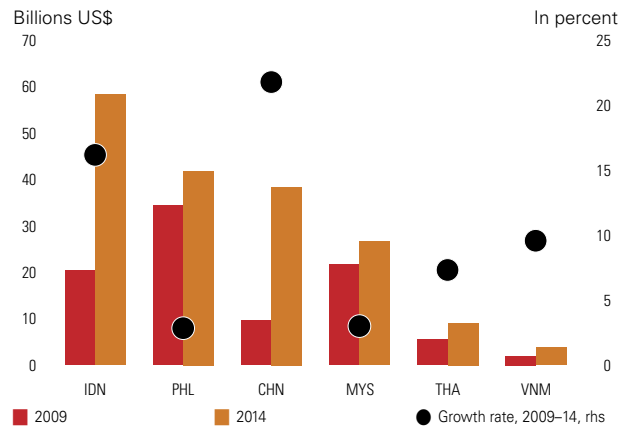
Figure I.B.3.4. Cross-border bank loans outstanding of nonbanks, in percent of total bank loans outstanding



Sources: CEIC, BIS.

Note: *In China, includes domestic bank loans in foreign currency.

Figure I.B.3.5. International debt securities outstanding of nonbanks, in billions US\$



Source: BIS.

Second, the issuance of dollar bonds by non-U.S. borrowers has grown even faster and more steadily in recent years than dollar bank credit, but the trend may not be sustainable. Between 2010 and 2013, emerging market issuers, mostly nonbanks, sold an unprecedented net US\$1 trillion in international dollar bonds. Developing East Asia and Pacific issued US\$80 billion, with Indonesia, the Philippines, China, and Malaysia accounting for the bulk (figure I.B.3.5). This expansion was partly the result of unconventional U.S. monetary policy and the resulting compression in the U.S. term premium (McCauley, McGuire, and Sushko 2015). During this period, for instance, many lower-rated Indonesian firms actively sold 10-year dollar bonds. However, the market for dollar bonds issued by non-U.S. residents will deteriorate when U.S. short-term rates and the term premium rise.

Finally, dollar credit, as a share of GDP, has risen faster in economies with wider interest differentials relative to the United States; it may fall as U.S. interest rates increase. Wider policy rate differentials relative to the U.S. federal funds rate spur subsequent-quarter growth in dollar bank loans; analogously, wider 10-year bond yield differentials relative to U.S. bond yields spur subsequent-quarter growth in dollar bonds outstanding (McCauley, McGuire, and Sushko 2015). These associations have strengthened since the global financial crisis.

⁹ In China, in the 12 months through September 2014, cross-border bank credit surged by 37 percent, whereas domestic credit increased by only 15 percent. In Vietnam, these trends partly reflect the diminished capacity of domestic banks, with their impaired balance sheets, to extend credit to local borrowers.

I.C. Policy Considerations

In the short term, addressing fiscal challenges will help manage the risks associated with an uncertain global outlook. Bolstering revenue and rationalizing expenditure is therefore a continued priority in most large economies. And fiscal consolidation is needed in the major fuel exporters, Mongolia, and to a lesser extent Lao PDR, Myanmar, and several Pacific Island Countries. In this context, low world fuel prices generate a unique opportunity to both remove fuel subsidies and raise energy taxes more broadly. Over the medium term, developing human capital and physical infrastructure is important, including in fuel exporters striving for diversification. Over the longer term, the region needs to address aging-related fiscal challenges, improve the investment climate, and promote further integration.

Bolstering fiscal revenue and rationalizing expenditure remains a short-term priority

Across the region, it is critical to address fiscal challenges, and to base public budgets on prudent medium-term fiscal plans, as a hedge against the uncertain global environment. Authorities should expand their ability to respond to any global slowdown. In this context, both fuel exporters and fuel importers need to approach both fiscal revenue and expenditure in terms of realistic and cautious medium-term targets and scenarios. Fuel exporters should assume continued low world fuel prices; contingency plans should also be drawn up in case of further price declines (box I.B.2). Fuel importers should assume that the boost from falling world fuel prices will gradually die out, and indeed that these prices will partially recover.

In most large economies, some combination of bolstering revenue and rationalizing expenditure will help create fiscal space for both productivity-enhancing investments and targeted social protection and insurance programs, although the specific fiscal challenges vary. In Thailand, the significant fiscal stimulus should be framed within a medium-term plan to strengthen the revenue base. Public investment projects need to be well selected and effectively managed. In the Philippines, similarly, it is a priority to broaden the tax base and rationalize income-tax incentives. In the short run, the targeted increase in the deficit, from 0.6 percent to 2 percent of GDP, will appropriately allow for post-typhoon reconstruction work and some infrastructure upgrading, while keeping debt ratios moderate and fiscal buffers adequate. In Vietnam, the sizable deficit and rising public debt need to be contained, including through improvements in tax administration and more targeted social spending.

China faces a delicate balancing act; the pace of reform needs to be sustained, but the likelihood of sharp contractions minimized. Strengthening local government finances is a key immediate challenge. This will involve aligning local revenue with expenditure and improving the management and oversight of local government borrowing, as envisaged in a new pilot framework. It is critical that any efforts to support growth be designed so as not to undermine restructuring efforts; in particular, any fiscal stimulus program will need to avoid unsustainable increases in local government debt.

In the major fuel exporters, lower fuel prices will erode fiscal revenues over time, offsetting any gains from fuel subsidy reform, and creating a need for consolidation. In Malaysia, the oil and gas sector accounted for 30 percent of fiscal revenues in 2014, a share that is projected to decline to just over one-fifth in 2015. As a result, the government already raised its deficit target from 3 percent to 3.2 percent of GDP, and undertook a reprioritization of expenditures. Additional responses would be to reduce the number of exemptions to the goods and services tax, and to introduce a new personal income-tax bracket for high earners. In Indonesia, where the oil and gas sector accounts for 20 percent of fiscal revenues, it will prove challenging to achieve the targeted 30 percent increase in tax revenues in 2015, and hence the targeted doubling of capital expenditure. In Timor-Leste, the public sector is extremely dependent on petroleum revenues, which finance 85 percent of the 2015 budget. The immediate impact of falling oil prices has been dampened by the country's sizable natural-resource fund,¹ which negates short-term liquidity concerns. However, low oil prices reduce the country's prospective petroleum wealth, partly through uncertainty around the development of future oil fields, and generate fiscal sustainability issues. In this context, the 11 percent increase in the recurrent budget in 2015² generates particular concerns.

Among the smaller economies, fiscal consolidation is urgently required to rebuild fiscal buffers in Mongolia and to a lesser extent Lao PDR and Myanmar; in addition, fiscal institutions need to be strengthened. Mongolia has the highest fiscal deficit and public debt in the region. It needs to unify authority over all fiscal activity, and in particular bring under the budget the significant quasi-fiscal activities of the Development Bank of Mongolia. The total deficit, including such quasi-fiscal spending, should be gradually brought down to 2 percent of GDP. In Lao PDR, fiscal consolidation, targeting a nonmining deficit of 5 percent of GDP, will help reduce fiscal vulnerability. In this context, it will be important to proceed with plans to increase excises on vehicles, tobacco, and alcohol; improve tax administration; and control spending through reductions in public hiring, a wage freeze, and a more selective, higher-quality public investment program. Myanmar needs to strengthen its capacity to develop and implement policy; macroeconomic stability and continued reforms remain a prerequisite for development. In particular, the deficit will need to be kept below 5 percent of GDP; in this context, the rapid increase in the wage bill raises the urgency of broad pay and grading reform. In Cambodia, donor grants are expected to continue declining. The government will need to rebuild deposits, its only fiscal buffer; carefully manage contingent liabilities; and continue public financial management reforms to increase accountability.

The Pacific Island Countries continue to face significant short- and medium-term fiscal sustainability issues. Outside Timor-Leste and Papua New Guinea, oil- and gas-related issues are not critical. However, Vanuatu, already under fiscal strain from planned infrastructure development programs, now faces additional large reconstruction needs in the wake of Cyclone Pam. In the Federated States of Micronesia, the Marshall Islands, and Palau, grants from the United States under the terms of the Compact of Free Association are set to expire in 2023, requiring substantial fiscal adjustment. And in Samoa, public external debt has ballooned from 30 percent of GDP in 2008 to 52 percent in 2014.

1 The value of the Timor-Leste's Petroleum Fund was US\$16.5 billion (290 percent of GDP) in 2014.

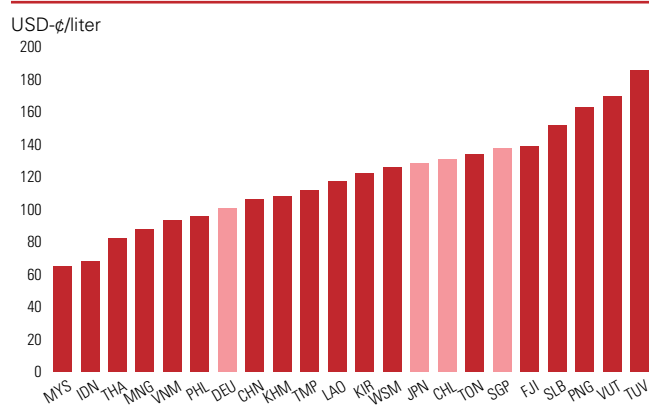
2 Driven by a 21 percent planned increase in transfers for social assistance program, and a new development project in the enclave of Oecusse.

Low world fuel prices create an opportunity to both eliminate fuel subsidies and raise energy taxes

Low world fuel prices afford developing EAP a unique opportunity to both eliminate fuel subsidies and raise energy taxes more broadly; this will reduce inefficiencies and help address fiscal challenges. Countries should not pass through reduction in world fuel prices, but rather seize the chance to reform energy pricing with only a muted impact on politically sensitive domestic consumer prices. Such measures will discourage wasteful consumption, minimize resource misallocation in production, strengthen government finances, and boost current accounts.

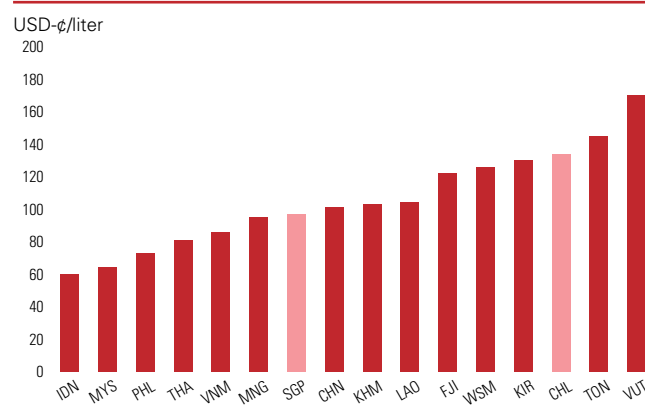
Fuel prices differ markedly across the region, and have historically been particularly low in Indonesia, Malaysia, and more broadly the ASEAN-4. Even as of last December, domestic gasoline and diesel prices in Indonesia and Malaysia were 40 percent lower than in Cambodia and Lao PDR (figure I.C.1 and figure I.C.2). Prices were also low in the Philippines and Thailand, including when compared to advanced economies and other emerging markets. Conversely, many Pacific Island Countries were characterized by relatively high fuel prices, reflecting the impact of their remoteness on fuel shipping and distribution costs.

Figure I.C.1. Domestic gasoline prices



Sources: World Bank survey, November–December 2014, and CEIC.

Figure I.C.2. Domestic diesel prices



Sources: World Bank survey, November–December 2014, and CEIC.

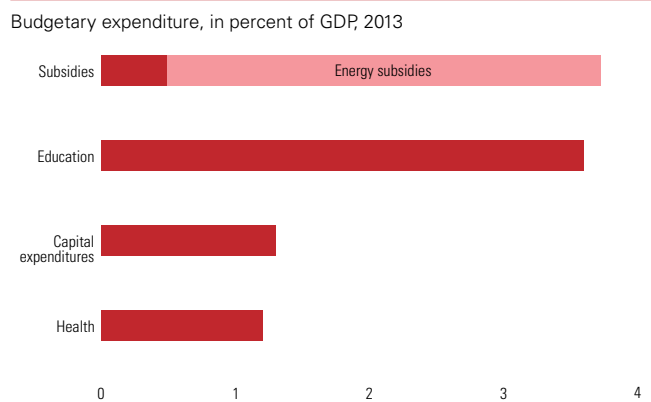
Fuel subsidies have strained public finances, particularly in fuel exporters. In Indonesia, fuel subsidies in 2013 amounted to 2.2 percent of GDP, or almost 20 percent of central government total budget expenditure. This amount was larger than the capital expenditure budget, and more than 1.5 times the health budget. Electricity subsidies accounted for a further 1 percent of GDP (figure I.C.3). In Malaysia, fuel subsidies in 2013 amounted to 2.4 percent of GDP, or the equivalent of half the education budget and more than 1.3 times the health budget (figure I.C.4).³ These subsidies, in addition to draining government fiscal resources, have at times also forced state-owned enterprises to divert resources away from investment spending. In Thailand, fuel subsidies amounted to about 0.8 percent of GDP in 2012.⁴ There have also been smaller subsidies in the

³ This comparison refers to operational expenditures on education and on health.

⁴ The subsidies were mostly targeted to LPG, electricity, and natural-gas vehicles (IISD 2013). Much of the expenditure was financed through transfers from the oil price stabilization mechanism ("Oil Fund"). This was established in 1979, and over extended periods has not just stabilized but also acted to reduce average energy prices, leading to periodic required injections of government funds.

Philippines,⁵ and in Mongolia the Price Stabilization Program has attempted, among other things, to reduce domestic fuel prices by extending favorable loans to oil-importing companies.

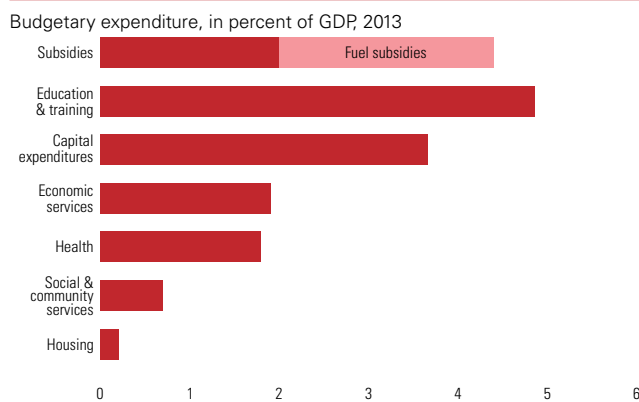
Figure I.C.3. Energy subsidies in Indonesia exceeded budgetary capital and health expenditures



Source: Ministry of Finance, Indonesia.

Note: Data refer to central government expenditure.

Figure I.C.4. Fuel subsidies in Malaysia exceeded operating expenditures for health, social services, and housing



Source: Ministry of Finance, Malaysia.

Note: Development expenditures for economic services and for all social sectors are included in the capital expenditures budget item.

Beyond explicit subsidies, fuel-related tax expenditures have also weakened fiscal balances, particularly in fuel importers. China, the Philippines, and Thailand have all occasionally reduced various taxes to lower fuel prices for end users (Kojima 2013). In the Philippines, the continued failure to adjust petroleum excises in line with inflation cost 1 percent of GDP in foregone revenues in 2013 alone.⁶ In Thailand, diesel taxes were largely eliminated during 2011–14, at an annual cost of 1 percent of GDP (IISD 2013). In Mongolia, taxation of petroleum products has since 2008 been adjusted to stabilize domestic prices, which in practice has resulted in a reduction in average fuel prices.

Such measures to reduce domestic fuel prices have weakened current account balances. They encourage excess fuel consumption, and as a result discourage other key imports, including capital goods imports. To obtain a sense of the potential magnitude, in Indonesia, the trade deficit in oil and gas accounted for a large and rising share of the current account deficit in recent years.⁷ Relatedly, fuel imports amounted to 1.5 times capital goods imports in 2013–14 (figure I.C.5). In Thailand, fuel imports in recent years have amounted to over 12 percent of GDP, and about 82 percent of capital goods imports (figure I.C.6).

Recent steps to reduce fuel subsidies and increase fuel taxation have established a positive momentum, which now needs to be sustained; remaining fuel subsidies should be eliminated, and increases in broader energy taxation should be considered. In Indonesia, Malaysia, and Thailand, as discussed, various fuel subsidies were reduced or eliminated. In Indonesia alone, these measures are projected to save approximately 1.8 percent of GDP in 2015. In Vietnam, increases in fuel taxes are expected to offset the reduction in fiscal revenue stemming from falling oil prices. But in these countries, as elsewhere in the region,

5 Some of these subsidies have proved transitory. For instance, fuel for jeepney and tricycle drivers was subsidized in 2008, when oil prices peaked, and again in 2011.

6 The specific excise on gasoline has been fixed, in nominal terms, since 1997. The specific excise on diesel, always very low, was abolished in 2005.

7 An average 42 percent during Q4 2012–Q3 2013, and more than 55 percent during Q4 2013–Q3 2014.

both subsidies and tax expenditures can be reduced further. In Indonesia, remaining fuel subsidies amount to approximately 0.6 percent of GDP; kerosene and LPG prices are fixed at a subsidized level, and there is still a limited diesel subsidy. In Malaysia, there remain substantial natural gas subsidies of over 1.25 percent of GDP, and diesel subsidies for public transport and fishing. Thailand should consider raising electricity tariffs and LPG prices. The Philippines should consider raising petroleum excises and linking them to world prices. And Timor-Leste will need to act to contain electricity subsidies. In all cases, if and when fuel prices start increasing again, the reforms to date will need to be defended. More broadly, higher energy taxes, whose specific form may vary, should be considered to address objectives related to energy efficiency, pollution, and climate change, particularly in large fuel consumers such as China and the Philippines.

Figure I.C.5. Oil and gas imports in 2013 and 2014 amounted to 1.5 times capital goods imports in Indonesia...

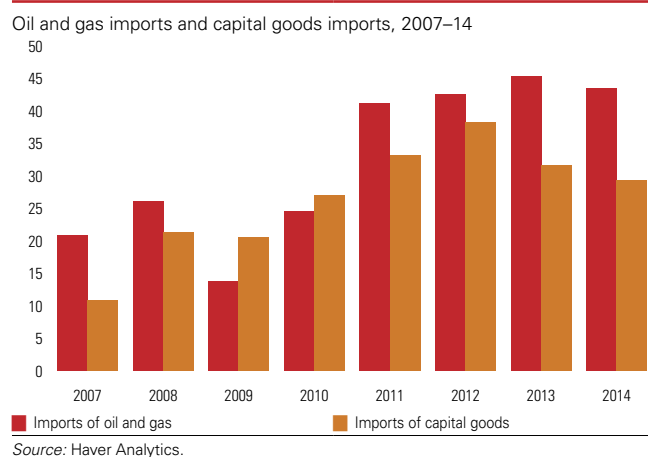
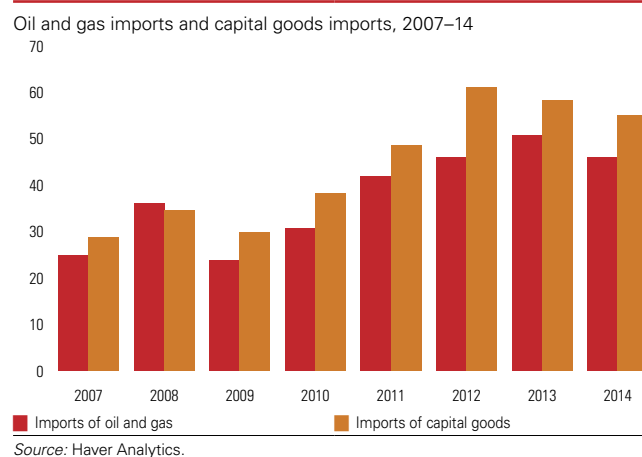


Figure I.C.6. ...and approximately 90 percent of capital goods imports in Thailand

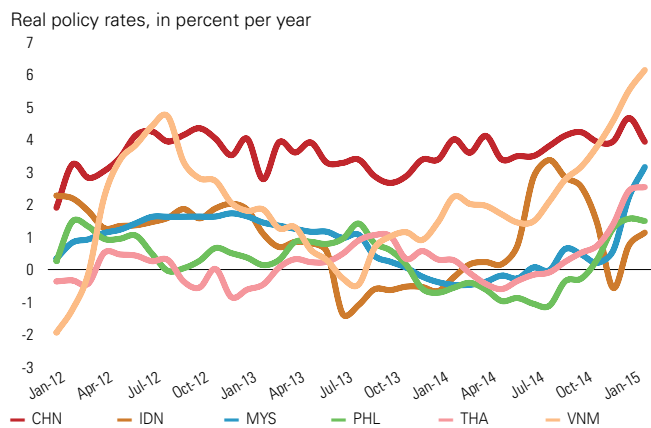


Monetary policy should remain accommodative across much of the region

In most economies, there is no immediate need for monetary tightening, although authorities need to remain cautious, because the disinflationary impact of lower world commodity prices may not persist. Lower oil prices have helped reduce headline inflation across the region, including through lower food prices, and there are no incipient inflationary pressures. The spike in headline inflation in Indonesia and Malaysia in Q4 2014, following the cut in fuel subsidies, proved temporary. That said, as world commodity prices stabilize and possibly recover, the downward trend in inflation will not continue, and may even be reversed.

In the ASEAN-4, the general tightening in 2014, and the limited loosening by Indonesia in February 2015, has resulted in an appropriately accommodative monetary policy stance. Policy tightening in Indonesia, Malaysia, and the Philippines in 2014 helped to end a period of very low or negative real policy rates (figure I.C.7). If continued, this could have created financial stability risks, in particular by encouraging overborrowing, while potentially eroding banks' margins and capital. In Thailand, a further monetary easing might be appropriate if the economic recovery is weaker than anticipated. The central bank's plan to define its target in terms of headline rather than core inflation may indeed present advantages in terms of easier communication with the public.

Figure I.C.7. Real policy rates in Indonesia, Malaysia, the Philippines, and Thailand were negative at various times during 2014



Sources: Haver Analytics and staff estimates.

Note: Real rates are calculated using realized inflation.

In those economies, particularly Mongolia, where monetary policy has been extremely loose and credit growth exceptionally rapid, further tightening remains imperative. In Mongolia, the central bank began to phase out directed credit in 2014, and raised policy rates last July and in January 2015; nevertheless, the outstanding stock of central-bank liquidity injections into quasi-fiscal lending programs remains at an elevated 10 percent of GDP. In Cambodia and Lao PDR, slower credit growth would also help contain macrofinancial vulnerabilities; in addition, improved financial sector regulation and supervision would help ensure early risk detection and mitigation.

The real exchange rate should be monitored as an indicator of emerging competitiveness problems. Most regional economies de facto attempt to limit swings in their bilateral dollar exchange rate. This is often understandable, given their need to service dollar-denominated debt (see box I.B.3). However, as a result of the rapid dollar appreciation against the euro and the yen, many countries in the region have experienced significant appreciation in real, trade-weighted terms. That said, the main component of any strategy to reverse losses in competitiveness will need to be a continued focus on medium-term structural reforms, several of which are noted below.

Developing human capital and physical infrastructure is a key medium-term priority

In fuel-importing countries, the decline in fuel prices creates an opportunity to increase investments in education, health care, and infrastructure. Lower fuel prices boost growth and relax fiscal constraints to expanding productivity-enhancing investments. For instance, much of developing EAP has made significant progress in expanding access to education. But countries now need to focus on developing labor market skills, including both cognitive and noncognitive skills. Primary and secondary education systems should focus on quality and on learning outcomes, including by strengthening autonomy and accountability. And the relevance of higher education, vocational education, and training needs to be improved by giving institutions

the capacity, incentives, and information to both increase quality and meet labor market needs.⁸ In a similar vein, infrastructural investments could yield significant returns. For instance, in the Philippines, characterized by a large infrastructure deficit, the main island of Luzon faces serious threats of a power shortage,⁹ and road congestion in the Metropolitan Manila region costs the economy 8 percent of GDP annually. That said, it will be important for greater investment in human and physical capital to be accompanied by increases in the efficiency of such expenditure. In turn, this points to the importance of strengthening institutions, including through public financial management reforms.

In fuel-exporting countries, development strategies must focus on removing barriers to economic transformation and diversification. The decline in fuel prices underscores the need to pursue a broad range of complementary structural reforms, including developing fiscal and monetary institutions to better manage volatility in natural-resource rents;¹⁰ again, providing high-quality education and appropriate infrastructure; and creating a competition regime that levels the playing field for enterprises (Gill et al. 2014).

Over the longer term, the region needs to address aging-related fiscal challenges, improve the investment climate, and promote further integration

Countries in the region—both low and middle income—face significant long-term fiscal challenges, as demographic trends and social pressures lead to rising social security expenditure. EAP is aging faster than any region in history, driven primarily by a rapid decline in fertility, but also increased longevity. This will affect growth prospects. Combined with growing pressures to expand pension coverage, it will also raise the costs of pensions. The policy response must be twofold (see Part II.A, “Healthy and Productive Aging in East Asia and Pacific”): first, sustaining productivity growth, boosting the labor force participation of women and older urban people, and in some cases increasing immigration; and second, reforming social security financing so as to expand the revenue base.

In a similar vein, demographic trends and social pressures will lead to sharp increases in health expenditures. The fiscal costs of health care and long-term care will be affected by both demographic aging, and pressures to expand health care coverage through universal enrollment, a greater degree of financial protection, and access to higher-quality health services. These welcome expansions in coverage need to be accomplished in a fiscally sustainable manner. The revenue base for health care must therefore be expanded. In addition, costs must be contained, including by reforming the mechanisms for paying health care providers, purchasing pharmaceuticals, and adopting new health care technologies (see Part II.B, “Macro-fiscal Implications of Achieving Universal Health Coverage in East Asia and Pacific”).

Will lower-income economies in developing EAP benefit from China’s move into higher value-added sectors? The answer depends partly on the extent to which Chinese labor-intensive manufacturing relocates *within* China rather than to other countries. As China’s economy matures, its labor-intensive manufacturing

8 See *East Asia and Pacific Economic Update*, October 2014, Part II.A, “Moving from Education to Skills in East Asia and Pacific.”

9 The result of aging generating plants, low reserve capacity, and deficient alternative sources of power; see the World Bank *Philippine Economic Update*, January 2015.

10 Including natural-resource stabilization funds and sovereign wealth funds structured to assist in smoothing government expenditure. See Gelb et al. (2014), IMF (2012), and Sugawara (2014).

will face pressures to move to lower-cost economies across the region. However, such international relocation has so far proved limited. Rather, as costs have risen in China's manufacturing hub on the eastern coast, industry has moved to lower-cost areas within the country, both within the eastern coastal region, and in other regions in China (see Part II.C, "Manufacturing Relocation in China"). Underlying factors include China's significant advantages in terms of labor productivity, a favorable investment climate, robust logistics, and superior infrastructure. For developing EAP, making progress in these areas will prove critical to developing their industrial sectors.

Increasing competitiveness in services through further regional integration will be necessary for ASEAN economies to sustain growth in the long run. Services such as finance, education, health care, transportation, and telecommunications are critical to modern economies, including as key drivers of productivity in high-value-added manufacturing. Recognizing this, the ASEAN members have committed to liberalizing and integrating their services markets, in the context of the formation of the ASEAN Economic Community at end-2015. However, little de facto progress has been made so far, and ASEAN remains among the most restrictive regions in the world with respect to trade in services (see Part II.D, "ASEAN Integration in Services"). Correcting this will require a focus on promoting regulatory cooperation and coordination through harmonization or mutual recognition, together with the development of regulatory capacity.

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Part II. Medium-Term Development Agenda

II.A. *Healthy and Productive Aging in East Asia and Pacific*¹

East Asia and Pacific (EAP) is aging faster than any region in history, though the stage and pace of demographic transition exhibits significant diversity across countries. The richer countries in the region, such as Japan and the Republic of Korea, are already dealing with shrinking labor forces and rising spending on pensions, health, and long-term care. For middle income countries, including China, rapid aging has started or is imminent, and will require urgent policy reform. For younger low income countries, it is vital to make policy choices that take into account future aging. For all countries, rapid aging raises many challenges and risks, but EAP is well positioned to manage the risks through appropriate policy reforms. Many people in EAP already work until fairly old ages, save significant amounts throughout their lives, and are living healthier longer. At the same time, much of the developing EAP is “growing old before growing rich,” as income growth trails the pace of aging. Addressing the resulting fiscal risks requires a concerted policy focus to sustain high productivity growth, boost the labor force participation of women and older urban people, and in some cases increase immigration. In addition, balancing old-age financial protection with broad coverage and fiscal sustainability will require fundamental changes in the financing of pension and health systems, delivery of health services, and development of long-term care systems. The region is at a crossroads, and sustaining its economic dynamism will require politically challenging policy choices across the life cycle. In the face of such fundamental reforms, the nature of the social contract between the state and citizens, between generations and genders, is likely to evolve quickly in the coming years.

Aging is a subject that has often generated dramatic predictions about its implications for the economic future of EAP, but about which discourse is often oversimplified. Media and popular discourse in much of the region are full of dire warnings about an “aging time bomb,” a “silver tsunami,” and similar descriptions of the negative consequences of rapid aging for future prosperity. While rapid aging is a current or imminent reality in much of the region, the “geriatric Malthusianism” that this sometimes triggers is frequently based on selective reading of the evidence and the misplaced assumption that demographics will change but that policy and behavior will not. This section summarizes key messages and evidence from a forthcoming World Bank report on aging in EAP and implications for public policy.

Rapid aging raises many challenges and risks, but EAP is well positioned to manage the risks, provided it makes sensible policy choices that promote appropriate behavioral change by households and employers. Initial conditions also position EAP better than some regions to achieve healthy and productive aging. It already has long working lives, high savings rates at all ages, and social security systems that to date have fewer unsustainable legacy commitments. But the region is at a crossroad, and managing rapid societal aging while sustaining EAP’s economic dynamism will require policy choices that are politically challenging and that will require strong leadership and building of social consensus.

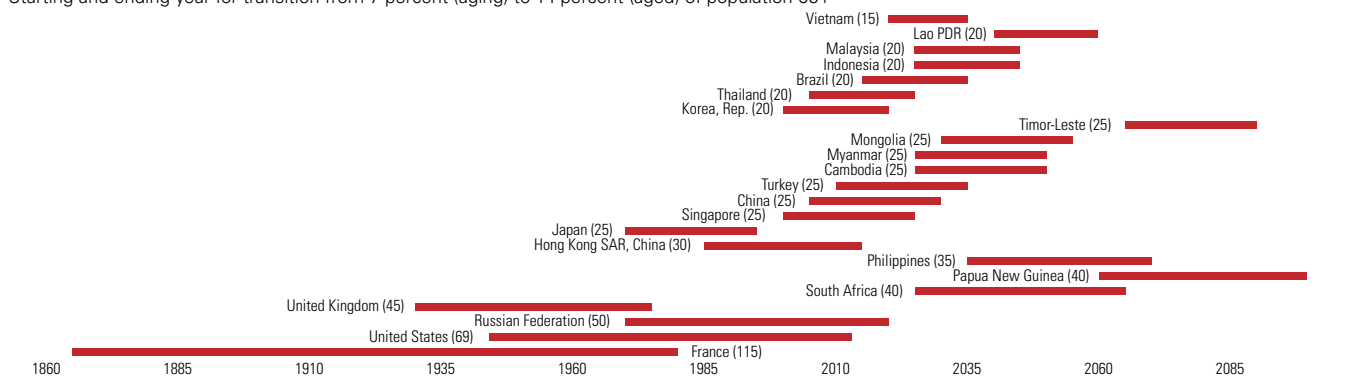
¹ This section was prepared by Philip O’Keefe, Nithin Umapathi, and Aparnaa Somanathan.

EAP is Undergoing a Rapid Demographic and Epidemiological Transition

EAP is aging faster than any region in history, driven primarily by a rapid decline in fertility, but also increased longevity. Nearly all EAP countries outside the Pacific are in the midst of or will soon experience a pace of aging that is unprecedented, transitioning from young to aged societies in 20 to 25 years—transitions that took 50 to over 100 years in Organisation for Economic Co-operation and Development (OECD) countries (figure II.A.1). While the starting points vary, nearly all EAP countries move from aging to aged societies relatively quickly once the aging threshold is reached (with exceptions such as the Philippines and Papua New Guinea).

Figure II.A.1. East Asia countries are aging more quickly than any others in the past

Starting and ending year for transition from 7 percent (aging) to 14 percent (aged) of population 65+



Source: Bank staff estimates using UN (2013) revision and Kinsella and He (2009).

Note: Aging and aged thresholds are UN definitions.

The main driver of aging in EAP has been a sharp decline in fertility. Fertility rates in EAP declined dramatically between 1960 and 2005, from 5.91 to 2.46 children per woman, significantly faster than the global decline from 5.51 to 3.03 children per woman. Fertility rates in several East Asian countries are now among the lowest in the world, with richer East Asian countries averaging only 1.28 children per woman in 2010, and major middle-income countries such as China, Thailand, and Vietnam well below replacement fertility and continuing to fall.

The picture on aging within EAP is diverse, with three groupings of countries evident. The demographic diversity of countries in EAP suggests three groupings. Japan; the Republic of Korea; Singapore; and Hong Kong SAR, China—the wealthiest countries and hereafter called the “Red countries”—are advanced agers, with populations 65+ on average of 14 percent of the total populations in 2010 (figure II.A.2). China, Indonesia, Malaysia, Mongolia, Thailand, and Vietnam represent a middle group, hereafter called the “Orange” countries, which is currently aging very quickly. The third group—hereafter called the “Green” countries—consists of Cambodia, Lao PDR, Myanmar, Papua New Guinea, the Philippines, Timor-Leste, and the Pacific Island Countries (not shown). These countries are still quite young—an average of 4 percent of the population was 65+ in 2010—but will begin to age quickly in coming decades.

Figure II.A.2. Three distinct aging patterns are apparent among EAP countries

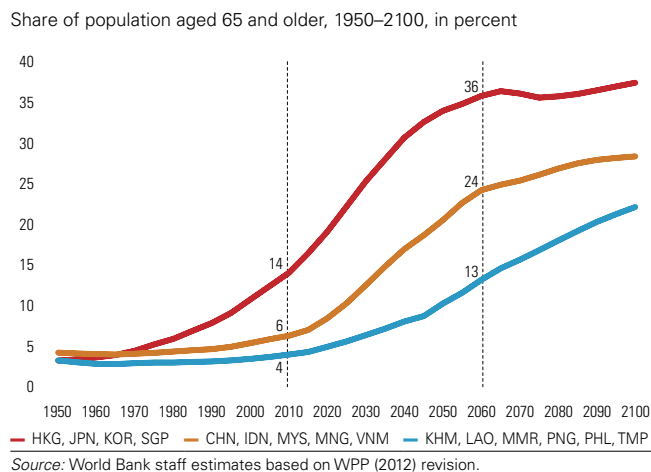
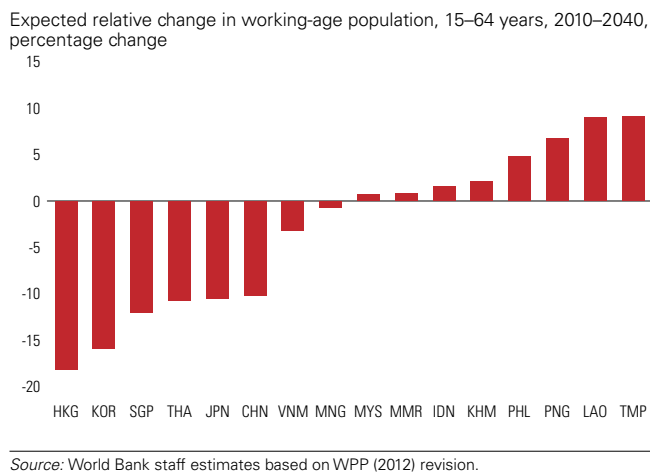


Figure II.A.3. The working-age population will shrink in richer EAP countries



Demographics drive divergent trends in working-age populations, with a number of EAP countries projected to experience sharp declines in their labor forces (figure II.A.3). Several countries will experience substantial declines in the working-age share of their population between 2010 and 2040, of over 15 percent in Korea and at or above 10 percent in Thailand, Japan, and China. In contrast, in Green and some Orange countries, the working-age share of the population is not expected to shrink until after 2040. In absolute terms, the Philippines and Indonesia will account for a large share of the regional increase.

Together with demographic transition, EAP is experiencing a rapid epidemiological transition toward noncommunicable diseases (NCDs), in part driven by population aging. On a positive note, healthy life expectancy (HALE) increased in EAP between 1990 and 2010, though slightly less than total life expectancy. At the same time, the burden of disease due to NCDs has grown rapidly, with initial onset increasingly happening in middle age. Cardiovascular disease, cancer, and diabetes accounted for the bulk of disability-adjusted life years (DALYs) among those aged 60+ in 2010. In low-income EAP, communicable diseases still account for a significant share of premature mortality and morbidity, creating a double burden of disease.

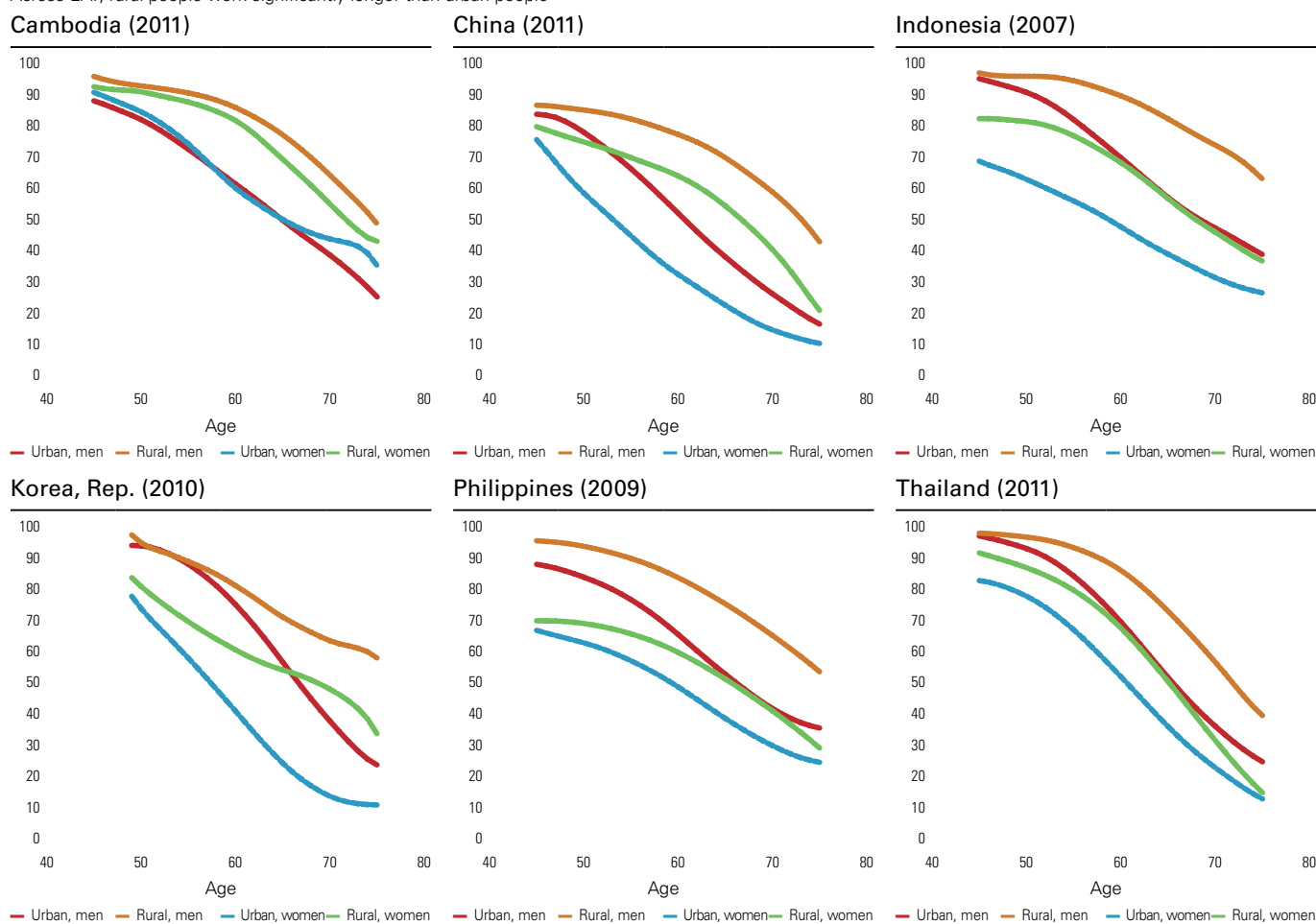
The Situation of Older People in EAP

The situation of older people in EAP is diverse across and within countries, in terms of their poverty status, labor market behavior, and primary sources of support. In terms of living standards, older people across developing EAP have shared in the significant falls in poverty. At the same time, poverty in a number of East and Southeast Asian countries tends to rise with age after 45, before flattening or even declining at the oldest ages. As with the general population, older people with high levels of education (and those who have children with higher levels of education), access to a formal sector pension, and with better health status tend to be better off than their peers. In contrast to the younger adult population, however, employment status has a more complex relationship with elderly poverty, in part because many poorer, often rural, older people have to “work till they drop.”

Co-residence of older people with adult children is significant in EAP, though it varies considerably across countries, and has declined significantly over time in some. Co-residence of older people with their children is quite high, and generally increases between middle age and the mid-60s. For people aged 60+, co-residence rates vary significantly across EAP countries (between 25 and 30 and over 80 percent), with notable variation by gender and urban/rural location. They are particularly high in low-income countries, and, consistent with global patterns, tend to be lower at higher-income levels within countries. Elderly co-residence with children has also been declining rapidly in China, Korea, and Thailand. In China, the co-residence rate for those aged 65 to 70 fell from close to two-thirds in the early 1980s to roughly 43 percent by 2011, while in Korea, co-residence of those 65+ was over 80 percent in 1980 but had fallen to well below 30 percent by 2010.

Figure II.A.4. Labor force participation rates by location and gender, various EAP countries

Across EAP, rural people work significantly longer than urban people



Sources: Giles, Hu, and Huang (2015) using data from the EAP harmonized household surveys, CHARLS 2011; IFLS 2007; KLoSA 2010; and Thai SES 2011.

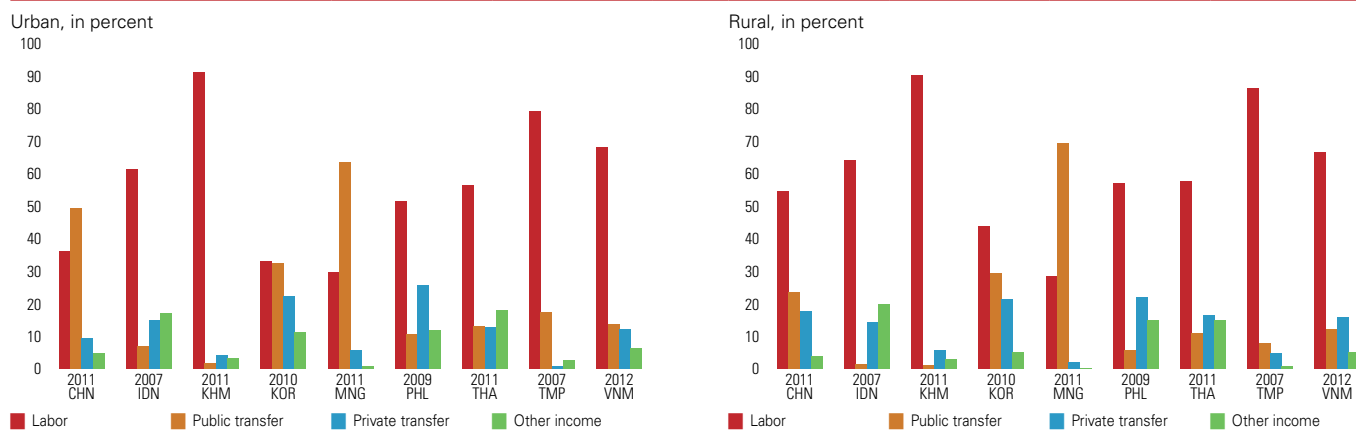
While older people in EAP often work until very old age, there are also significant differences between urban and rural areas and by gender. There are very distinct urban and rural labor markets for older people in EAP (figure II.A.4). While on average people work until late in life, many in urban areas withdraw from work relatively early, and in cases like urban Chinese women, retirement occurs very early, with only around one-third still working at age 60. Withdrawal of urban people from work is clearly correlated with access to a formal sector pension, though caregiving responsibilities for grandchildren and older elderly also play a role in the early

withdrawal of urban women from formal work. Nearly everywhere, urban women are the least likely to work into old age, and gender gaps in participation are substantial. Among those who continue working into old age, self-employment is the dominant form of work, with self-employment rates of 90 percent and higher common in rural areas of EAP.

In addition to working until old ages by global standards, older people in East and Southeast Asia tend to work hard, particularly in rural areas. For countries analyzed for the report, men who continue to work beyond age 65 are working on average 40 hours or more per week, and women are working 30 to 45 hours per week. The picture in rural areas is even more striking, with rural men who continue to work working 30 to 40 hours per week even at age 75, and women working between 20 and 35 hours per week. In addition to what is formally counted as “work,” older people in EAP are often undertaking significant caregiving roles, a social and economic role that is not formally recognized in national accounts.

In terms of sources of support, developing EAP has a distinctive pattern in terms of the roles of the state, families, and individuals in old-age support. Unlike regions such as Latin America and the Caribbean or Europe and Central Asia, where the state has played an important role in old-age support through generous and widespread pension systems, older people in EAP have relied more heavily on their own labor and the support of their families, especially in rural areas. Labor income plays a critical role in old-age support in EAP, with work income dominating other sources of support in nearly all countries for rural areas and in most for urban areas (figure II.A.5). For most countries, private transfers to elderly people in rural areas are also more significant than public transfers, and such familial support is even more pronounced once nonfinancial support is factored in.

Figure II.A.5. Income sources for people 60–85, various EAP, urban (left) and rural (right)



Sources: Giles, Hu, and Huang (2015) using data from the EAP harmonized household surveys, CHARLS 2011; IFLS 2007; KLoSA 2010; and Thai SES 2011.

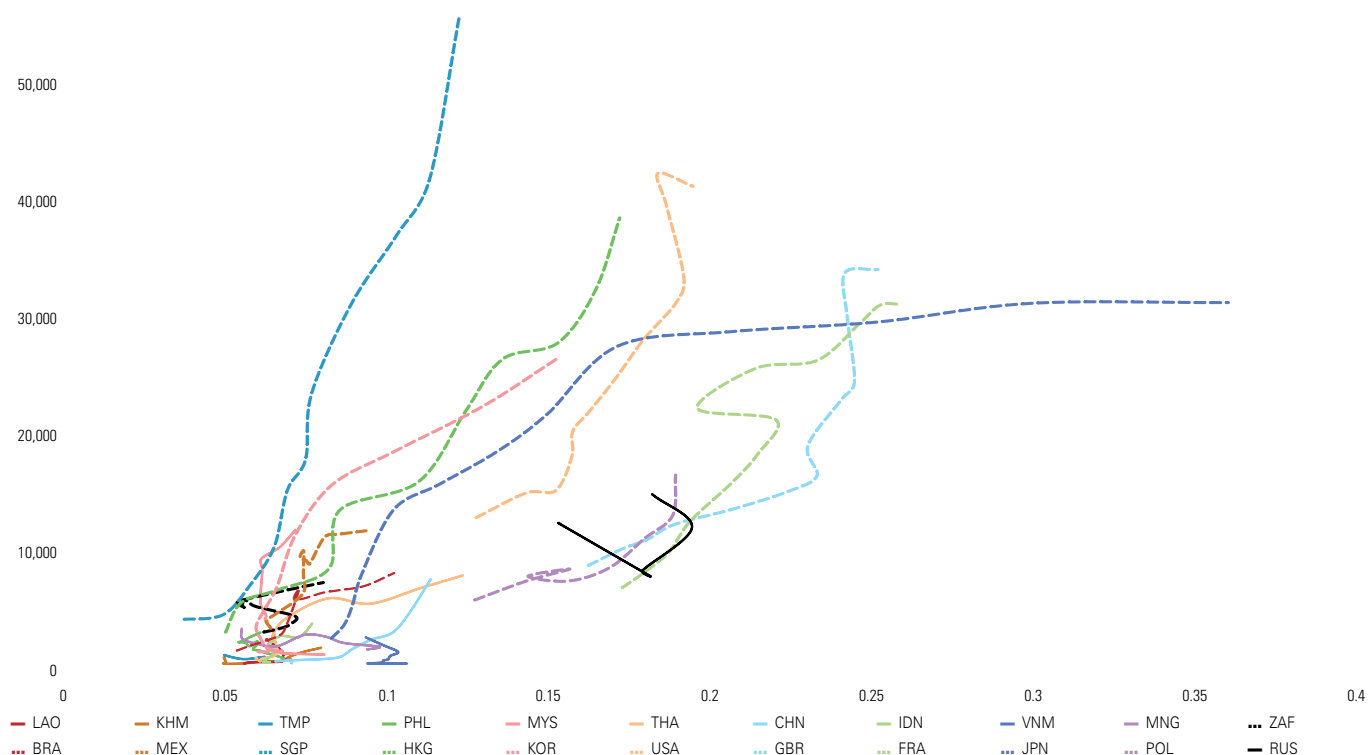
While EAP has common cultural features with respect to sources of old-age support, there is also growing diversity across and within countries rooted in initial conditions such as labor market formality, urban/rural shares, and formal social security coverage. Differences are emerging within EAP, with public transfers playing an important role in, for instance, Mongolia and urban China, but a negligible role in Cambodia and Indonesia, where informality is high and pension and social assistance systems are underdeveloped (figure II.A.5). Even within China, the sharp differences between rural and urban areas are notable. All this points to a rapidly changing landscape. While public transfers play a relatively modest role in old-age support to date in most EAP countries, social expectations of the relative role of the state, families, and retirees themselves in postretirement support are changing rapidly, with opinion surveys showing expectations of future state (rather than familial) support rising sharply.

Aging, Growth, and the Fiscal Situation of EAP Countries

Developing EAP is an acute example of “getting old before getting rich,” with increased elderly dependency kicking in at far lower income levels than in OECD and developed EAP countries. The Orange (largely aging MICs) and Green (largely younger and poorer) countries have been aging—in some cases rapidly—at low levels of gross domestic product (GDP) per capita (figure II.A.6). Two things are clear in this regard. First, aging increases the pressure to maximize productivity growth for developing EAP. Second, both Orange and Green countries will fail to reach the income levels of Red (richer and older) EAP countries, or OECD or middle-income countries such as Mexico, at similar points of the demographic transition, even with sustained productivity growth. Thailand provides a case in point; even with solid growth in recent decades, the pace of aging is outstripping per capita income growth. It is following a path closer to that of Poland, which is now struggling with fiscal pressures from aging. Mongolia provides a more dramatic example of stagnant GDP per capita in the face of rapid aging. While developing EAP countries cannot avoid getting old before getting rich, they can adopt productivity-enhancing reforms that result in elderly dependency/GDP trajectories more like that of Korea than those of Thailand or Mongolia.

Figure II.A.6. Getting old before getting rich in developing EAP

GDP per capita and elderly dependency ratios in EAP, 1980–2010, \$2005 PPP
60,000



Sources: GDP data are PPP converted GDP per capita (Chain Series), at 2005 constant prices for 1950–2010 from Penn World Tables (2012).

Note: Elderly dependency ratios = ratio of population 65+ to population 15–64 using UN (2012) data. PPP = purchasing power parity.

The demographic dividend has played a substantial role in EAP’s remarkable growth story over recent decades, though younger EAP countries will need to deepen reforms if they are to realize the same growth impacts as older EAP countries did at similar stages of demographic transition. Literature on

East Asia finds that around one-third of the high per capita income growth in East Asia from 1960 to the 1990s can be attributed to the demographic dividend, with some estimates of the effect as high as 44 percent of growth in per capita incomes from 1960 to 1990 (Bloom and Williamson 1998; Bloom, Canning, and Malaney 2000; Bloom, Canning, and Sevilla 2003; Kelly and Schmidt, 2005).² In most East Asian countries, the pure demographic effect was compounded by improvements in educational attainment, capital investment, and other factors. For younger EAP countries now in the midst of their youth bulges, and for which rapid aging will come only in future decades, the key is to make these productivity-enhancing reforms and investments now, so that they both maximize the demographic dividend and are prepared for rapid aging when it comes.

The tailwind provided by demographics to growth in older EAP countries has raised fears of a headwind as labor force size declines and aging accelerates, but these forces can be mitigated by policy and behavioral responses. Overall, while the risks to future growth are real, even rapidly aging countries have significant scope to mitigate the potentially negative labor force and growth impacts of aging. However, while the channels for mitigating the potential impacts of aging on growth in EAP are significant, benign outcomes cannot be taken for granted.

Managing the growth impacts of aging will require public policy action and wider behavioral change in a range of areas, and it is important to keep in mind that “aging policy” is not just about old people but must address issues across the life cycle. At the macro level, the balance of priorities is somewhat distinct across the country groupings in EAP:

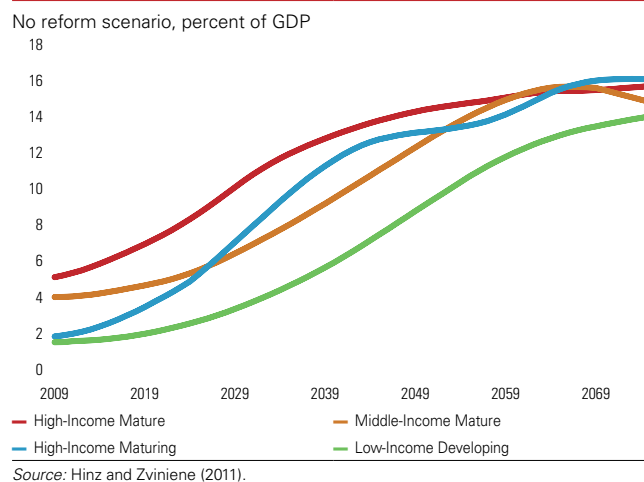
- For *Red countries*, slowing the structural labor force decline from aging will be the most critical challenge, since most are closer overall to the productivity frontier and, therefore, without easy options for major gains in labor productivity. An enhanced focus on increasing female labor force participation, extending productive working lives, and in some countries increasing immigration of younger workers from within the region, will be vital (see below).
- For *Orange countries*, the challenges of the demographic transition require sustaining high productivity growth. Even assuming this, they will enter the ranks of aged societies at much lower levels of income than the Red countries. At the same time, they will need to mitigate the labor supply and fiscal impacts of rapid aging through ongoing reforms of pension and health systems and labor policies to extend the working lives of their urban and formal sector workers as they undergo rapid urbanization and control the fiscal risks of entitlement programs. There are reasons for cautious optimism, because healthier and more educated cohorts will be better prepared for the prospect of longer working lives than previous generations.
- The younger *Green countries* will enjoy favorable demographics as the youth bulge continues to feed into the labor force for the next few decades, and the priorities are, first, to establish the conditions to realize maximum GDP growth from the demographic dividend (basically investments to raise productivity and maximize youth employment); and second, to avoid adopting policies in areas like pensions and health that are affordable now but would rapidly become unsustainable once aging accelerates. Their success in doing so will determine their readiness to manage aging when it accelerates over the coming two to three decades.

² This literature generally excludes the Pacific.

More specifically, deepening reforms in labor and financial markets, immigration policy, the education sector, and other areas will be vital, but is also likely to prove challenging. With respect to labor force decline, the channels for mitigating the effects of aging include extending productive working lives (through a mixture of incentives and mandates, both within the labor market itself and in areas such as pension reform), raising female labor force participation (with particular emphasis on making childcare available and affordable), and increasing immigration (which will require proactive efforts in both sending and receiving countries). These quantitative channels will be supplemented by improvements in labor force *quality* as a result of the impressive achievements of EAP countries in expanding access to higher levels of education over recent decades and ongoing efforts to improve educational quality. There is also likely to be capital deepening in response to labor force decline, so that labor productivity could be expected to increase. More broadly, evidence from EAP suggests that concerns about the impacts of aging on savings and capital formation may be overstated. First, household and corporate savings rates are high in EAP and provide a more solid foundation than other regions. Second, survey evidence points to flatter savings/age profiles in EAP than in other parts of the world, and to an increase in savings rates at all ages in the region over recent decades. Third, there are significant inefficiencies in financial markets in developing EAP that suggest there is large scope for more efficient mediation of savings into capital formation and productivity.

Even assuming that overly adverse *growth* impacts from rapid aging can be avoided, the *fiscal* risks of “business as usual” in core programs such as pensions, health, and long-term care are substantial. Major fiscal risks from aging are already manifesting in the region and will require policy leadership to mitigate. Various projections of pensions and health spending in EAP reveal significant fiscal pressure over coming decades in the absence of reform. For instance, stylized projections by broad country type in Asia-Pacific Economic Cooperation (APEC) countries through 2070 show countries converging to spending to GDP ratios that are 8 to 12 percentage points higher than current levels (figure II.A.7). Cash flow deficits are expected to emerge in most developing EAP defined benefit schemes in coming decades, with deficits ranging from 1.4 to 4.5 percent of GDP by 2040. Health care spending projections also point to increasing public spending (though notably lower than increases in pension spending). Aging accounts for around one-third of the projected increase in public health spending in several developing EAP countries, though the affect is higher in China. Across pensions and health, a more complex (and uncertain) picture of fiscal pressures from aging emerges if debt dynamics are incorporated into fiscal projections. Where increased age-related spending drives up deficits and they are funded through debt, the potential for an upward spiral in public spending is substantial.

Figure II.A.7. Pension projections by stylized country groupings for APEC countries, 2010–70



Challenges for Pensions, Health, and Long-Term Care Systems with Aging

Across the key areas of pensions, health, and long-term care, there are some common reform challenges:³

- The first is that policy-driven coverage expansion (achieving universal health coverage in the case of health and wide coverage of pensions, plus exploration of a state role in long-term care) is being executed at the same time as rapid aging is taking place in most Orange and some Green countries. There is thus a growing commitment to shift some of the burden of old age financial support and health care costs from families and individuals to the state through pooling mechanisms of different forms. In that sense, there is a double challenge to navigate on the expenditure side.
- The second is that pension and health systems face challenges of balancing coverage, adequacy, and sustainability. To date, the emerging approach in developing EAP has been to prioritize coverage expansion, though often with shallow financial protection (as evidenced by the reliance on modest social pensions to expand coverage of pensions in countries such as China, Thailand, and several Pacific Island Countries; and the fact that even those with health insurance coverage have continued to have fairly high out-of-pocket spending in countries such as China, Indonesia, the Philippines, and Vietnam; see Part II.B, "Macroeconomic Implications of Achieving Universal Health Coverage in East Asia and Pacific" on universal health care).

In terms of pension system design, no region exhibits a greater heterogeneity than East Asia, and this is reflected in the policy challenges faced by different groups of countries. The pension challenges facing EAP countries vary not only because of their disparate demographic situations, but because of past policy choices and the nature of their labor and capital markets. The richer (Red) countries have achieved wide coverage of their systems with better financial sustainability than other rich countries, but they face challenges of pension adequacy and hence old-age financial protection. The middle-income (largely Orange) countries are grappling with the dual challenges of improving sustainability of their existing or legacy systems at the same time as trying to expand coverage to large uncovered informal sectors, both challenges given urgency by the rapid pace of aging. For the poorer and younger (Green) EAP countries, the key question is the appropriate model of pension systems that can achieve significant coverage over time, and how to avoid overreliance on contributory pension models that have proven ineffective in the rest of the world in expanding coverage sustainably.

Addressing the pension coverage gap in East Asia will require policies that move away from the reliance solely on payroll taxes to finance pensions—that is, a paradigm shift in the way that pension systems have been financed historically. This shift is motivated by the limitations of a traditional social insurance approach. As in many developing countries, traditional contributory approaches risk “losing the race” between pension coverage expansion and rapid societal aging. The good news is, however, that considerable innovation is already happening within EAP. There has been a rapid expansion of social pensions and budget-financed matching contribution schemes for informal sector workers in response to the persistent failure of contributory pension schemes in “closing the coverage gap.” This was the case in Korea in the 2004 reform, Chile in 2008, China in 2011, Thailand in the 2000s, and Mexico in 2012.⁴ It also parallels the successful regional experience

³ See Part II.B, "Macroeconomic Implications of Achieving Universal Health Coverage in East Asia and Pacific", for a review of the health systems challenges posed by the rise of NCDs in the region.

⁴ See Holzmann, Robalino, and Takayama (2009) on regional and global experience with social pensions; and Hinz et al. (2013) on experience with matching defined contributions.

in expanding health insurance coverage through heavily subsidized health insurance premiums. Meanwhile, the use of consumption taxes in Japan and budget support for the contributory pension scheme in China is partly driven by reluctance to raise payroll tax rates further. The trend is not uniform, however, as evidenced by the introduction of a social insurance scheme in Lao PDR and legislation in Indonesia and Myanmar that make these countries among the last in the world to have followed the Bismarckian path to pension provision. The experience of dozens of countries that had once faced the same choice suggests that it may not be the appropriate path.

A way forward in pension reform should be based on the premise that the redistributive element of the pension system should be financed from general revenues and clearly distinguished from the insurance or savings component. The latter should ideally be financed by individuals on an actuarially fair basis. The simplest approach would be to eschew the mandated scheme altogether and instead have a social pension with broad coverage (for example, universal or affluence-tested) complemented by a voluntary retirement savings scheme. This is the approach in New Zealand, which features an opt-in default for a voluntary defined contribution scheme that has led to relatively high participation rates. However, this option is not likely to be realistic in countries that already have contributory mandates, even for those such as Myanmar and Timor-Leste, which only recently passed legislation mandating contributions. Countries like these with nascent contributory systems, along with Indonesia, which has yet to define its defined benefits scheme parameters, should aim for actuarially fair and modest schemes and leave redistribution to be financed through general revenues, either through social assistance or social pensions.

For the wider group of EAP countries with mature but low coverage mandated contributory systems, they should also shift the balance of pension system financing toward general-revenue-financed redistribution and modest target benefit levels, but in a way that does not compromise incentives to participate in the contributory scheme. This requires strong coordination between social and contributory pension design and implementation. The most feasible path for such countries is likely to mix residual mandatory contributory systems with subsidized voluntary contributory approaches, and social pensions targeted to wider or narrower populations depending on the level of coverage achieved through contributory mechanisms. Countries such as China, Korea, and Thailand provide distinctive models of this approach. While for now the adequacy of pensions for the majority is very modest, sustained growth should allow for deepening financial protection over time.

In the health sector, aging exacerbates systemic reform challenges for all EAP countries because the increased incidence of chronic NCDs with age means both that the share of people living with these conditions will increase, and there will be higher shares of people living with multiple chronic NCDs. In this context, the consequences of a fragmented and acute care model of health service delivery are even more pronounced in populations with rising shares of older people. The evidence in EAP indicates that health system shortcomings and welfare consequences are notably more severe for older people. They are much more likely to be admitted to inpatient care (often unnecessarily); are much more reliant on pharmaceuticals than average, and hence are more affected by poor pharmaceutical purchasing and prescription practices; and they experience substantially higher out-of-pocket spending and higher rates of catastrophic health spending. They also have higher co-morbidity rates, which necessitate a more mixed set of services and more complex management of movement between levels of the health system. And finally, older people experience functional and cognitive decline, which engenders new demands on health systems such as dealing with dementia and mobility challenges. Therefore, in an aging population, it is all the more imperative to implement a health system where prevention and treatment are offered in a coordinated manner over a sustained period of time,

and in which individuals assume greater responsibility in managing their own care. Detailed recommendations in this regard are provided in section II.B on universal health care in this Update.

Formal long-term care (LTC) systems in developing EAP remain nascent, but a growing number of aging countries are grappling with the appropriate role of the state in an area that has traditionally been the domain of families, communities, and the health system. Rapid aging and social change have exposed the limitations of traditional informal modes of LTC for frail elderly people in EAP. Part of the response has been default reliance on health systems for LTC, but this tends to be costly and complicates health reform efforts. Proactive policy choices in the LTC domain are therefore important, but require careful planning with respect to their interaction with informal care systems and formal health and welfare systems. The policy choices for LTC in developing EAP remain for the most part open.

Overarching Challenges and Knowledge Gaps in Aging

One of the key challenges in shaping public policy responses to aging is its inherently multisectoral nature. Aging—like areas such as early childhood—presents inherent challenges to the institutional and policy setups of many governments due to the fact that it cuts across so many sectors and stages of life. Governments are typically not well arranged to respond multisectorally. While a number of EAP countries have recognized this challenge and have established national aging commissions to promote more holistic thinking on the subject, they tend to be primarily advocacy agencies that to date lack the political and bureaucratic clout to drive whole-of-government approaches. There are, however, examples from richer countries in the region that aim to bring the wider view into sectoral policies, a good case being the periodic Inter-Generational Reports produced by the Productivity Commission of Australia for the Treasury, which help set long-term expenditure and policy priorities for age-related programs. Other countries such as Japan are better placed than some others institutionally, with a consolidated health, labor, and welfare ministry that brings a critical mass of age-related policies and programs under a single body.

A second overarching challenge is the political economy of reform and behavioral change. Many of the policy reforms needed to promote healthy and productive aging are politically difficult and may challenge societal norms. Extending working lives has proven politically challenging in many parts of the world, most notably on efforts to raise retirement ages. Increasing female labor force participation involves deeply rooted cultural norms and in some cases trade-offs, such as when retired middle-aged women provide the backbone of informal childcare and aged care. Similarly, the track record on immigration from younger to older countries in the region is mixed. Health system reform is also notoriously difficult, both with providers and the wider population, and changing ingrained lifestyle habits that drive the NCD epidemic is a generational challenge. All these measures will require patient building of social consensus. There is also a wider challenge of intergenerational equity and political economy. Larger aged populations in other parts of the world have been successful at lobbying for their interests, at times at the cost of younger generations. Experience from Red EAP countries suggests that they have balanced the interests of different generations and shared the costs and benefits of an aging population more equitably than other parts of the world, but the further evolution of the political economy dynamics around aging will be interesting to watch.

Another big picture question is the appropriate roles of public policy and market forces in shaping the response to rapid aging. While proactive public policy will be required, it will not necessarily be the right response to every challenge, and a careful balance of mandates, incentives, and reliance on market forces will be required. The experience of Red EAP countries in the area of extending working lives provides a nice case in point where supportive public policies are gaining more traction as the market forces of supply and demand have increased the appeal of older workers. Equally, the most effective public policies will sometimes involve a retreat from state direction in cases where policies like rigid seniority wages or unnecessary restrictions on women's work hinder the play of market forces that would be expected to increase the employment of older people and women.

Finally, it is clear that there remains a huge amount that is unknown with respect to aging in EAP and globally. While there is a growing body of work and policy innovation in EAP with respect to aging, no country can be said to have "got it right," and understanding of long-term trends and policy impacts is often speculative. There are large remaining knowledge gaps—on the interaction of labor and savings market behavior and rapid social security reforms; on societal and individual behavioral change in the face of rapid growth, urbanization, and changing family structures; on how to reverse ultra-low fertility rates in richer EAP countries; on the productivity of older workers and the cost-effectiveness of policies to extend working lives; on the cross-country dimensions of aging in the region with respect to migration, capital flows, and other factors; and more broadly on the respective roles of market forces and public policy in promoting health and productive aging. Even the most fundamental question of the trajectory of fertility and aging has been shown in the past to be consistently imperfect. Even where global experience offers useful lessons, the speed of aging in EAP and its unique cultural and political economy context suggests that caution is needed in predicting future trends.

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II.B. *Macroeconomic Implications of Achieving Universal Health Coverage in East Asia and Pacific*¹

Many countries in East Asia and Pacific have made universal health coverage (UHC) an explicit public policy goal in recent decades. Financing and implementing UHC programs in a fiscally sustainable manner will be vital for the success of these policies. General revenue financing has played a crucial role to date, and will continue to be important. Experience from across the world shows that delinking entitlement to health coverage from employment and from users' direct contributions is critical to ensuring that the poor, near-poor, and informal sector workers are enrolled. To this end, it is necessary to fully subsidize coverage through general revenues. Moreover, UHC implies not just universal enrollment, but also improving financial protection and ensuring access to good-quality services. All this will put immense pressure on public budgets, exacerbated by other cost drivers such as population aging and noncommunicable diseases. To increase fiscal space, governments need to expand the revenue base for health. Potential new revenue sources include excise taxes on alcohol and tobacco ("sin taxes"), and consumption taxes such as value-added taxes and mobile phone taxes. In addition, costs urgently need to be contained, by reforming mechanisms for paying health care providers, purchasing pharmaceuticals, and rationalizing among new health care technologies.

Moving toward Universal Health Coverage

The East Asia and Pacific (EAP) region is diverse in terms of levels of health care coverage achieved across countries and health systems features. Countries such as Japan, the Republic of Korea, Malaysia, and Thailand have achieved high levels of access to services and financial protection for the entire population. In many of the low- and middle-income countries, health-related expenditure shocks caused by inadequate coverage are a prominent source of impoverishment for millions of households every year. Health care is financed predominantly through general revenues in Malaysia and Hong Kong SAR, China; mainly social health insurance in Japan, Korea, and Taiwan, China; and some combination of the two in most others. Service delivery typically involves a mix of public and private services, but countries differ widely in the share of each.

Diverse as they are, most countries have made universal health coverage (UHC) an explicit public policy goal in the last two decades, with support from the highest levels of government. Countries such as China can claim to provide almost universal coverage. Other countries have set explicit target dates as a way to mobilize political support: Indonesia in 2019, Vietnam in 2020, and Lao PDR in 2025. Such high-level commitments are motivated by the need to address inequalities, strengthen social cohesion, and meet the expectations of a growing middle class. They also reflect growing recognition that investments in the health of the population are ultimately beneficial for economic growth. Recent estimates suggest that reductions in mortality accounted for about 11 percent of recent economic growth in low- and middle-income countries (Jamison et al. 2013).

¹ This note was prepared by Aparnaa Somanathan, Caryn Bredenkamp, Eko Setyo Pambudi, and Ajay Tandon.

Looking ahead, increasing fiscal space for health by expanding the revenue base and securing better value from existing resources will be critical for the financial sustainability of efforts to achieve UHC. To date, government health spending financed through general revenues has played a critical role in the progress of EAP countries toward UHC. Several challenges remain, however. Large segments of the population remain without any form of coverage. Benefit levels remain relatively shallow in many publicly funded programs, while out-of-pocket spending is generally high. From a service delivery perspective, health systems in the region are ill-prepared to cope with rising health care demand fueled by expanded entitlements, the rise in the prevalence of noncommunicable diseases (NCDs), and a rapidly aging population, all of which are significant cost drivers. Further increases in the budgetary allocation for health will be important for meeting UHC goals. However, mobilizing general revenues to finance all of the UHC policy commitments is not desirable from a macrofiscal perspective. Addressing inefficiencies and securing better value from existing resources will be just as important.

This note examines the macrofiscal implications of the drive to achieve UHC in the region, and policy options for dealing with them.

What exactly is UHC?

UHC has been defined as a system in which all people who need health services receive them, without undue financial hardship (WHO 2010). This is an aspirational goal. Even where all people are protected from financial hardship, there is always some gap between the need for services and the use of services, and quality often falls short. To transform UHC from an aspirational goal into an achievable objective requires identifying the specific goals embedded within the definition and orienting policy toward progress on these goals. Reframing the goal as moving toward UHC, rather than achieving UHC, helps shift the focus toward taking actions to reduce the gap between the need for and use of services, and improving financial protection (Kutzin, Cashin, and Yip, forthcoming 2015).

Measuring Progress

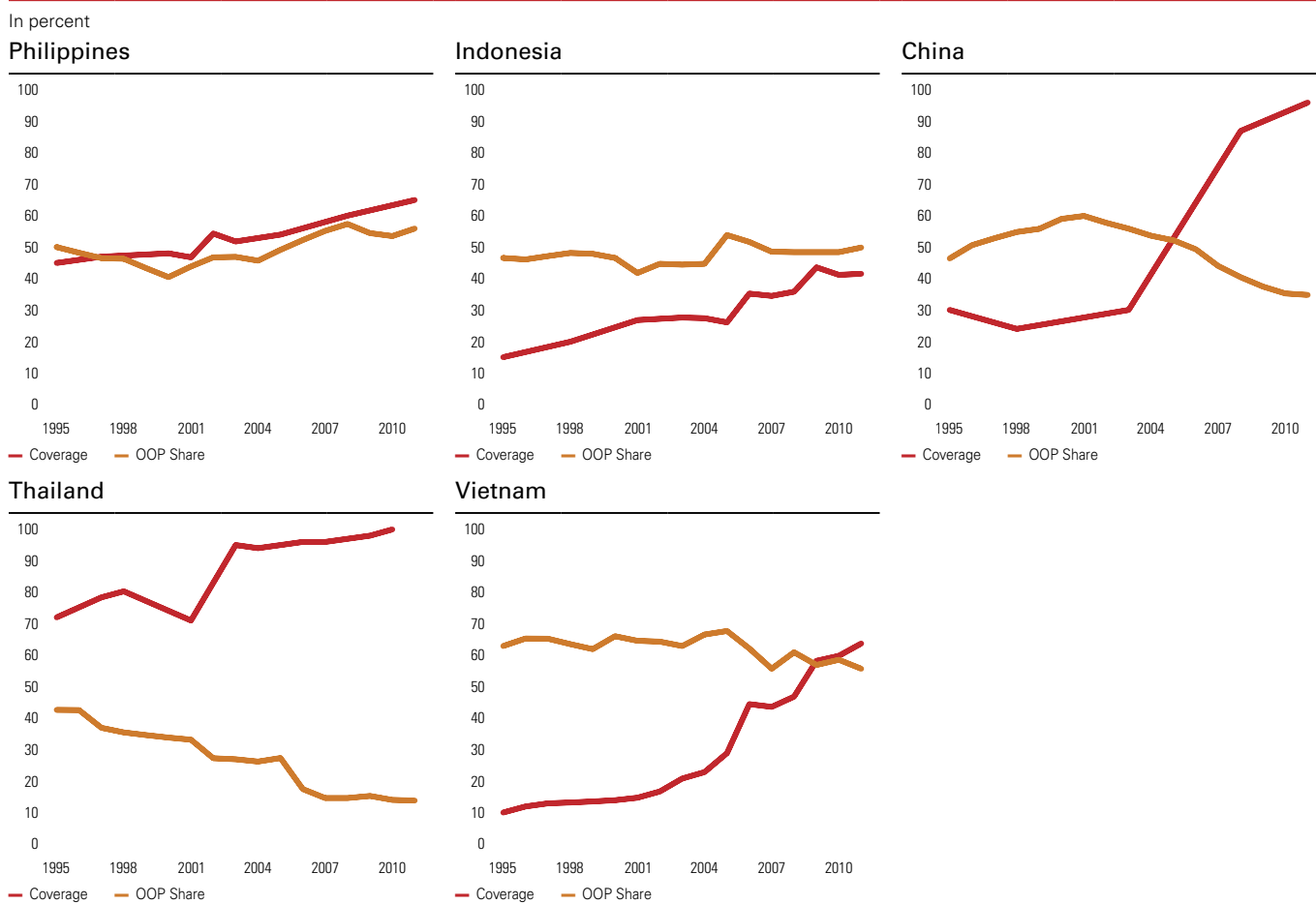
In moving toward UHC, there are three interrelated goals to consider: (a) the full spectrum of quality health services according to need, (b) financial protection from direct payment for health services when consumed, and (c) coverage for the entire population (WHO 2013). The World Health Organization-World Bank framework for monitoring progress toward UHC recommends two sets of targets for assessing progress to UHC: at least 80 percent coverage of essential health services, regardless of level of wealth, place of residence, or gender; and 100 percent financial protection from both catastrophic and impoverishing health payments for the population as a whole, including for specified groups of the population such as the poorest 40 percent. Comparable data for all of these indicators are not yet available.

EAP countries have made progress in increasing population coverage of insurance and/or general-revenue-funded programs. Indonesia and Vietnam have increased enrollment in health insurance to 40 to 60 percent of their populations with a combination of contributory and noncontributory tax-financed social insurance programs. The ratios are 85 to 95 percent in the Philippines, China, and Mongolia. Coverage is lower in poorer countries such as Cambodia, Lao PDR, and Papua New Guinea, but efforts have been made to

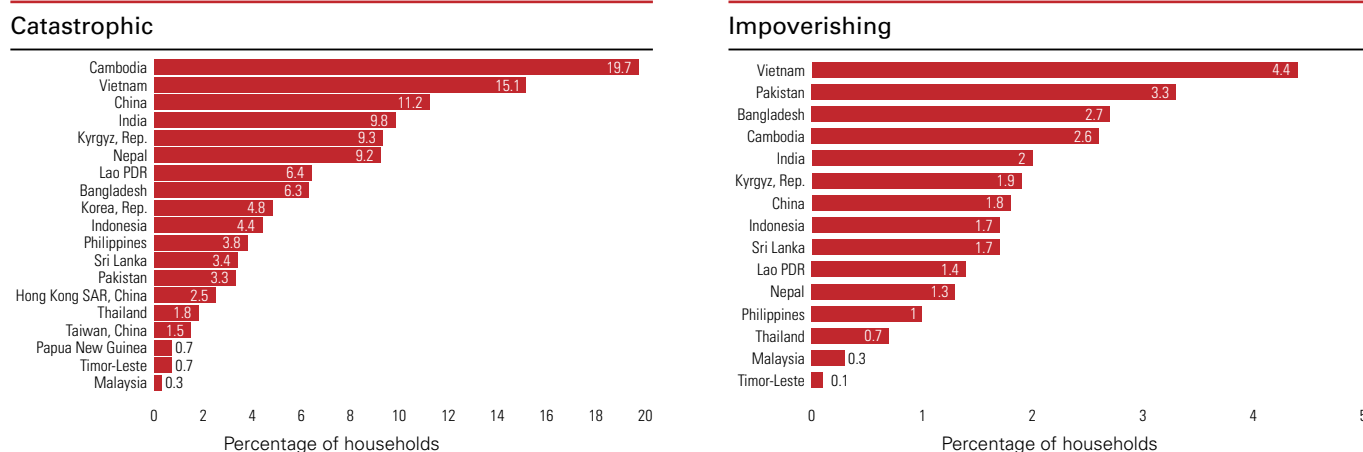
remove financial barriers for targeted subgroups such as the poor and/or specific services, such as maternal and child health.

UHC policy commitments have not always translated into affordable coverage and financial protection for the population (Chakraborty 2013; Hanvoravongchai 2013; Harimurti et al. 2013; Liang and Langenbrunner 2013; Somanathan, Dao, and Tien 2013). The out-of-pocket (OOP) share of total expenditures (figure II.B.1), and the incidence of catastrophic and impoverishing OOP payments remains high in most countries (figure II.B.2). In Cambodia, China, and Vietnam, 10 to 20 percent of households incur OOP payments that are catastrophic, defined as exceeding 25 percent of their monthly household budget in any one month.

Figure II.B.1. Trends in coverage and OOP share of total health spending, 1995–2010



Source: Somanathan et al. 2014.

Figure II.B.2. Catastrophic and impoverishing impacts of health OOP expenditures, 2000s

Source: Rannan-Eliya et al, 2013.

Note: (a) Catastrophic impacts based on threshold of 25 percent of household expenditure in past month. Impoverishing impacts are percentage of households pushed below PPP\$2.15 poverty line in past month. (b) Survey design can differ across surveys, so comparisons are not strictly comparable.

The Political Economy of UHC

The political economy underpinnings of UHC are important for understanding their macrofiscal implications for the region. UHC as a concept emerged after World War II, underpinned in many countries by a broad value consensus on social cohesion (Kutzin, Cashin, and Yip, forthcoming 2015). In postwar Japan, as the major political parties competed over the establishment of the welfare state with health insurance for all as a popular and tangible goal, insurance coverage expanded quickly (Ikegami et al. 2011). Similarly, in EAP today, the adoption of UHC as a national priority has been motivated by the need to mobilize political support and increase social cohesion.

In many EAP countries, high-level policy commitments to attain UHC were preceded by major economic and political transitions. In Indonesia, they followed the financial crisis in 1997 and democratization in the early 2000s. In China and Vietnam, the breakdown of the state-run health system following market-oriented reforms in the 1990s, and its deleterious effects on health and welfare, led to gradual coverage expansion in the 2000s. More recently, the political leadership in these two countries has prioritized the deepening and consolidation of coverage as a means to enhance social cohesion. In Mongolia, following the collapse of the state-run health system, the first democratically elected government stepped in to subsidize near-universal enrollment in social health insurance in 1993. In Papua New Guinea, the removal of user fees for primary health care, an important step in moving toward UHC, was a promise to voters that the newly elected government delivered on in 2013.

In other EAP countries, social movements were instrumental in putting UHC on the political agenda, and holding governments accountable for those reforms. In Thailand, for instance, health care professionals founded an organization called the Rural Doctors' Society, which worked with grassroots partners in civil society to make UHC an issue in the national elections in 2001. The movement remained engaged in the implementation and governance of the new Universal Coverage Scheme (Harris 2013). In Malaysia, where universal coverage was established in the 1950s, politics continues to play a role: health financing reforms were a major political issue during the 2013 elections.

The significant political momentum underlying EAP's coverage expansion has two important macrofiscal implications.

First, it means that governments choose to use general revenues to finance health. Before UHC as a policy goal gathered momentum, many countries introduced contributory health insurance for formal sector workers. The expectation was that such coverage programs would become self-sustaining, enabling public subsidies for health services to be captured only by the poor. However, a commitment to UHC means covering whole populations including the poor and the informal sector, who are less likely to contribute. It implies a shift away from purely contributory funding mechanisms to general revenues to subsidize the health insurance contributions of those who cannot afford to pay or whose contributions are administratively difficult to collect (Kutzin, Cashin, and Yip, forthcoming 2015).

Second, the way in which coverage expanded has created entrenched political interests, leading to inefficient financing arrangements and undermining cost-containment goals in the health sector. By initiating explicit coverage with the formal sector, EAP governments provided privileged access to health care to a group that is politically and economically influential. Those initially covered resisted extending the same entitlements to the rest of the population, resulting in multiple insurance schemes being created with varying levels of coverage. They also proved politically difficult to integrate, since any such measure would redistribute resources across organized interest groups. Reforms aimed at moving toward UHC in Indonesia and Vietnam led to the unification of different insurance schemes in principle, but with large variations in coverage in practice. In Thailand, interest group politics have prevented the unification of schemes; civil servants maintain their own scheme as do formal sector workers. Multiple risk pools are both inequitable and inefficient. Moreover, the initial, fairly generous benefit levels provided to the formal sector stymie efforts to rationalize benefits packages based on cost-effectiveness and other criteria. This is a serious threat to cost containment since coverage of the same generous benefits package is extended to the whole population.

The Macrofiscal Implications of UHC

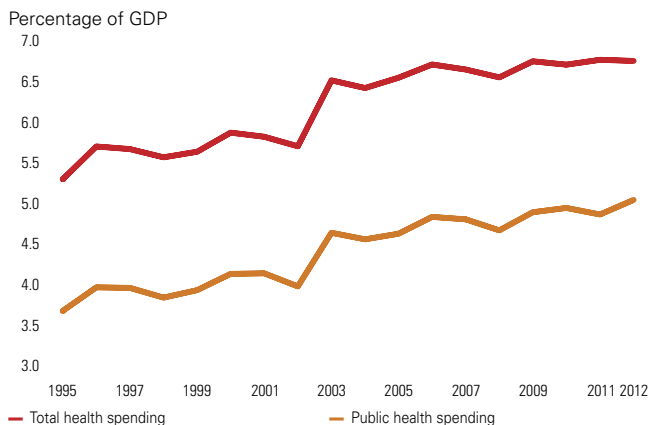
Government health spending: a critical component in the drive to achieve UHC

Health spending as a share of GDP has risen dramatically in the last two decades in EAP (figure II.B.3). Today, the EAP region is a relatively high spender on health compared to other regions (table II.B.1), but with a lot of variation across countries in levels and composition of spending (figure II.B.4). Total health expenditures per capita were under US\$50 in Myanmar, and over US\$900 in Palau in 2012.

The share of government expenditures devoted to health also rose dramatically during 1995–2005. It is currently just under 13 percent, second only to the Latin America and the Caribbean region (figure II.B.5). All the countries that achieved significant expansion in coverage during the late 1990s and early 2000s (China, Indonesia, Mongolia, the Philippines, Thailand, and Vietnam) saw public health spending rise relative to GDP (figure II.B.6). For instance, in Thailand, during its big national push toward UHC between 1998 and 2008, the share of the national budget devoted to health increased by around 14 percentage points. Spending subsequently declined

slightly, but the health share remains among the highest in the region. Similarly, in Vietnam, as social health insurance was introduced between 2006 and 2010, government health spending increased faster than GDP or overall government spending.

Figure II.B.3. Significant increases in health spending in EAP, 1995–2012



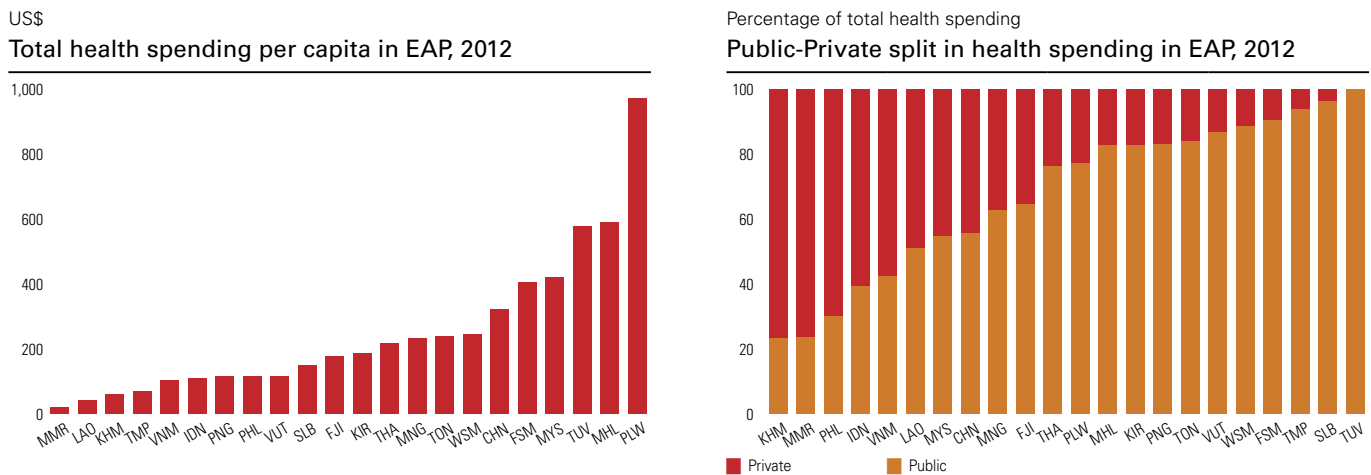
Source: Authors' estimates using WHO (2014).

Table II.B.1. Health spending in EAP compared to other regions, as a share of GDP, 2012

Region	Total health spending (%)	Public spending on health (%)
East Asia & Pacific	7.5	4.1
Europe & Central Asia	7.4	4.2
Latin America & the Caribbean	8.2	4.5
Middle East & North Africa	6.4	2.1
North America	10.9	7.7
South Asia	8.6	1.8

Source: Authors' estimates using WHO (2014).

Figure II.B.4. Wide variation in levels and composition of health expenditures across EAP, 2012



Source: Authors' estimates using WHO (2014).

Figure II.B.5. Health as a share of government expenditure, 1995–2012

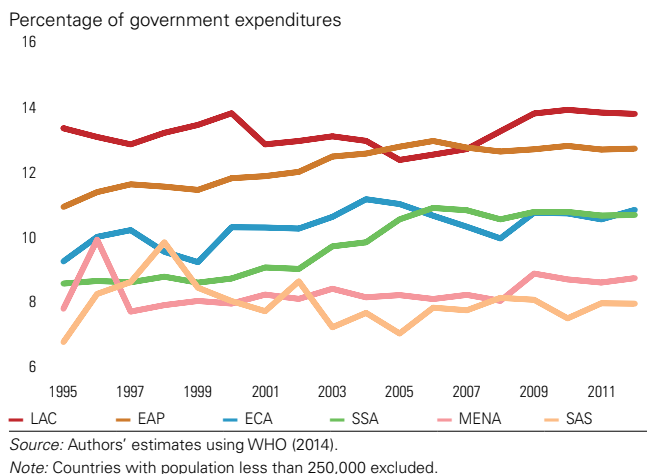
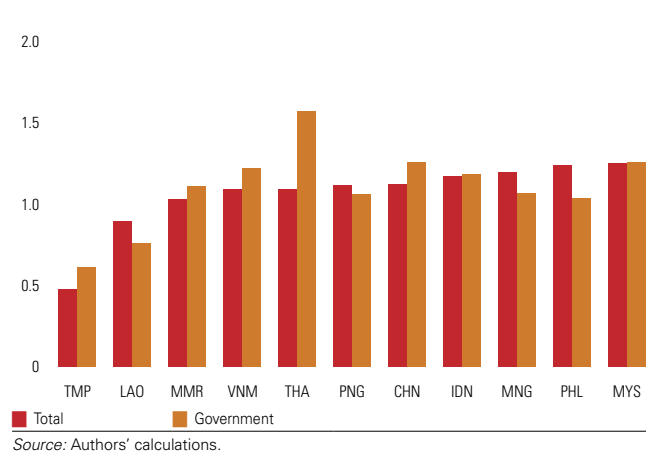


Figure II.B.6. Elasticity of total and public health spending relative to GDP in selected EAP countries, 1995–2012



Why has general revenue financing been so critical for progressing toward UHC?

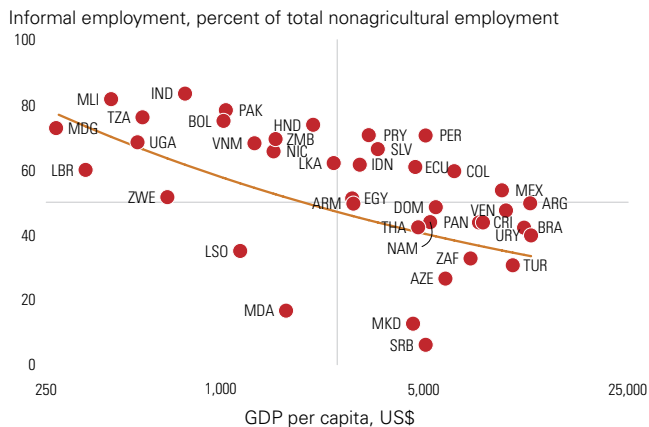
Enrolling the poor and other vulnerable groups² through contributory means, even if partially subsidized, has proven difficult in many countries. Despite large reductions in the poverty rate, 18 percent of EAP's population continues to live on less than \$2.00 a day PPP (see Part I). Not only does this mean that premiums could be unaffordable for many, the process of having to enroll creates additional barriers to access for the poor. Using general revenue financing to cover the poor avoids many of the challenges of contributions-based enrollment. Indonesia, the Philippines, Thailand, and Vietnam have adopted this approach.

Enrolling the informal sector has proved even more challenging. Globally and historically, richer countries tended to have lower levels of informality (figure II.B.7). Japan; Korea; and Taiwan, China saw dramatic reductions in informality alongside income growth through the 1970s and 1980s, which enabled them to expand coverage through contributory enrollment. In EAP, informality has proved more persistent (figure II.B.8). Empirically, partial subsidies, even when combined with assistance in enrolling (for instance, information and reminders) have proven less effective than thought in increasing enrollment in the informal sector (Capuno et al. 2014; Wagstaff et al. 2014). For informal workers, who are also often near-poor, the financial and transaction costs of enrolling are binding constraints. Globally, the evidence is clear: absent full subsidies that reduce the financial and transaction costs of enrolling to zero, it would be impossible to fully enroll the informal sector. The only countries that have been successful in enrolling all or most of the informal sector are Thailand (100 percent premium subsidy) and China (90 percent premium subsidy under the National Cooperative Medical Scheme).

The reliance of EAP countries on general revenues to finance coverage expansion is not unusual. Globally, with the move toward UHC, entitlement to health coverage is being delinked from employment and direct contributions from users generally. The share of the budget devoted to health typically increases substantially during periods of rapid expansion, sometimes with a time lag after the policy commitment is made (figure II.B.9).

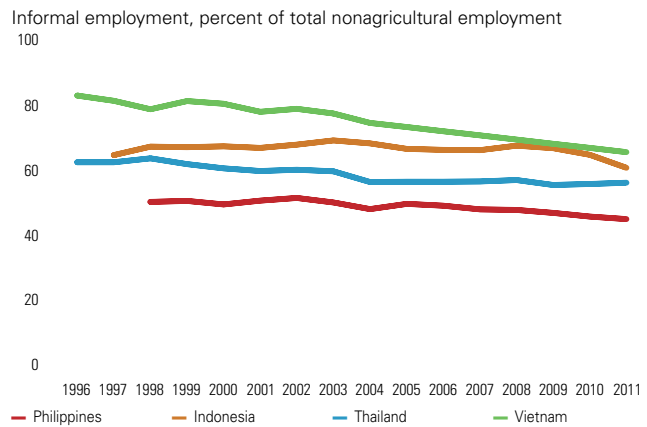
² These included the elderly, war veterans, children, students, and others. Groups included varied across countries.

Figure II.B.7. Informal employment and GDP per capita in 41 countries



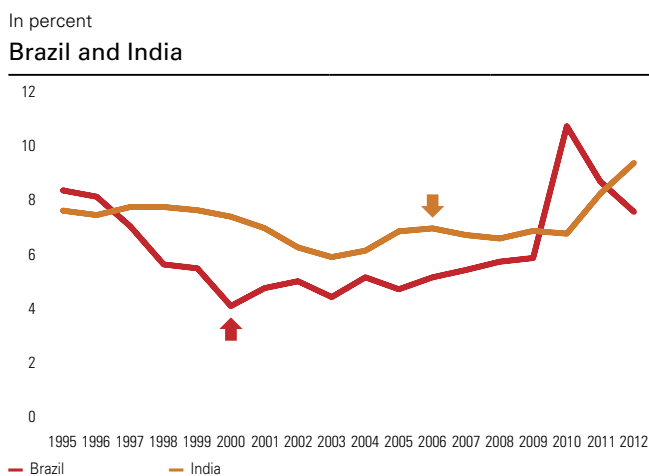
Source: Bonfert, Martin, and Langenbrunner 2013.

Figure II.B.8. Levels of labor market informality in selected EAP countries, 1996–2011



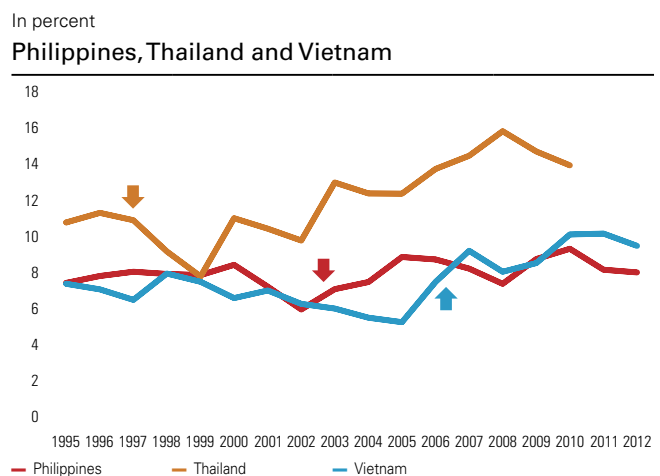
Source: World Development Indicators 2014.

Figure II.B.9. Share of government expenditures on health during periods of coverage expansion



Source: Authors' estimates.

Note: Arrows indicate when policy commitments were made to significantly expand coverage.



Challenges Ahead: Cost Drivers that Undermine Fiscal Sustainability

The drive for UHC and accompanying increases in public health spending have fueled concerns about **fiscal sustainability in EAP**. These are reasonable concerns given that the region faces numerous challenges in containing health care costs due to population aging, the growing burden of NCDs, and inefficiencies in the health systems. High-level policy commitments to expand coverage will only add to these fiscal pressures.

Rapid population aging implies simultaneously coping with rising health expenditures and a diminishing revenue base.

EAP is one of the most rapidly aging regions of the world. The implications of this for government budgets, on both the revenue and expenditure side, are discussed in Part II.A of the report, “Healthy and Productive Aging in East Asia and Pacific.”

NCDs are now the biggest health challenge facing the EAP region and are expected to drive up health care demand and expenditures.

NCDs (cardiovascular disease, diabetes, cancer, and chronic respiratory conditions) caused 76 percent of deaths in EAP in 2008, and this figure is expected to rise to 85 percent by 2030. NCDs are generally diseases of slow progression and long duration. The initial onset of many NCDs occurs at increasingly younger ages in EAP, implying longer years lived with chronic conditions and disability and greater demand for health care. In older ages, NCDs are associated with co-morbidities that interact with each other and complicate approaches to treatment and care.

Underlying these trends is growing exposure to risk factors, with the poor more vulnerable than others.

Between 1990 and 2010, premature death and disability owing to NCD-related risk factors such as high salt intake, blood pressure, total cholesterol, and blood sugar increased everywhere in the world, but the increase was relatively more in EAP. Key risk factors such as smoking are more prevalent among the poor. The poor are also affected by their inability to access or afford preventive services and treatment. Late diagnosis owing to delays in seeking care means more chronic illness and complications. The economic impact of ill health on low-income households can be substantial, creating a vicious cycle that forces people deeper into poverty and perpetuates illness.

EAP countries and their health systems are ill-equipped to respond to the rapid rise of the NCD challenge in the region. Adequately responding to NCDs requires a life-course perspective to health care, which involves reduction of behavioral risk factors at all ages and increased early detection and management of the disease. Health system weaknesses are discussed in the next section. What makes the NCD challenge unique is that compared to higher-income countries, lower- and middle-income EAP countries face higher levels of NCD at earlier stages of their development and with relatively fewer resources at their disposal. The costs of treating NCDs will be enormous for both governments and health care users. The poor are particularly vulnerable since they are more likely to incur impoverishing OOP spending because of the higher cost and longer duration of treatment for NCDs.

Most EAP countries are characterized by low-value, high-cost health systems that pose multiple challenges to cost containment

EAP health systems are generally characterized by low-value, high-cost service delivery structures that are hospital-centric, with preventive and primary care services ineffective and of poor quality (figure II.B.10 and figure II.B.11). Too often better health is incorrectly attributed to more consultations/admissions, drugs, and procedures. Meanwhile, too little attention is paid to the prevention, early diagnosis, treatment, and control of health conditions. As discussed above, this is particularly detrimental to the treatment and

control of NCDs. Once a diagnosis is made, care is rarely coordinated across provider levels, resulting in service duplication and lack of continuity. Health care is often sought too late, leading to high-cost treatment in expensive acute care hospitals. The lack of effective referrals, gatekeeping, and post-discharge care contributes to costly (and avoidable) admissions. Moreover, incentives embedded in provider payment systems encourage physicians to overprovide services or provide unnecessary care. Finally, there is a lack of effective quality assurance mechanisms to ensure that health care provided is evidence-based, clinically effective, and also cost-effective.

Figure II.B.10. Hospital and nonhospital share of current health expenditures in selected Asian countries, 2012

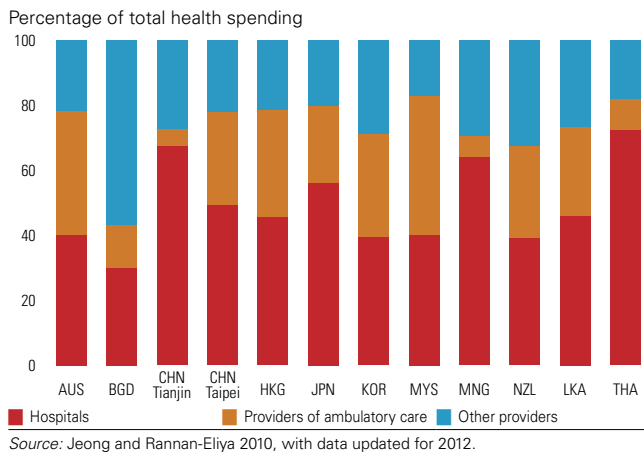
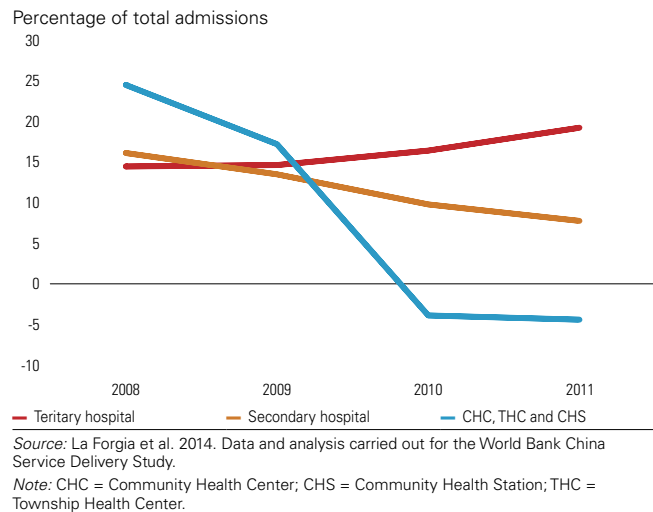


Figure II.B.11. Tertiary hospitals experienced the fastest growth of inpatients and outpatients in China, 2008–11



Together these factors result in overprovision of potentially clinically ineffective treatments at inappropriate levels of care, which drive up costs not only for the government but also for households. It is the main reason why out-of-pocket spending has continued to grow despite increases in health insurance coverage, and why containing costs is proving difficult in many EAP countries.

More resources will be needed to deliver on UHC policy commitments.

Most countries face an unfinished agenda with regard to coverage for the informal sector. Given the persistence of informality in labor markets, the challenges of enrolling and collecting contributions from informal sector workers are likely to continue. Thus, there is no alternative to fully subsidizing enrollment by the informal sector, as for the poor. The informal sector also includes the near-poor, who remain at risk for financial catastrophe owing to health care costs, making it imperative to extend coverage to these groups.

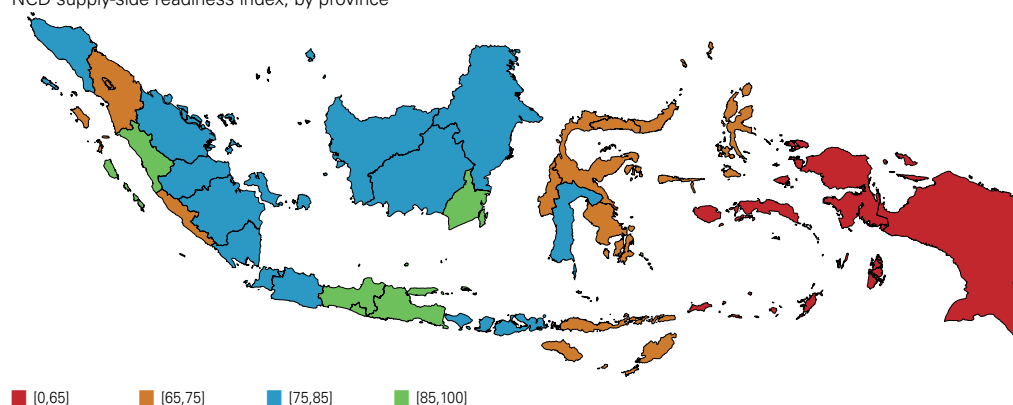
Moreover, much of the emphasis to date has been on achieving universal enrollment in health insurance. Increased enrollment coverage does not always imply a reduction in out-of-pocket costs (figure II.B.11). Nor does enrollment mean effective access to needed, good quality health services. There are large variations within countries in the level and quality of human resources and diagnostic and treatment capacity at health facilities, with poor and/or rural regions worse off, as shown in figure II.B.12 for the treatment of NCDs in Indonesia.

A transformation of the delivery system is needed in most countries if they are to make significant progress toward UHC. This would be aimed at strengthening primary care services, shifting care away from acute care hospitals, reducing overprovision, and improving coordination among providers. The quality of the health workforce needs to be substantially improved. While these reforms will help contain costs in the long term, in the medium term they will require additional budgetary spending.

Delivering on UHC commitments implies not just universal enrollment, but also improving financial protection and ensuring access to good quality services. In Indonesia, the Philippines, and Vietnam, it is estimated that additional government expenditures of at least 1 to 2 percent of GDP will be needed over the next few years to significantly increase all dimensions of health care coverage. This includes the costs of transforming the service delivery system to ensure that good quality, effective primary care services are available to the entire population.

Figure II.B.12. Disparities in supply-side readiness to treat NCDs in Indonesia

NCD supply-side readiness index, by province



Source: World Bank 2014.

Note: The NCD index is the average availability of NCD-related indicators in terms of the proportion of public primary care facilities across provinces that reported having any given indicator; the set of NCD-related indicators is derived from the World Health Organization's Service Availability and Readiness Assessment guidelines.

Delivering on the region's UHC commitments will inevitably require more fiscal resources. However, cost drivers inherent in the system could make the drive to UHC fiscally unsustainable. The next sections provide a range of policy options for expanding the fiscal space for health, including through cost containment.

Policy Options to Increase Fiscal Space for UHC

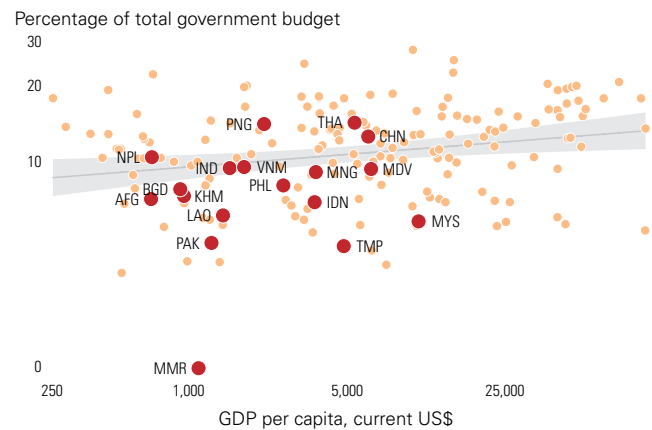
There are two complementary approaches to generate fiscal space for health: (a) increasing the budgetary allocation through reprioritization of health within the budget and levying additional, potentially earmarked, taxes; and (b) securing better value for money from existing resources through better cost containment.

Increasing budgetary allocations

Re-prioritizing health in the government budget

While EAP governments have substantially increased the health share of the government budget, in most countries this is still less than what would be expected given income levels (figure II.B.13). Even in the large middle-income countries with explicit political commitments to UHC (Indonesia, the Philippines, and Vietnam), health budget shares lie below what would be expected given income levels. Only China and Thailand spend more than what would be expected. Still, with the possible exception of countries lying substantially below the average (Indonesia, Lao PDR, Myanmar, and Timor-Leste), room for maneuver may be limited.

Figure II.B.13. Public health expenditure as a share of total government expenditure versus income per capita, 2012



Sources: World Development Indicators and WHO (2014).

Note: x-axis log scale.

New revenues for health

Excise tax revenues such as those on tobacco and alcohol (“sin taxes”) merit further exploration. In the Philippines, a marked increase in tobacco and alcohol excise taxes, coupled with earmarking for UHC (specifically, for the health insurance premiums of the poor), increased the national Department of Health’s budget from US\$1.3 billion to US\$2.1 billion during 2013–15, and the number of families with government-subsidized health insurance from 5.2 million to 14.7 million. The Philippines’ experience is notable for two reasons: the very large share of revenues earmarked for health (around 85 percent of incremental revenues), and revenues that are earmarked for the government’s UHC initiative rather than for broader health promotion (as in Thailand, for instance). Besides tobacco and alcohol, consumption taxes are also levied on other unhealthy food and drinks, for instance in Pacific Islands countries. Such “sin taxes” have the added attractiveness of addressing unhealthy diets and behaviors.

Other consumption taxes used to finance health around the world, but not yet widely used in EAP, include value-added tax (VAT) levies, taxes on mobile phone services, and financial transactions. Ghana is well-known for the 2.5 percent VAT levy that is earmarked for the National Health Insurance Scheme: the levy complements insurance premium payments and a top-up subsidy from government funds. Taxes on the mobile phone industry are another potential source of revenue given the growth of mobile phone use in the region. Gabon, for instance, funds a good share of the health insurance for the poor through a 10 percent tax on mobile phone companies’ turnover (Humphreys 2013).

All of these examples involve earmarking revenues for health, which is controversial. Earmarking protects financing for health and increases its apparent predictability. However, earmarking introduces rigidities into the budgeting process, is limited in what it can raise, and the predictability of financing may be illusory. Since money

is fungible, even when excise taxes are earmarked for particular expenditures, the “additional” revenues may simply replace general budgetary funding (Bird and Jun 2007). In the case of consumption taxes, revenues are vulnerable to changes in consumption patterns. Still, tying increases in taxes to health benefits can help make unpopular tax increases palatable and partially compensate for the presumed regressivity of consumption taxes.

Securing better value for money

Mobilizing general revenues to finance all of the UHC policy commitments is not sustainable. Coverage expansion, rise in NCDs, and population aging will drive up health care demand and expenditures in future. Meanwhile, the current systems of financing and delivering health care are often inefficient. Funneling additional public resources into inefficient health systems is clearly not fiscally sustainable. Three areas where significant efficiency savings could be gained in the short to medium term are discussed below.

Paying providers

Provider payment reforms are needed to move away from the perverse incentive structures that encourage overprovision of services and overcharging for care in EAP. The latter is a consequence of having fee-for-service payment mechanisms without budget caps or other mechanisms to contain costs. Provider payment systems need to be designed to address the specific policy issues and objectives inherent in the health sector. Global experience with payment reforms points toward reimbursing hospitals on the basis of expected costs for clinically defined episodes of care, and reimbursing primary care providers a “lump sum” per patient regardless of how many services the patient receives.

Purchasing pharmaceuticals

Inefficiencies in purchasing pharmaceuticals result in high prices being paid for drugs, driving up costs for both the government and users. The price of common statins (cholesterol-lowering drugs critical for pharmacological management of cardiovascular disease) varies significantly across countries (table II.B.2). For the same common statins that are off-patent, Vietnam pays considerably more than Sri Lanka, Thailand, and even New Zealand. The current procurement system in Vietnam is highly decentralized and complex, involving more than 1,000 entities, resulting in wide differentials in the prices of medicines, often for the same type, dosage, and formulation across hospitals and supplies. Meanwhile, the Ministry of Health in Sri Lanka and the National Health Security Office in Thailand have virtual monopsony power in procuring drugs because they buy on behalf of a large number of hospitals in each case, and are able to secure exceptionally low prices.

The EAP region can learn from pharmaceutical purchasing strategies used in other countries to reduce drug prices. These include risk-sharing arrangements for high-cost drugs, such as price-volume arrangements where the manufacturer pays for any volume over the agreed threshold; sole-source tendering, where the winning bidder is the sole supplier for a fixed term; and therapeutic reference pricing, where the purchasers set fixed reimbursement levels for the price of drugs by referencing a base drug within that therapeutic class.

Table II.B.2. Price comparisons of cholesterol-lowering drugs in selected countries

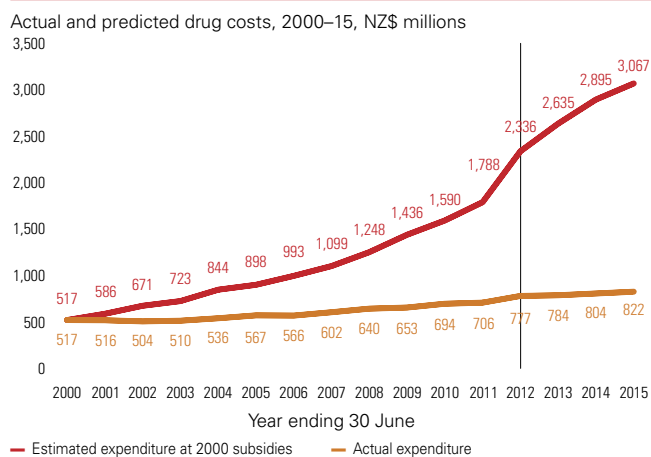
Drug	Atorvastatin	Pravastatin	Lovastatin	Simvastatin
Quantity	30 x 20mg	30 x 20mg	30 x 20mg	20 x 20mg
United Kingdom retail price (US\$)	2.74	2.47	—	1.53
New Zealand retail price (US\$)	1.10	4.31	—	0.53
Sri Lanka retail price (US\$)	0.17	*	0.20	—
Thailand retail price (US\$)	2.89	*	*	0.93
Vietnam retail price (US\$)	2.41	—	1.27	2.52

Note: *Not included in the drugs list. Drug prices indicated are those for the public system (for instance, the National Health Service in the United Kingdom, the Ministry of Health in Sri Lanka, Vietnam Social Security in Vietnam, and the National Health Security Office in Thailand). mg = milligram; — = not available.

Prioritizing among available interventions and technologies

Reining in the adoption and diffusion of new technologies is critical for controlling health expenditure growth. The lack of appropriate measures to prioritize among new technologies has already resulted in rapid growth in health technology spending in the EAP region. In China, for instance, the medical device market grew from US\$8 billion to US\$20 billion during 2006–11, a compound annual growth rate (CAGR) of 20.1 percent, exceeding even the pace of total health expenditures (CAGR 18 percent) (Le Deu et al. 2012). In recent years, new technologies have been dominated by costly product innovations in health care. In aging populations, this can be a significant cost driver.

Many OECD countries have introduced explicit prioritization systems, through health technology assessments (HTAs) that transparently assess the value for money of new technologies. HTAs constitute a systematic and transparent appraisal and deliberation process to make decisions on the public reimbursement of medical technologies, devices, and procedures. For instance, New Zealand's pharmaceutical management agency has been highly successful at keeping costs down over a 12-year period by combining HTAs with strengthened pharmaceutical procurement (figure II.B.14). Developing national capacity to undertake HTAs is costly and takes years. Meanwhile, EAP countries could start off by instituting transparent and evidence-based processes for prioritizing among new technologies and drugs, using the findings from more established HTA agencies to inform prioritization.

Figure II.B.14. Effective control of drug expenditures over time in New Zealand

Source: Pharmaceutical Management Agency 2012.

Conclusion

If implemented effectively, UHC-motivated reforms can reduce a key source of vulnerability, preventing millions from falling into poverty due to catastrophic health expenditure. This is particularly pertinent in a region where large segments of the population remain vulnerable to impoverishment. UHC can help reduce health-related inequalities and is a means for building human capital and sustaining future economic growth. Lack of financial protection has also been an important reason for high rates of precautionary savings by households, which are inefficient and welfare reducing. Having made the policy commitment to UHC, it is important that UHC programs are financed and implemented in a financially sustainable and effective manner. Otherwise, they risk becoming an excessive burden on future public finances, crowding out spending on other important sectors, and threatening future growth prospects. Given the significant political momentum behind them, UHC commitments could also become political liabilities, should popular expectations not be met.

What then must EAP countries do to ensure that UHC commitments do not turn into economic and political liabilities? General revenue financing has played a critical role to date, and will continue to be important. Experience from across the world shows that delinking entitlement to health coverage from employment and users' direct contributions generally is key to ensuring that the poor, near-poor, and informal sector workers are enrolled. The only way to do this is to fully subsidize coverage through general revenues. Delivering on UHC commitments implies not just universal enrollment, but also improving financial protection and ensuring access to good quality services. All of this will put further pressure on public budgets, exacerbated by other cost drivers such as population aging, NCDs, and inefficiencies in the health systems. To increase fiscal space for health and ensure that the drive to UHC is fiscally sustainable, governments will not only have to expand the revenue base for health, but also secure greater value from existing resources through better cost containment.

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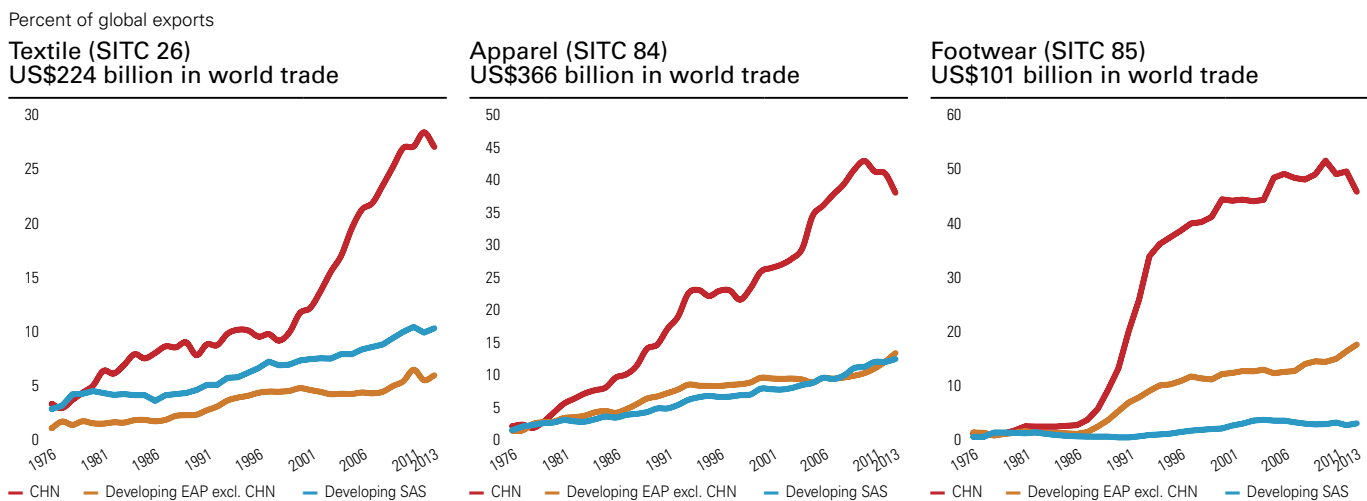
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II.C. Manufacturing Relocation in China¹

As China's economy matures, it is bound to shed its global dominance in labor-intensive and low-technology manufacturing in favor of the low- and other middle-income economies in the developing world. However, international trade data show that the migration of low-end export production from China has not occurred to the extent and with the speed that many expected. In part, China has responded to rising costs in its manufacturing hub on the eastern coast by enabling industrial relocation both to other regions in the country, and to other areas within the eastern coastal region, where costs are lower. Further, China retains significant advantages in terms of labor productivity, a favorable investment climate, robust logistics, superior infrastructure, and a relatively large domestic market. For developing EAP, making progress in these areas will prove critical to succeeding in the competition for industrial activity.

As China's economy matures, the country has long been expected to shed its dominance of labor-intensive and low-technology manufacturing. As excess labor from the rural and agricultural pool declines, labor costs in the urban and industrial sector rise, and manufacturing firms upgrade and move up the industrial value chain, traditional industrial sectors will come under increasing pressure and will relocate to the low- and other middle-income economies in East Asia and Pacific (EAP) and elsewhere in the developing world.

Figure II.C.1. Global market shares in traditional labor-intensive products, 2013



Source: Staff calculations based on UN COMTRADE data.

Note: SITC = Standard International Trade Classification.

And yet, international trade data show that the migration of low-end export production from China's industrial base in the eastern coastal region to developing EAP's export processing zones has not occurred to the extent and with the speed that many expected. China's global market share in traditional labor-intensive products—textiles, apparel, and footwear—remains high relative to the competition from

¹ This note was prepared by Antonio Ollero, Karlis Smits, and Luan Zhao. Nannan Liu and Wenrui Li provided outstanding research assistance.

developing areas, despite recent gains by low- and middle-income countries in EAP (Vietnam and Indonesia), as well as in South Asia (India and Bangladesh), and Europe and Central Asia (Turkey) (figure II.C.1).

Moreover, as China has moved up the value chain, it has significantly outpaced developing EAP in the manufacture and export of high-technology products. This is particularly evident in computers, telecommunications equipment, and electrical machinery, including their parts and components (figure II.C.2; see also *East Asia and Pacific Economic Update*, April 2014). In electrical machinery, the greater competition has recently come from EAP’s newly industrialized economies (principally the Republic of Korea; Singapore; and Taiwan, China). Overall, a recent analysis of China’s global manufacturing value chain concludes that it has increased in length, but in particular that imports have moved upstream, while exports on average have not moved downstream (figure II.C.3; see also Chor 2014). This suggests that China may be performing some new high value-added downstream activities, but is not necessarily shedding lower value-added upstream activities.

Figure II.C.2. Global market shares in high-technology products, 2013

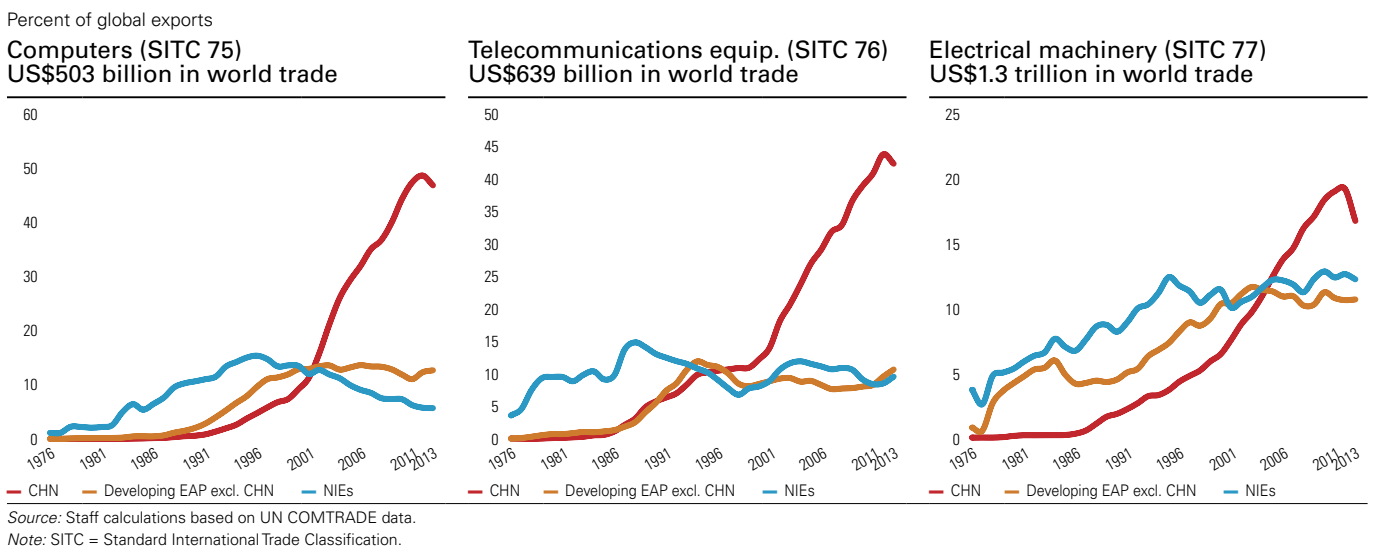
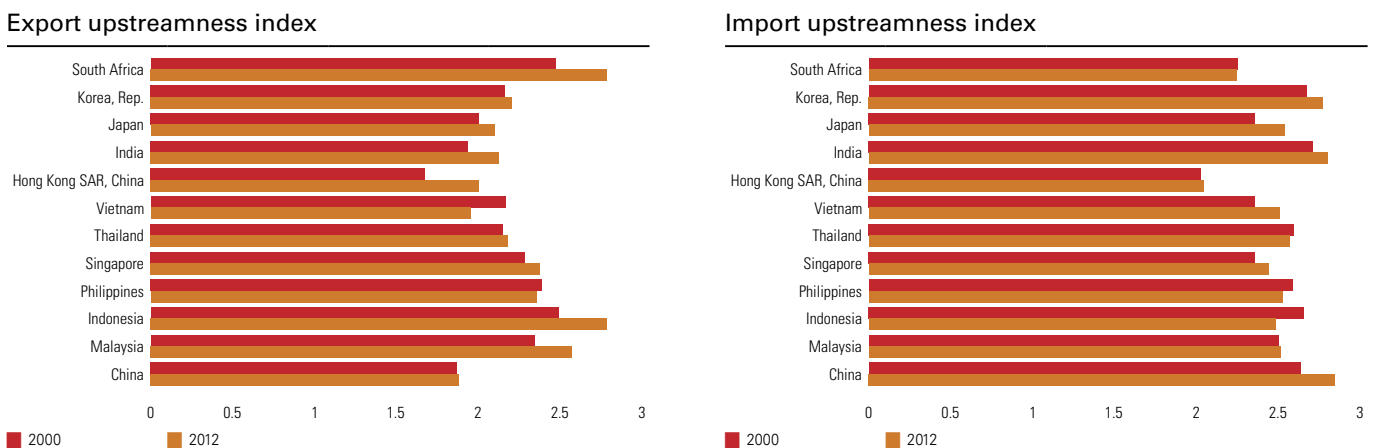


Figure II.C.3. Length of manufacturing value chain



China has sought to manage the challenges posed by rising labor costs, environmental damage, and congestion in its manufacturing hub on the eastern coast by enabling industrial relocation both to other regions in the country and to other areas within the eastern coastal region. There, costs are lower and firms can profitably expand. As a result, manufacturing of labor-intensive, low-technology products has been discouraged from migrating elsewhere to developing EAP.

Relocation...

The eastern coastal region² remains China's economic and industrial center (figure II.C.4). It accounted for half of GDP and industrial production, two-fifths of fixed investment, more than half of foreign direct investment (FDI), and more than four-fifths of merchandise exports in 2013. The region also accounted for two-fifths of the (registered) working-age population and almost two-fifths of wage employment in 2013.

Figure II.C.4. Gross industrial output in China, by region



Source: CEIC.

Note: The size of the dots is proportional to the region's industrial output.

Underlying this has been the strong performance of the Pearl River Delta (PRD) economic zone in Guangdong province. Its rapid growth began with the transformative “opening and reform” of the Chinese economy in 1979. It was given further impetus by the integration of the PRD with Hong Kong SAR, China; the emergence of Guangzhou as the country's leading trade fair center; and the rise of Shenzhen, next to Hong Kong SAR, China, as both a financial services and a global and regional sourcing center, with the fourth largest container port in the world. The greater PRD economic zone (which includes Hong Kong) has been able to leverage Hong Kong's advantage in logistics, finance, and other producer services to propel it into the ranks of the world's largest economies (Chen and Unterberdoerster 2008). Industry clusters in both labor-intensive products³ and high-technology products⁴ have enabled the region to increase the degree of concentration and specialization of both downstream and upstream industries.

2 Comprising the eight provinces of Fujian, Guangdong, Hainan, Hebei, Jiangsu, Shandong, Shanghai, and Zhejiang, and the two municipalities of Beijing and Tianjin.

3 Apparel in Zhongshan and Guangzhou, and shoes in Huizhou.

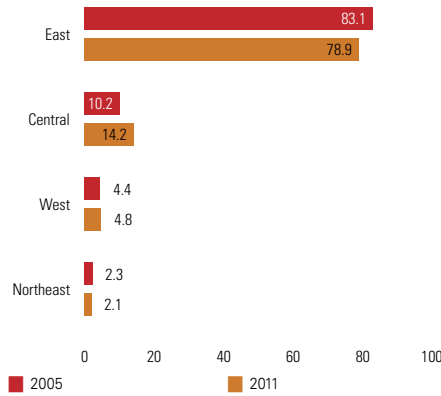
4 Electronics in Shenzhen, Dongguan, and Zhongshan; automobiles and auto parts in Guangzhou; and petrochemicals in Guangzhou and Huizhou.

Figure II.C.5. Distribution of labor-intensive industrial activity by region in China

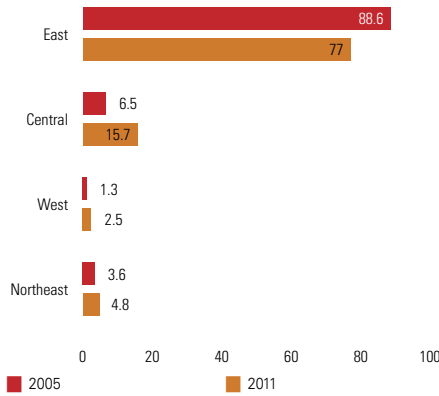
Percent of total for China

Textile industry

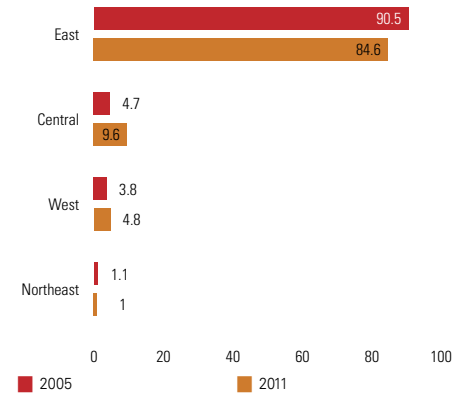
Number of Enterprises

**Apparel industry**

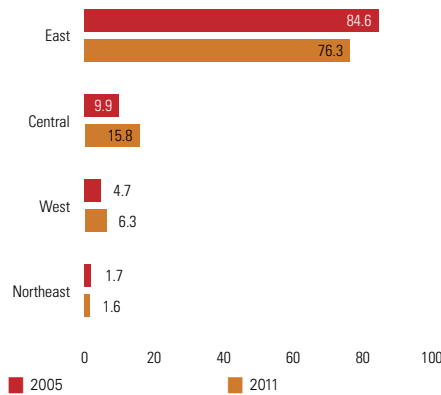
Number of Enterprises

**Footwear industry**

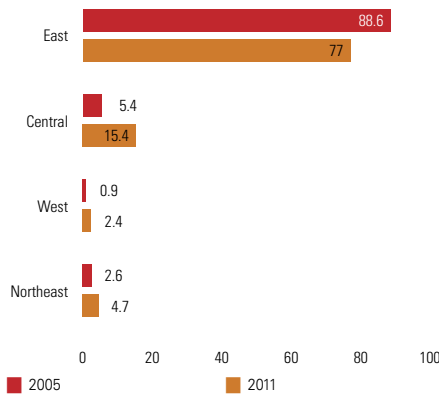
Number of Enterprises



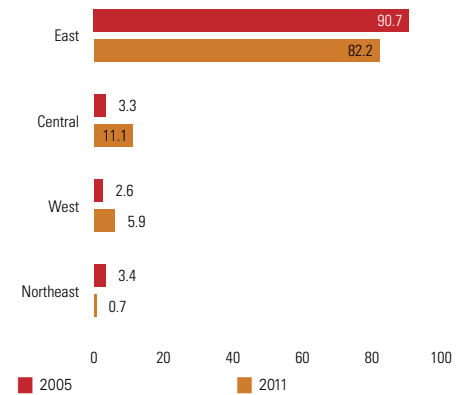
Gross Industrial Output



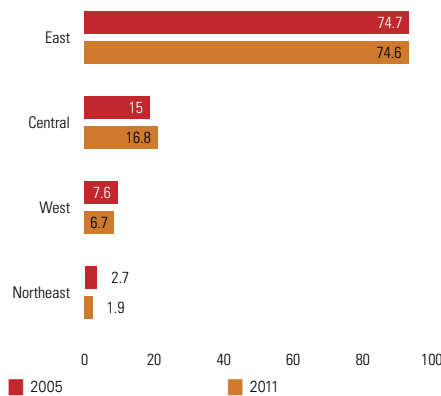
Gross Industrial Output



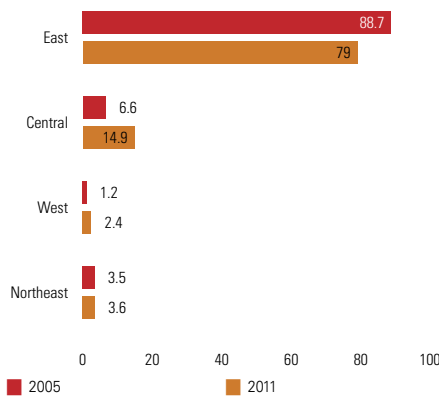
Gross Industrial Output



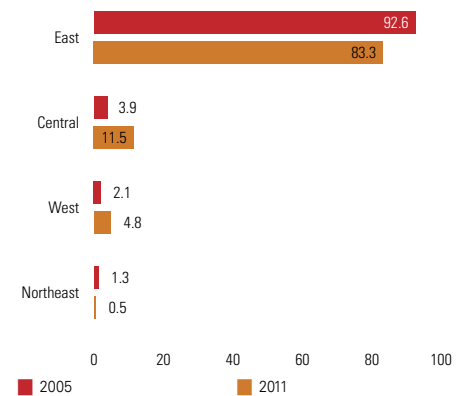
Employment



Employment



Employment

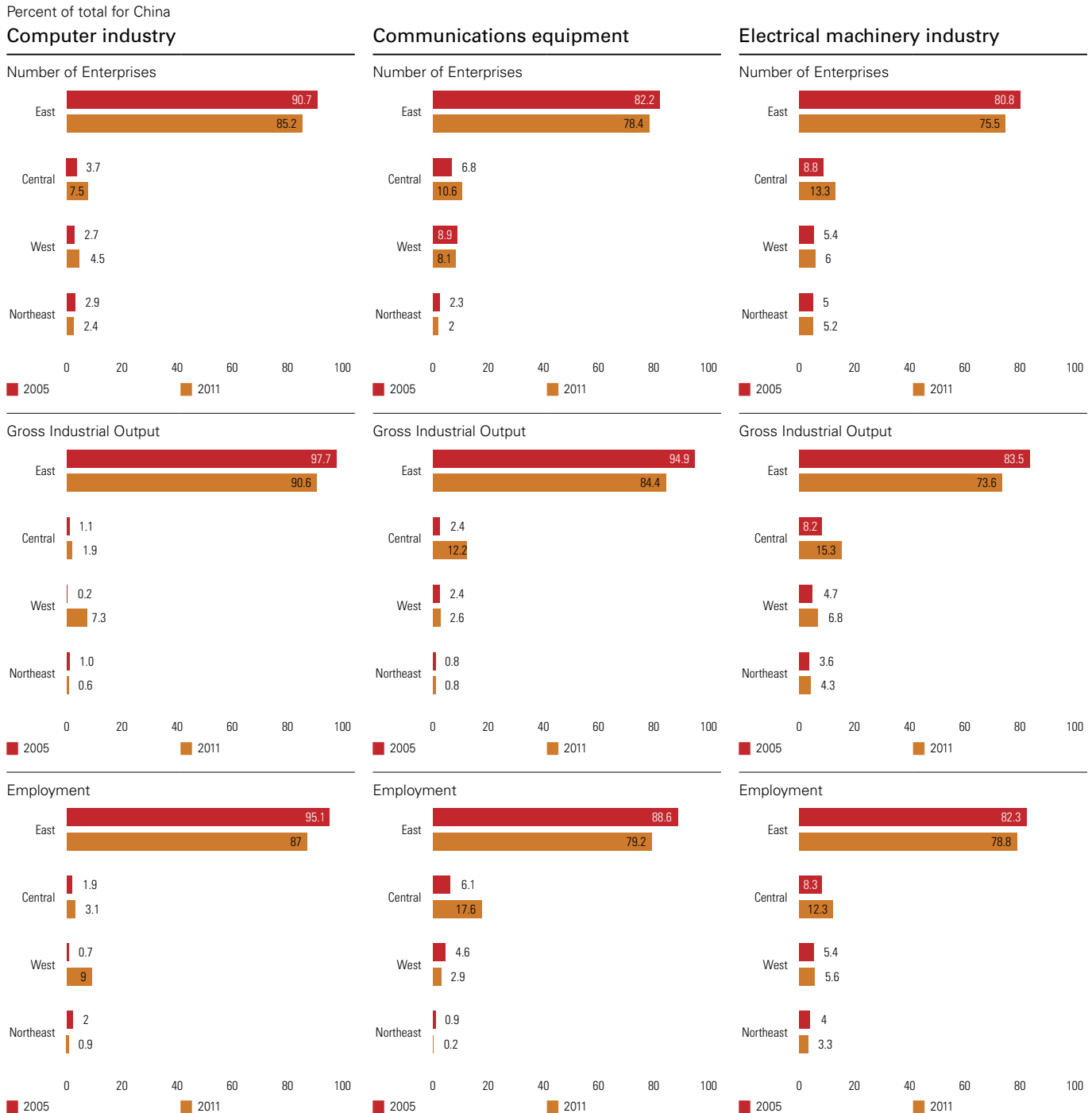


Source: Staff calculations based on CEIC data.

Notwithstanding the dominance of the eastern region in China's economy, there has been a perceptible transfer of industrial activity (corporate formation, industrial production, and employment) to areas outside the PRD, beginning about 2005. The relocation has been to the central and western regions for the textile and footwear industries, and to the central and northeastern regions for the apparel industry (figure II.C.5). Industry clusters in cotton textiles in Shihezi, in Xinjiang province in the western region; in nonwoven

textiles in Xintao, in Hubei province in the central region; and in linen products in Suihua, in Heilongjiang province in the northeastern region; are now ranked among the country's top 100 industrial clusters.

Figure II.C.6. Distribution of capital-intensive industrial activity by region in China



The inland regions have also started making gains in the electrical and electronics industries (figure II.C.6). The more notable advances have been in electrical machinery and apparatus manufacturing, where the

central, western, and northeastern regions now account for more than 25 percent of output, compared to about 15 percent in 2005. Industry clusters have emerged of late in household appliances in Hefei, in Anhui province in the central region, and in measuring instruments in Dandong, in Liaoning province in the northeastern region. Both have figured in lists of the country's top 100 industrial centers.

...and Agglomeration

Even more significant than the relocation of industrial activity to the inland regions has been the movement of firms *within* both regions and provinces,⁵ in support of industrial specialization and agglomeration objectives. As China's industries advance closer to the production possibility frontier, economic growth is increasingly associated with the ability to take advantage of higher economic concentration (agglomeration), greater economies of scale (specialization), and more efficient allocation of factors of production (mobility).

Industrial agglomeration has increased steadily in China,⁶ with a significant, positive impact on productivity. Agglomeration has allowed firms to exploit economies of scale arising from being near other producers of similar products (localization economies) and from being close to producers of a wide range of products and services (urbanization economies). For instance, in the textile sector, increased spatial concentration in the southeastern coastal region enabled firms to benefit from close proximity to large markets.⁷ More broadly, industrial agglomeration has led firms to increase their size and reap greater economies of scale, and to co-locate with a number of larger firms, rather than simply clustering with a larger number of firms (Li, Lu, and Wu 2012).

Economies of scale from agglomeration vary across industries and city sizes: smaller cities tend to specialize in mature industries, larger cities in services and high-skill industries.⁸ Improved infrastructure and transportation also allow firms to become more specialized and to exploit economies of scale not associated with agglomeration. Such internal economies of scale arise as firms purchase intermediate inputs at volume discounts, the fixed costs of operating a plant are spread over a larger volume of production, and managers learn to operate a plant more efficiently. But as cities become larger, they benefit less from industrial agglomeration, and can indeed face severe agglomeration diseconomies, since residents in bigger cities are burdened with congestion and higher living costs for housing, food, and public services (Fujita and Ogagwa 1982; Henderson 2002; Muth 1969).

As a result, maturing industries, especially in manufacturing, have started to move out of the largest cities in China over the last decade. Manufacturing has also started to shift out of prefecture-level cities and into counties, where the share of national manufacturing employment grew from 41 percent to 50 percent from 2000 to 2010. As a result, services account for a higher share of economic activity in the larger cities. In

5 In particular, out of old core into new emerging economic zones, and out of first- and second-tier and into third- and fourth-tier prefecture-level cities and counties (cities are classified according to their socioeconomic importance; first-tier cities are the largest in terms of their economic importance and population size).

6 As measured by the Ellison-Glaeser Index, using firm-level data from 1998–2005 (Lu and Tao 2009). However, it remains much lower than in leading advanced economies, such as the United States, France, and the United Kingdom.

7 Based on an analysis of more than 22,000 textile firms from 2000 to 2005 (see Lin, Li, and Yang 2011).

8 Evidence from other countries shows that geographic clustering is more pronounced in high-skill and high-technology industries (such as electronic computing machinery, process control instruments, semiconductors, and pharmaceuticals) than in light industries (such as textiles or food) (see Glaeser 1995; and Henderson 1997).

2011, services accounted for 66 percent of GDP in the largest cities (15 million or more people), but only about 33 percent in smaller cities (with fewer than 1 million people). Assembling integrated computers, which is becoming a mature industry, has become less concentrated. Producing steel, which benefits from economies of scale, remains fairly evenly dispersed across provinces. That is explained in part by a legacy of central planning and state ownership. Before the 1980s, remote inland sites were favored for key sectors, such as iron and steel production, and spatial clustering was discouraged (Fan and Scott 2003). The rising prices of land and housing also influence the choice of location of industries (Fan and Shao 2011).

In the dominant eastern coastal region, new economic zones have emerged to promote industrialization into higher-value-added manufacturing. The Yangtze River Delta (YRD) special economic zone, counting on a vast heavily industrialized interior with advanced transport infrastructure facilities, including airports, ports, expressways, and highways, specializes in more technology-intensive industries that rely on more skilled production workers than the PRD, whose industrial activity relies on processing trades, such as logistics, based on exports and on labor-intensive industries employing semiskilled and unskilled labor (Fang, Wang, and Yue 2012).⁹ In addition, the Bohai Economic Rim (BER), in the northern end of the eastern coast, has emerged as a third economic zone to rival the YRD and the PRD. The BER, traditionally involved in heavy industries, has become a significant growth cluster for the automobile, electronics, and petrochemical sectors.¹⁰

Even within existing zones, agglomeration has been associated with significant relocation to smaller cities. For instance, in Guangdong, the prefecture-level border cities Heyuan, in the northeast of the province, and Qingyuan, in the northwest, have gained from further specialization in the core PRD cities (Zhang 2009). In particular, nonmetal mining products and nonferrous metallurgy in Qingyuan, and electrical machinery and electronics in Heyuan, expanded significantly as a result of their relocation from other PRD cities.

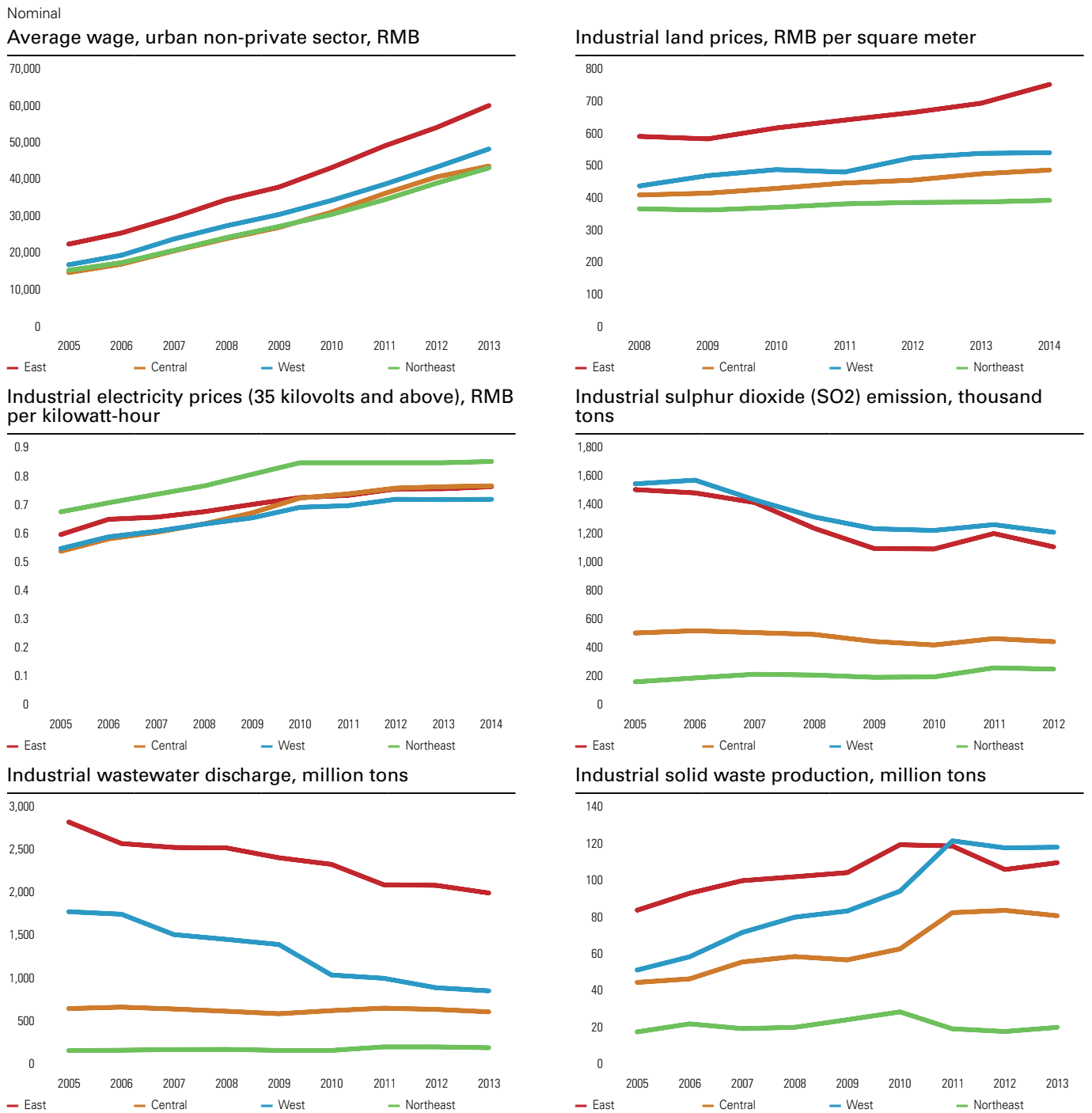
Drivers of Relocation

The changing industrial geography in China reflects the interplay of numerous factors that influence the location decisions of industrial firms. Rising labor, land, energy, and environmental costs, particularly in the eastern coastal region and in the hub prefecture-level cities of special economic zones, are giving industrial firms reason to consider alternative locations (figure II.C.7). However, agglomeration economies, but also more favorable investment climates, continue to wed industrial firms to their traditional strategic locations.

9 For instance, Nanjing, in Jiangsu province in the YRD, is a hub for the automobile and electronics industries, and for the energy, and iron and steel industries. Suzhou, also in Jiangsu, is a strong manufacturing base for foreign firms in the electronics industry (in particular, circuit boards and information technology products). Ningbo, in Zhejiang province, also specializes in electronics (especially household electronic appliances). And Shanghai is dominant not only in finance, banking, and logistics, but also in automobiles.

10 For instance, Tianjin is strong in aviation, logistics, and shipping. Beijing has strong petrochemical, education, and R&D industries. Shenyang, in Liaoning province, is a cluster for the automotive, aircraft, and software industries. Dalian, also in Liaoning province, attracts foreign investments in manufacturing. And Qingdao, in Shandong province, is strong in health services.

Figure II.C.7. Average labor, industrial land, electricity, and environmental costs by region

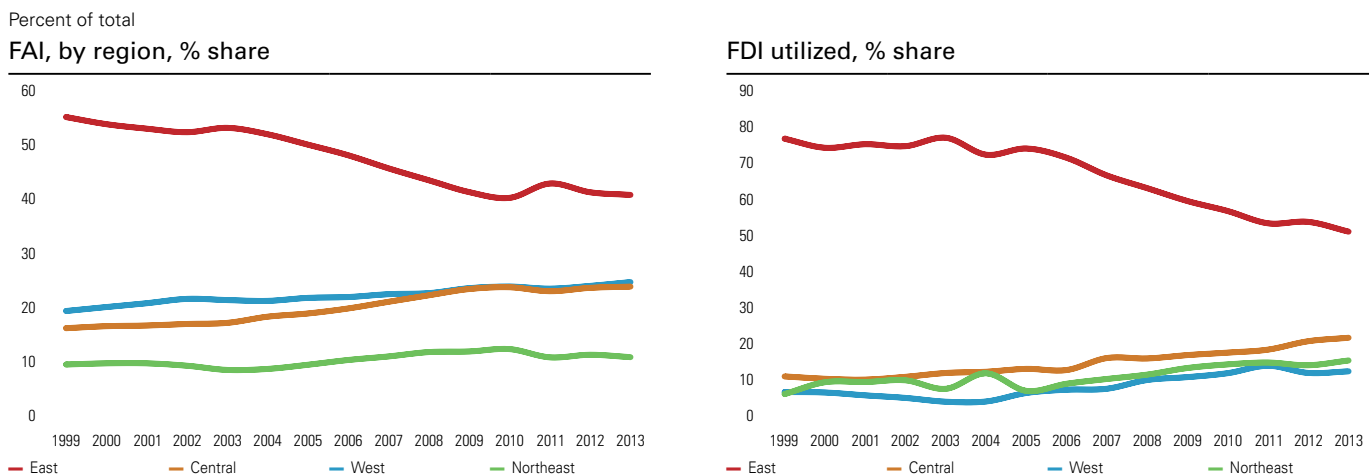


Government Policy: Intervention and Distortion

Comparative intraregional costs are not the sole consideration affecting firm location decisions in China: market signals are muted by a broad system of mandates, incentives, and subsidies offered by the national and local governments to shape the country's industrial geography. Since the onset of economic reforms in 1979, and beginning with the creation of two special economic zones in Guangdong province in the same year, the national government has been active not just in designating certain regions and zones as preferred locations for particular industries and industrial clusters, but more importantly in developing the requisite infrastructure, offering incentives, and extending subsidies (loans from development banks and tax breaks) for foreign and domestic investment to locate in the preferred areas.

Efforts to direct industrial migration to, and support broader economic development in, the inland regions is guided by framework plans which have since been adopted as national development strategies beginning in the late 1990s.¹¹ Twenty-nine destinations were designated by the Ministry of Commerce (MOCOM) as industrial relocation sites in the central and western regions by 2008. With infrastructure development a centerpiece of government efforts to spur economic activity in the inland regions, fixed asset investment in the central and western regions accounted for half of the country's total in 2013, compared to a third in 1999 (figure II.C.8). Meanwhile, FDI into the inland regions accounted for almost half of all FDI into the country in 2013, compared to a fourth in 1999.

Figure II.C.8. Distribution of fixed asset investment (FAI) by region



Local governments have been no less active than the central government in enticing certain industries and firms to locate in economic zones, industrial parks, science parks, and “urban agglomeration” and “demonstration” areas within their jurisdictions, and conversely, in requiring enterprises that do not fit into their regional industrial plans to migrate to other locations. For instance, Guangdong province earmarked RMB 40 billion in spending over 2008–12 (1.1 percent of 2008 provincial GDP) for its “Double

¹¹ For instance, the “China Western Development” or “Open Up the West Program” in 1999, the “Northeast Area Revitalization Plan” or “Revitalize the Northeast Industrial Bases” in 2003, and the “Rise of the Central Plain Plan” in 2004.

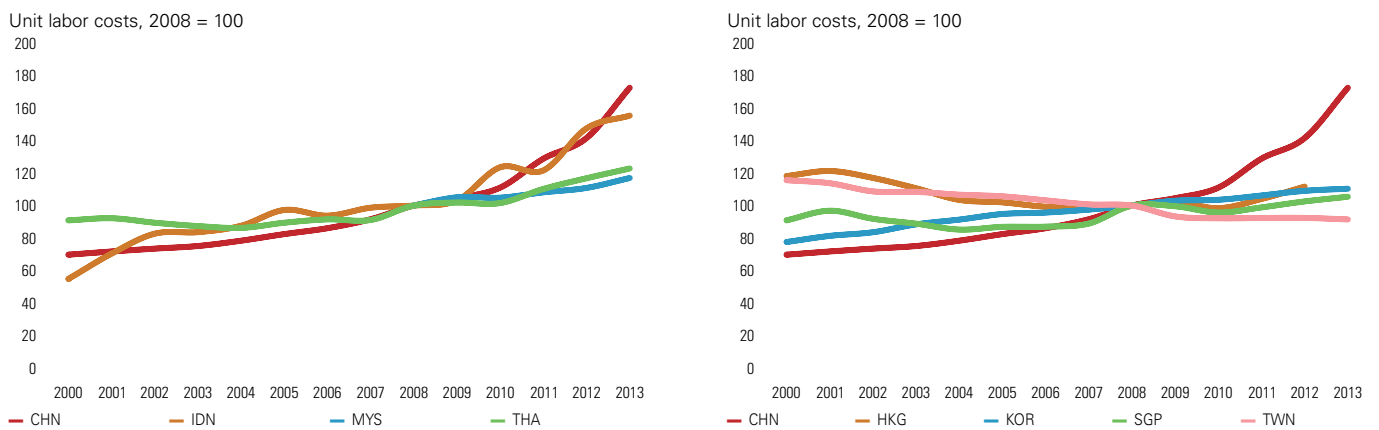
Relocation Strategy.”¹² The funds were used to acquire land, develop industrial relocation parks, improve urban transport infrastructure, and train labor in the destination areas, and to set up an “award fund” to encourage relocation. Zhejiang province, also in the eastern coastal region, used firm screening and technological and environmental standard setting to spur the relocation of low-end manufacturing, high energy-consuming, and heavy pollution-emitting firms to alternative locations in the central and western regions of the country (Wei and Bai 2014). Meanwhile, cities and provinces designated as preferred relocation destinations in the central and western regions of the country are competing aggressively against each other to win over industrial firms migrating from the eastern coastal region.¹³

Measures to upgrade infrastructure, improve government services, and enhance the investment climate are all legitimate tools that local governments can employ to attract investment; in contrast, subsidies, commonly in the form of concessional finance and tax breaks, are suboptimal and likely to prove distortionary. In principle, the authorities should allow agglomeration economies and congestion costs to more freely determine the location and relocation of industrial activity within China. Market forces should enable manufacturing and export firms to find suitable locations that extend China’s comparative advantage in labor-intensive and low-technology products.

Implications for Developing EAP

Unit labor costs have increased sharply in China in recent years, reducing its competitiveness vis-à-vis the rest of developing EAP (figure II.C.9). Indeed, average manufacturing wages are now higher than in the rest of the region (figure II.C.10, left panel). However, so is average manufacturing productivity (figure II.C.10,

Figure II.C.9. Unit labor cost dynamics in selected EAP countries



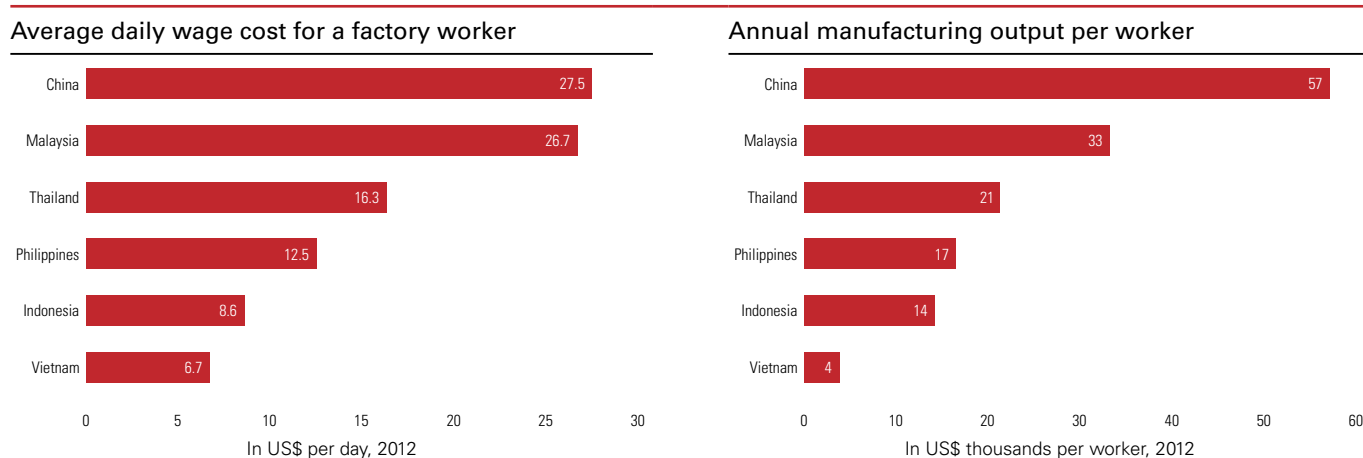
Sources: National data sources and Haver Analytics.

¹² This was aimed at moving textile, apparel, footwear, electrical appliance, light industrial machinery, toy, furniture, and watch and clock manufacturers from the cities of Dongguan, Foshan, Guangzhou, Shenzhen, and Zhongshan in the PRD to some 24 industrial relocation parks in the eastern, western, and northern cities and counties of the province.

¹³ Hunan province, in the central region, has moved to improve services in its customs offices and logistics centers, and to provide funds to support relocation projects. Within the province, the city of Yueyang provides tax breaks to firms relocating there, and Chenzhou offers subsidies in the construction of manufacturing plants.

right panel). Further, China's large labor force remains a strategic advantage: modernization of agriculture could release as many as 100 million excess workers (World Bank 2014a).

Figure II.C.10. Average daily wage and output per worker in manufacturing sector in selected EAP countries



Source: McKinsey Global Institute 2014.

Labor costs are not the sole driver of location decisions. China has been able to compensate for higher labor costs with a favorable investment climate, robust logistics, superior infrastructure, and a relatively large domestic market.

China's investment climate is relatively favorable, compared to potential alternative industrial locations. For instance, regulatory quality is relatively high, particularly in the areas of registering property and enforcing contracts, compared to other developing countries with the potential to develop labor-intensive, low-technology manufacturing (table II.C.1).

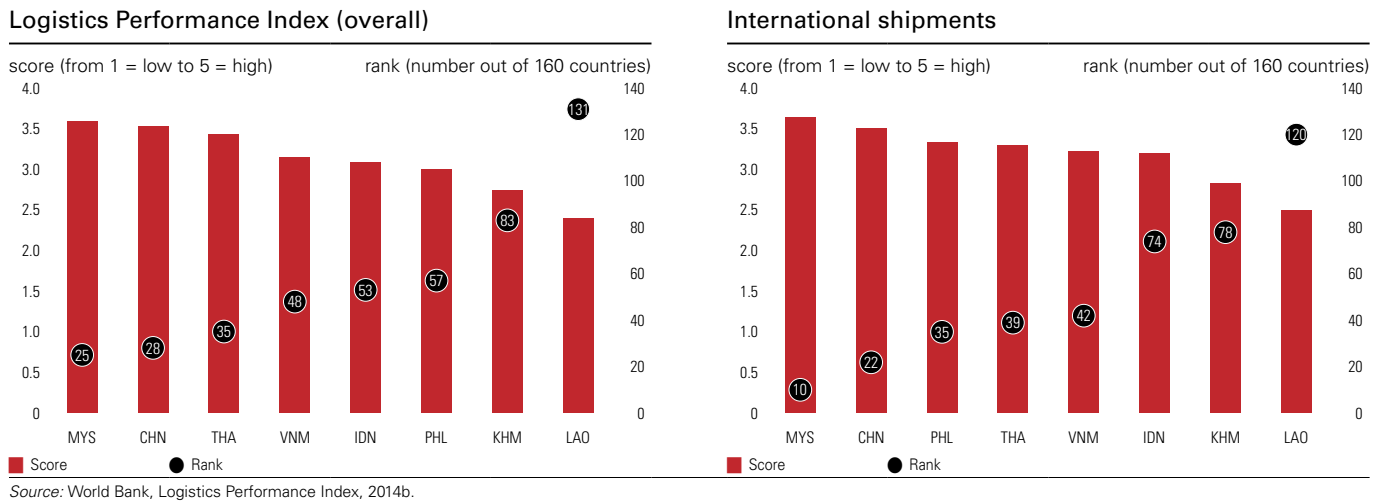
Table II.C.1. Ease of doing business

	China	Turkey	Vietnam	Indonesia	India	Bangladesh
Country ranking, "Ease of Doing Business"	90	55	78	114	142	173
Starting a Business	128	79	125	155	158	115
Dealing with Construction Permits	179	136	22	153	184	144
Getting Electricity	124	34	135	78	137	188
Registering Property	37	54	33	117	121	184
Getting Credit	71	89	36	71	36	131
Protecting Minority Investors	132	13	117	43	7	43
Paying Taxes	120	56	173	160	156	83
Trading Across Borders	98	90	75	62	126	140
Enforcing Contracts	35	38	47	172	186	188
Resolving Insolvency	53	109	104	75	137	147

Source: www.doingbusiness.org/rankings.

China ranks higher than most middle- and low-income countries in developing EAP on trade logistics (figure II.C.11). It performed particularly well along two key dimensions: the quality of trade- and transport-related infrastructure (ports, railroads, roads, and information technology), and ease of arranging for competitively priced international shipments.

Figure II.C.11. Logistics performance



Relatedly, China has invested heavily in infrastructure compared to the rest of developing EAP. Container port traffic by China was almost four times greater in 2012 than in 2000, and air transport traffic 53 times greater (figure II.C.12). China increased its rail routes by 7,600 kilometers over the same period, while the rest of developing EAP barely added to them. Paved roads accounted for 64 percent of all roads by 2011, up from 44 percent in 2000, and electric power consumption increased by 230 percent during this period.

Figure II.C.12. Transport infrastructure

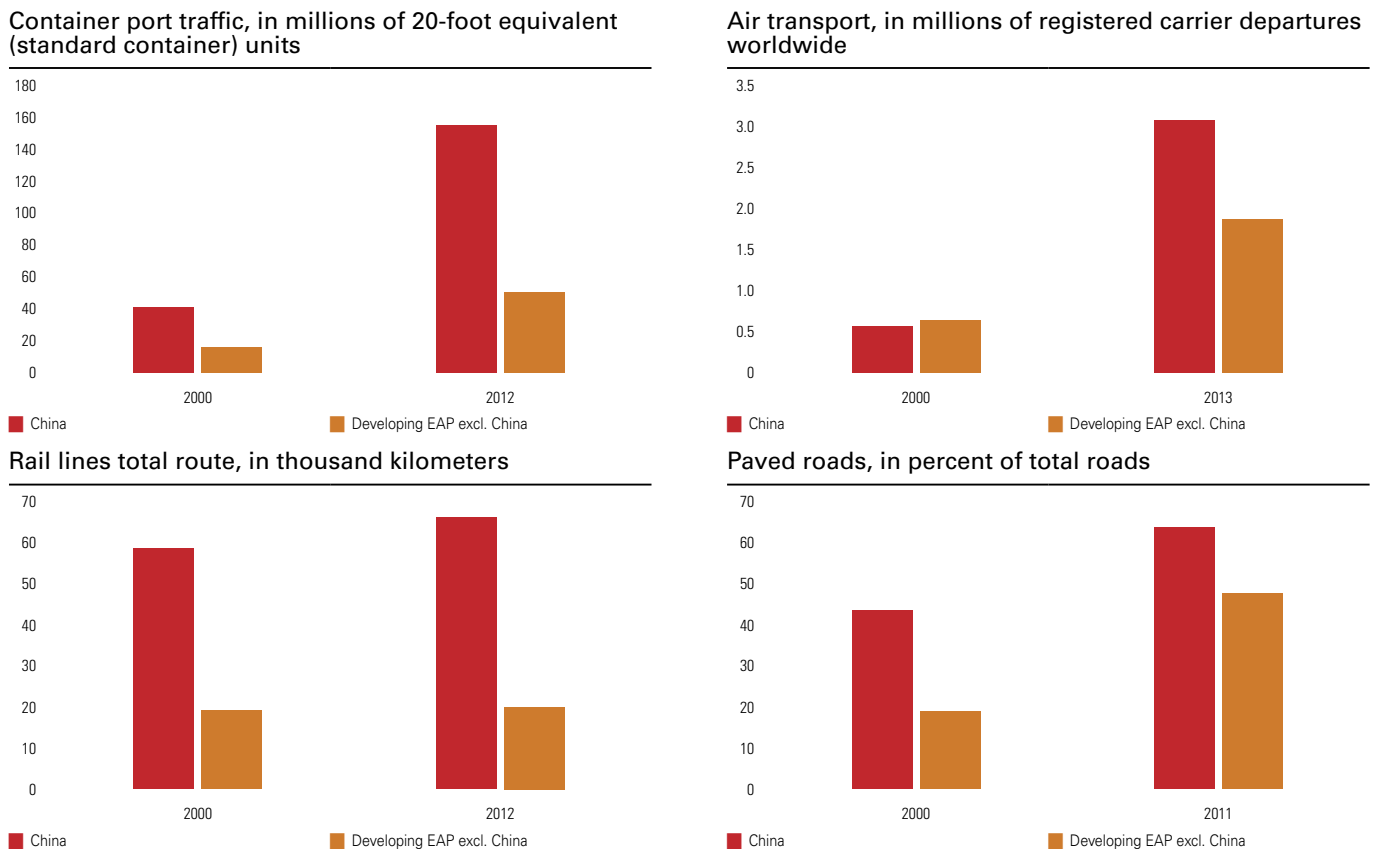
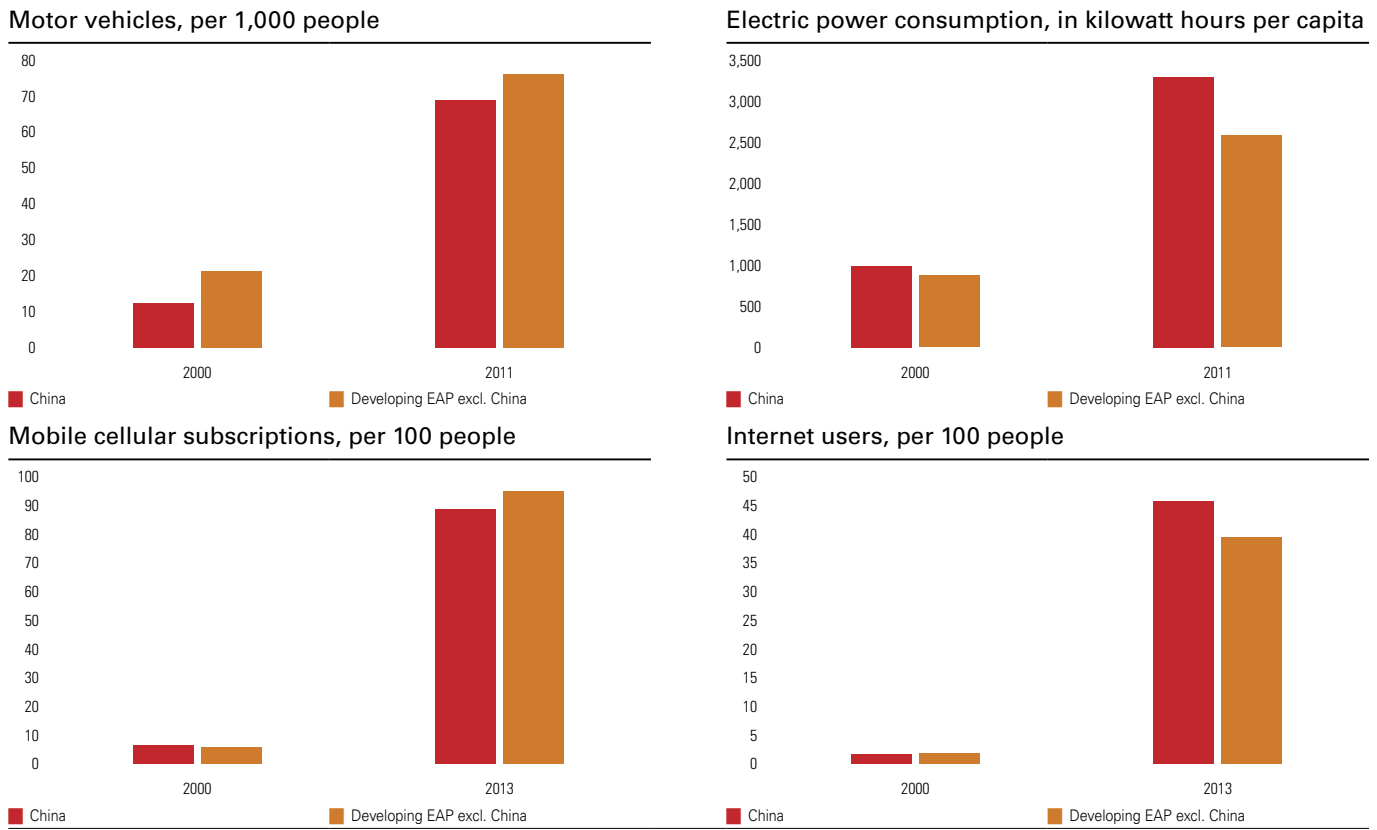


Figure II.C.12. Transport infrastructure



Source: World Bank WDI.

The implication for developing EAP is that increasing its own productivity, logistics, infrastructure, and investment climate will prove critical in the competition for that industrial activity that will increasingly come under pressure in China.

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II.D. ASEAN Integration in Services¹

While the ASEAN economies grew rapidly over the last four decades primarily as manufacturing and exporting powers, the role of the services sector and services trade has grown increasingly important over the last decade. Since services (such as finance, transport, telecoms, professional services, education) are key inputs in modern economies, increasing competitiveness in services through trade will be necessary for ASEAN economies to sustain growth as they become mature, middle-income economies. Services integration provides large potential for gains as well as challenges. Recognizing this, ASEAN countries have committed to services integration, particularly through liberalization, as part of forming the ASEAN Economic Community at the end of 2015. However, ASEAN countries currently fall well short in implementation of these commitments, impeded by the uneven quality of regulations among the member countries. Policy data suggest that ASEAN is still one of the most restrictive regions in the world with respect to trade in services, and that despite commitments, actual policies provide modest preferential treatment to ASEAN Member States. This note suggests that ASEAN's services integration process needs to be strengthened in several ways that would increase focus on implementation of commitments. The key priority here will be promoting regulatory cooperation and coordination through harmonization or mutual recognition, and the development of regulatory capacity, which includes cooperation among regulatory bodies, the exchange of information for regulatory purposes, and sharing the experiences of regulatory reforms.

The Importance of Services

While the economies of the Association for Southeast Asian Nations (ASEAN)² grew rapidly over the last four decades primarily as manufacturing and exporting powers, the role of the services sector and services trade has expanded over the last decade. Services accounted for more than 40 percent of total value added and employment in 2012 (figure II.D.1). Trade in services has more than doubled since 2005 (figure II.D.2). Many of these services, such as finance, transportation, and communication, are backbone services that feed into other production processes. Trade in and growth of these services can help firms gain access to better quality and more diverse inputs at lower costs and thereby boost productivity across the economy.

The services growth and trade agenda will become even more important for ASEAN countries in the future as they climb up the ranks of middle-income countries and confront what has been called the “middle-income trap” (Aiyar et al. 2013; Eichengreen, Park, and Shin 2013; Gill and Kharas 2007). Eight of the 10 ASEAN countries are middle-income countries, and the two others are on the verge of becoming so. But, worldwide, only 14 countries have managed to grow from middle-income to high-income countries since 1960. Research suggests that when countries reach per capita incomes of around purchasing power parity

¹ This note was prepared by Ahmad Ahsan. It draws on the forthcoming ASEAN Secretariat-World Bank *ASEAN Services Integration Report* prepared by staff from the World Bank with support from the ASEAN Secretariat.

² ASEAN comprises 10 member states: Brunei Darussalam, Cambodia, Indonesia, Lao PDR, Malaysia, Myanmar, the Philippines, Singapore, Thailand, and Vietnam.

(PPP) US\$10,000 to US\$11,000, or again between PPP US\$15,000 to US\$16,000, their growth slows markedly (Eichengreen, Park, and Shin 2013). This failure to make the transition is because most middle-income countries are unable to boost their productivity adequately to remain competitive as their wages increase. Most middle-income countries are unable to innovate and diversify their economies to more productive manufacturing and services. As a result, on one side, middle-income countries are outcompeted in traditional sectors by other developing countries where wages are low. On the other side, the middle-income countries cannot compete with high-income economies where productivity and technological sophistication are much higher. Increasing the productivity and competitiveness of the services sector will be central because services—transport, finance, health, education, research, and professional services—are essential inputs for increasing innovation and productivity in all sectors of an economy.

Figure II.D.1. Services are important for value added and employment in ASEAN countries

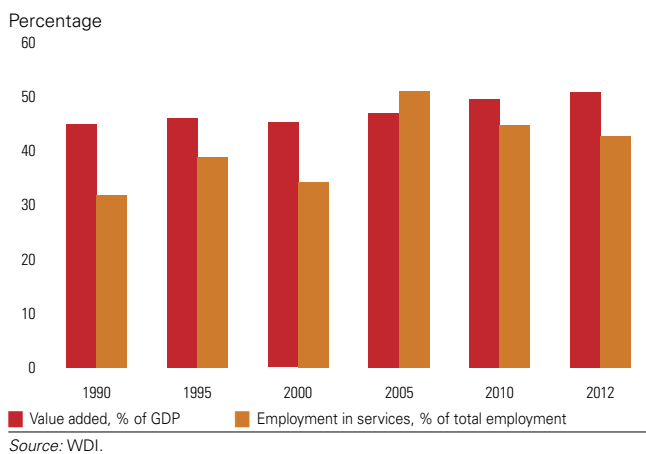
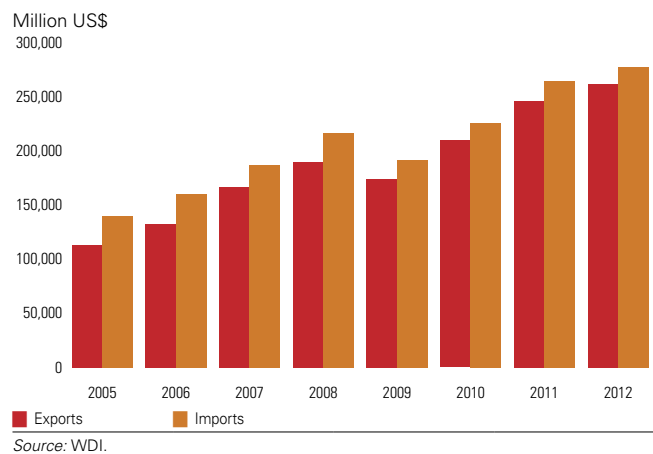


Figure II.D.2. ASEAN trade in services has also increased significantly since the 2000s



The formation of the ASEAN Economic Community (AEC) at the end of 2015 also offers new opportunities for developing services and services trade among ASEAN economies. Aware of the potential gains from services, ASEAN economies have made integrating services a key part of the AEC. The services integration agenda in the region was first institutionalized through the ASEAN Framework Agreement on Services, signed as early as 1995. The ASEAN Economic Community Blueprint (AEC Blueprint) adopted in 2007 went considerably further by providing a bold vision of deep integration where goods, services, investment, and skilled labor would move freely across the borders of ASEAN countries by 2015. The AEC will help create a single market of more than 600 million people and US\$2.3 trillion of gross domestic product (GDP) with free flow of trade in goods and services. There is considerable potential for realizing gains from trade in services among ASEAN's members (Plummer and Yue 2009; ERIA 2012; ASEC and World Bank 2013). While the region generally tends to underperform in services production and trade for their level of development, a few ASEAN economies have already emerged as highly competitive suppliers and exporters of services, as discussed below. The potential of the region in services is underscored by the foreign direct investment (FDI) the services sector has been able to attract, which accounts for more than 50 percent of total ASEAN FDI.

This note discusses progress made in the services integration agenda and the challenges facing the ASEAN countries. (ASEAN and World Bank, Forthcoming 2015). The note discusses the performance of ASEAN economies in services output and trade; the impact of current policies on trade and integration in services; and the challenges ASEAN economies face as they try to integrate services.

ASEAN Economies Underperform in the Services Sector

With a few exceptions, ASEAN countries' performance in services has run contrary to trends in most of the world. Their share of services in GDP, for instance, has remained unchanged or even declined, with the exceptions of the Philippines, Singapore, and Lao PDR (figure II.D.3). Moreover, while most ASEAN countries are quite open to goods trade, services trade lags behind. The East Asia and Pacific region (including China, Mongolia, and Timor-Leste, in addition to the ASEAN countries) lags behind the other regions in services trade openness compared to goods trade openness (figure II.D.4). Given the rapid pace of integration of ASEAN economies into the global trading system and the intensifying pace of free trade agreement negotiations, it would be timely now for ASEAN member countries to deepen and widen services integration both within the region and with the rest of the world. Local services providers will be able to take advantage of new market openings and to benefit from new ideas and processes arising out of the opening up of trade.

Figure II.D.3. But the share of services in GDP in ASEAN remains low and unchanged

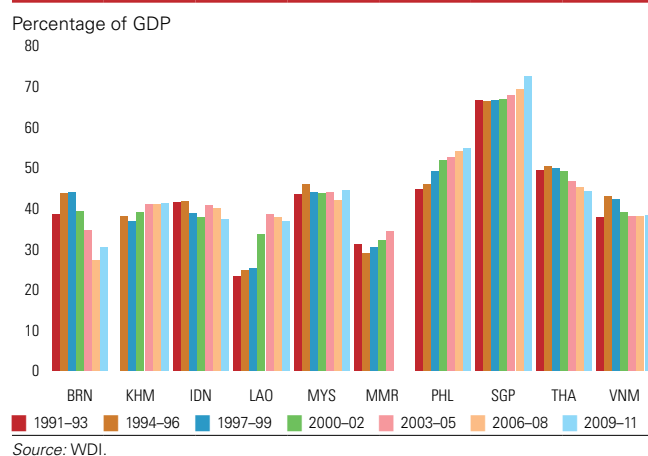
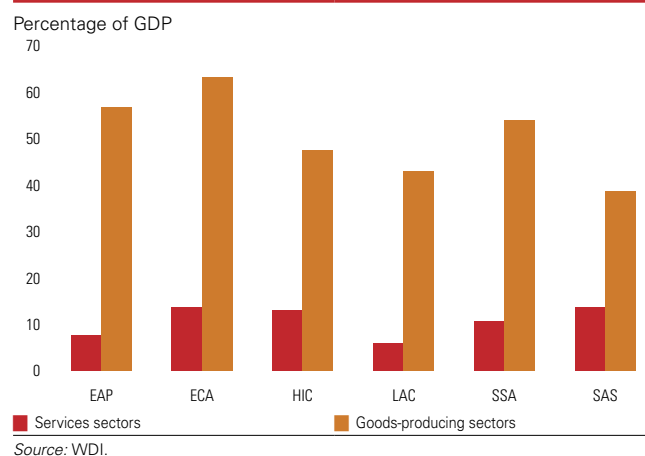


Figure II.D.4. And services trade remains substantially below goods trade



While trade in services has also grown rapidly in ASEAN countries, it did not exceed GDP growth, unlike in other middle-income and emerging economies. As a result, the share of services exports in GDP did not increase noticeably between 1996 and 2012, with the exception of Cambodia, the Philippines, and Singapore. In addition, while services trade growth in the region is significant, it still lags behind other sectors. Further, ASEAN members mainly export “traditional services” such as transportation, and travel and tourism services, and have been less successful in tapping into new services opportunities such as information technology (IT) and business-related services. The Philippines (in the business process outsourcing sector) and Singapore (in professional services) are exceptions to this.

There is considerable heterogeneity, however, across countries at the subsectoral level of performance, which suggests the potential for developing services trade and the gains from trade. Indonesia's and Thailand's exports show significant increases of trade in traditional services sectors such as transport and construction, along with some rise in professional services in recent years. Malaysia shows good performance in computers, information services, and financial services. The Philippines shows a rise in other professional services and insurance. Singapore shows the most diversified growth, dominated by financial services.

The participation of ASEAN countries in global value chains provides a good opportunity for developing services through trade. These economies have traditionally been strong in contract manufacturing, particularly for electronics, serving as vital export nodes for production. This experience in participating in manufacturing global value chains (GVCs) provides a basis for sustaining growth and economic development through using the GVC in services. The role of services in GVCs can thus be viewed from the perspective of creating or engaging more deeply in GVCs for both goods and services including in the services components of goods GVCs. In short, ASEAN economies could consider participation in services activities, particularly in high value added services in GVCs, as a path to sustained development.

If well implemented, the liberalization measures that ASEAN countries have committed to under the ASEAN Framework Agreement on Services (AFAS) can assist in transforming the AEC into a global services hub. There is already a concerted push for ASEAN economies to realize the goal of regional economic integration and make the services sector within ASEAN more efficient. Under the Framework Agreement of Priority Integration Sectors, signed in 2004, eleven priority sectors were identified for fast-tracking regional integration, four of which are services-oriented: e-ASEAN, air travel, tourism and healthcare. Logistics was added as the 12th priority sector two years later, in 2006. These sectors serve as strategic inputs to all other sectors in the regional economy, both goods and services. To realize this potential gain from services, however, ASEAN countries will have to undertake services trade policy reforms to address the high barriers to services trade.

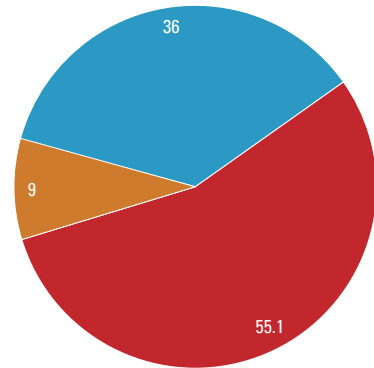
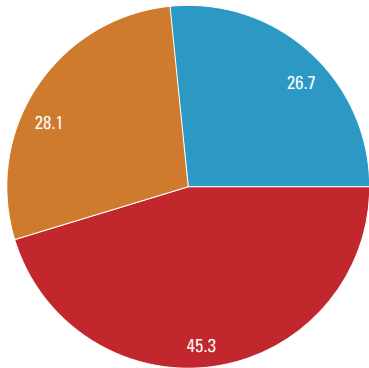
Liberalizing Highly Restrictive Services Trade Policies

A first glance at the data suggests that while the AFAS has made progress beyond the General Agreement on Trade in Services (GATS) in terms of commitments made by countries to liberalize services trade, it falls well short of the goals set out under the AEC. Liberalization commitments may be classified as “full,” “partial,” or “unbound” (figure II.D.5). Full commitments reflect the number of services subsectors that have been committed by ASEAN countries to not have any market access or national treatment discrimination or restrictions against foreign suppliers. Unbound commitments refer to the number of subsectors that have no commitments in either market access or national treatment. ASEAN Member States have almost doubled the aggregate number of subsectors committed for opening—expanding it from 35 percent to about 65 percent of covered subsectors. Almost 25 percent of subsectors have been fully opened within the region compared to only 10 percent at the multilateral level. More important, however, the progress under the AFAS in the first seven rounds of negotiations is far short of the goal of liberalization established under the AEC Blueprint.

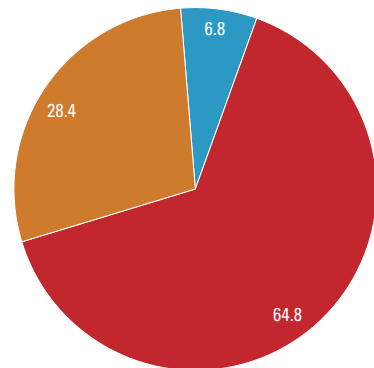
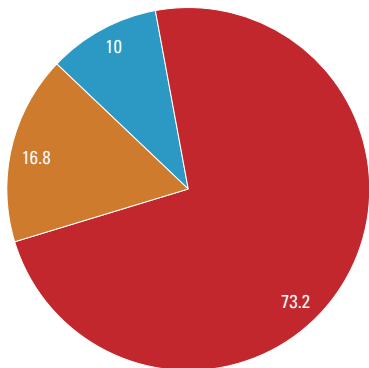
Moreover, despite making progress in committing to liberalize services trade under ASEAN services trade agreements, ASEAN countries still have generally more restrictive services policies than any other region in the world except the Gulf States. A survey of actual service trade policies across ASEAN, measured by the Services Trade Restrictions Index (STRI) carried out by the World Bank (ASEAN and World Bank 2013) suggests ASEAN countries have more restrictive services policies in general than any other region in the world except the Gulf States. The average STRI for the region is 60 percent higher than the global average (figure II.D.6), but restrictiveness of applied policies varies widely across countries and income levels. Cambodia and Singapore have the most open policies in the sectors covered. Myanmar and Vietnam are virtually open, with few restrictions, and the rest (Indonesia, Malaysia, the Philippines and Thailand) have significant restrictions.

Figure II.D.5. Level of commitments in trade agreements

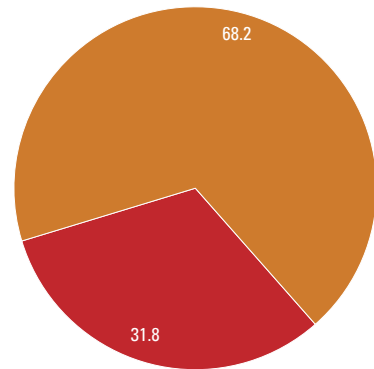
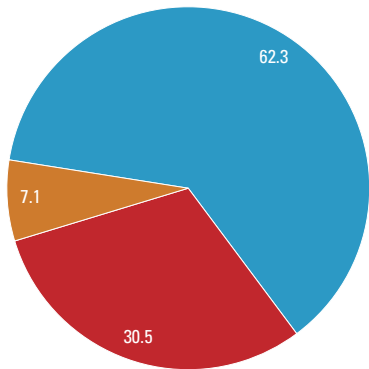
Cross-border services, in percent Commercial presence, in percent
AFAS (as of the Seventh Package of agreements)



GATS



Hypothetical AEC Blueprint (2010)



■ Unbound ■ Partial restrictions ■ No restrictions

Source: Forthcoming ASEC-World Bank, 2014 report. Based on commitments by ASEAN Members States under the AFAS (up to 7th package), GATS.

Figure II.D.6. STRIs by industry for ASEAN member countries, 2012

Also, despite commitments made under the World Trade Organization (WTO) and AFAS, actual liberalization by ASEAN countries has been modest in the last four years. While there are some instances of market opening, there are also instances of reversal of liberalization. For the six ASEAN Member States for which the same surveys were conducted in 2008, there was little change in the overall policy regime from 2008 to 2012 (regional average STRI fell only about 16 percent from its high level). As a consequence, even though actual openness is greater than that promised by current AFAS commitments, it is still not close to the ambitious goals specified in the 2007 AEC Blueprint, especially in the case of Mode 3 trade, that is, in liberalizing foreign investment (“commercial presence”) in services.

Nor have ASEAN countries made progress toward creating a more regionally integrated market. There is little evidence that ASEAN economies are more open toward each other in services trade than toward non-ASEAN countries. For the seven broad sectors (and relevant modes) covered by the STRI survey, this report found little difference between policy treatment toward intra-ASEAN and extra-ASEAN trading partners. ASEAN countries therefore received virtually the same treatment as non-preferential or most-favored-nation policies.

There are two areas, however, where there has been some progress in services integration. In air transport, a priority integration sector, ASEAN countries have taken steps toward regional open skies, while in certain professional services, mutual recognition agreements have been negotiated and concluded. These initiatives suggest that regional effort may have had incremental value when focused on areas not being addressed multilaterally. However, even in these areas, regional integration efforts are still on-going. In professional services, domestic regulations are still in the process of being aligned with the ASEAN Mutual Recognition Agreements or Arrangements (MRAs), while some MRAs need to be complemented with further bilateral negotiations to make them operational. In air transport, further liberalization may be necessary to achieve a truly integrated regional air market.

How Can the Services Integration Process Be Enhanced?

Going forward, completing the negotiations for achieving the AEC targets will be important, but the key challenge will be to implement the commitments made under AFAS. This requires strengthening of institutional and negotiation processes. For instance, one of the major shortcomings under the current mechanism is the difficulty in monitoring and, where needed, ensuring the implementation of commitments in services trade. To correct this, it will be critical to strengthen the foundation of the ASEAN services integration process, AFAS, or any successor agreement. AFAS is closely related to the GATS and follows its main principles, disciplines, and approach to liberalization, including provisions on market access and national treatment, and a typology for scheduling commitments. Under these rules, market access commitments prohibit a number of quantitative restrictions, and the national treatment obligations cover both de jure and de facto discrimination. A number of measures can be taken to strengthen the services integration process:

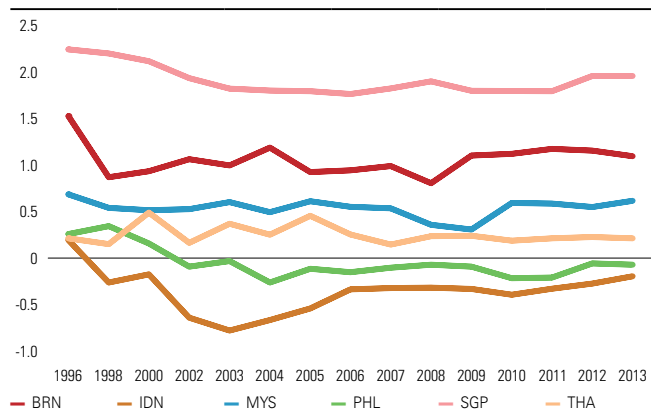
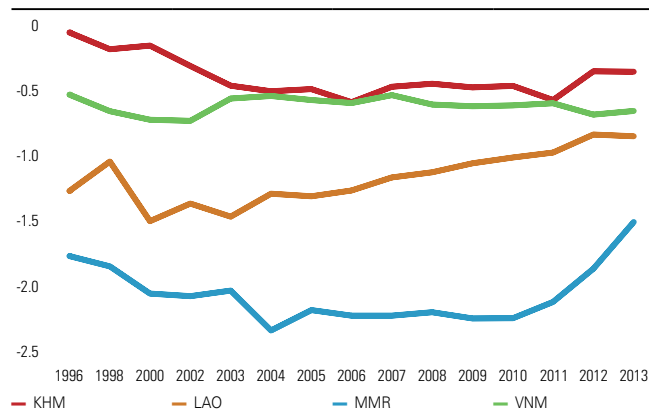
- The legal scope of AFAS needs to be better clarified. AFAS is based on the rules (disciplines) of the GATS, but the extent to which GATS disciplines and their interpretations apply need to be clarified. For example, the terms of GATS provisions on market access and national treatment have been interpreted by WTO panels and the Appellate Body in several dispute settlement cases. These interpretations help clarify the meaning of these provisions in the WTO context. But it is not clear whether such interpretations have any significance under the AFAS.
- Limitations on market access need to be removed, and discriminatory measures, including caps on foreign equity, eliminated. In some cases, public order, safety of services, or prudential reasons in the financial sector may justify some restrictions.
- Establishing an Implementation Monitoring Mechanism for AFAS that goes beyond the current legal compliance monitoring of the AEC scorecard and improving the existing ASEAN dispute settlement mechanism will help achieve the full potential of the agreement.

A key task will be to foster regulatory cooperation among ASEAN countries. Regulatory cooperation is important for integrating the services sector in general, and it is even more so for ASEAN countries because of their uneven quality of regulations (figure II.D.7), which may impede regional trade and investment. While trade negotiations and liberalization commitments are important, services are provided and traded under domestic regulations in each country. If the domestic regulatory quality is uneven across countries and if regulations are not complemented by necessary reforms, services trade liberalization commitments cannot realize their full potential.

Regulatory cooperation can take place at two different levels of regulation. First, cooperation at a horizontal level would require establishing common general principles that would guide domestic regulation on services trade and investment. To begin with, ASEAN Member States should recognize that domestic laws and regulations should conform to certain principles of good regulation, such as transparency, consultations (both public and interagency), due process, and efficiency. Even though they may work differently for each mode of supply, common regulatory principles and harmonization of regulation are key steps for the realization of the single market in all modes.

Figure II.D.7. Regulatory quality in ASEAN countries is heterogeneous

Higher score means higher quality

Singapore and middle-income ASEAN**Low-income ASEAN**

Source: Worldwide Governance Indicators.

Second, more detailed regulatory principles for adoption should be developed on a sectoral basis, in particular for heavily regulated services. This would follow the steps already taken in ASEAN in some services, like air transport and some financial services. Other key service sectors that would benefit from common regional rules may include land and water transport, telecommunications, and professional services. Regulatory cooperation with regard to company law will facilitate cross-border mobility of services providers. Following the European Union experience, ASEAN Members States may evaluate addressing basic requirements for the establishment of companies, including areas like compulsory disclosure of information, and power of representation of company organs. Requirements on disclosure, in particular, may include the harmonization of information requirements and establishment of an official company register accessible by all Member States.

ASEAN can also take advantage of the need for regulatory cooperation as an opportunity to build optimal regulatory areas for services. Such areas are composed of a set of countries whose welfare can potentially be maximized by regulatory coordination and convergence (Mattoo and Sauv e 2011). While regulatory convergence is overly ambitious for ASEAN at this point, the benefits of regulatory cooperation would emerge as a result of creating truly integrated markets and institutional capacity. An optimal regulatory area would lead to the adoption of similar regulatory principles to enhance regulatory quality. In the ASEAN context, the optimal regulatory area would imply cooperation in three areas:

- Regulatory cooperation, through harmonization or mutual recognition
- Harmonization of regulatory principles, in particular regarding the design, adoption, and application of regulations
- Building of regulatory capacity, which includes cooperation among regulatory bodies, exchange of information for regulatory purposes and experiences on regulatory reforms, and identifying and adopting good regulatory practices in new areas.

In conclusion, services integration in ASEAN will now require taking a more comprehensive approach centering on regulatory cooperation. ASEAN has been relatively successful in moving toward service markets integration, by committing to remove the most significant impediments to trade. However, services

trade policies are embedded in regulations that affect services and foreign services providers. Since regulatory quality is uneven, there is the potential to reap substantial additional benefits through regulatory cooperation. Otherwise, while formal integration under AFAS may progress quickly because countries are committed to the increased incorporation of sectors in their services schedules, the real integration that depends on regulatory harmonization among ASEAN members will be held up. Overall, services integration in ASEAN will require a more comprehensive approach that looks at other sectors and regulatory cooperation more broadly than is currently offered under the AFAS.

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Part III. Country Pages and Key Indicators



CAMBODIA

	2014
Population, mn	15.1
GDP, US\$ bn	16.1
GDP per Capita, US\$ (2013)	1,006.8
GDP per Capita, US\$ PPP (2013)	3,041.1
Gini index (WB estimate) (2012)	28.8
National poverty rate (2012) ^{1/}	17.7
US\$1.25 (PPP) a day poverty rate (2012) (%) ^{2/}	6.0
Life expectancy at birth, total (yrs) (2012)	71
School enrolment rate, primary (% , net) (2012)	98

Source: World Development Indicators, and Bank staff estimates.

1/2012 with national poverty lines: Riel 5,326 for Phnom Penh, Riel 4,273 for other urban areas and Riel 3,914 for rural households.

2/The US\$1.25 (PPP) a day in 2012 is approximately 3,605 Riels (nominal).

Cambodia continues to enjoy robust growth, albeit at a slightly slower pace. Real growth for 2014 is estimated to have reached 7 percent (Figure 1), but there are signs of weaknesses in garment and agricultural production that are slightly slowing growth.

Poverty continues to fall in Cambodia. As of 2012, the poverty headcount rate (according to the national poverty line) was 17.7 percent, almost 3 percentage points lower than in 2011. Moreover, recent economic growth has been particularly favorable for the less well off.

Recent developments

Garment exports eased to a year-on-year growth rate of 9.2 percent (value) in 2014, compared to 17.6 percent in 2013. This was largely due to the enduring impact of past labor unrest, appreciation

of the US dollar, and emergence of other low wage regional competitors.

The construction sector remains resilient, propped up by the return of confidence.

Tourist arrivals decelerated with a year-on-year rate of only 6.9 percent in 2014, versus 17.5 percent in 2013 due to an underperforming regional tourism.

Agriculture sector growth remains sluggish due primarily to slow yield improvements coupled with depressed agriculture commodity prices.

The external position remains stable, supported by healthy foreign direct investment. Due to decelerated exports, the current account deficit (excluding official transfers), however, slightly widened to an estimated 11.2 percent of GDP in 2014. Gross international reserves rose, reaching US\$ 4.6 billion, or about 4 months of imports, by the end of 2014.

Exchange rate targeting supports price stability, but erodes competitiveness of exports to the EU market. The riel hovered at around 4,000 per US dollar but appreciated against the euro by 17 percent since July 2014.

Inflation eased significantly, dropping to 1.2 percent year on year at the end of 2014, compared to 4.6 at the end of 2013 with depressed food and oil prices.

Financial deepening continues. Private sector deposits growth reached 30.6 percent year-on-year, by end-2014, more than double the 14.2 percent year-on-year increase, at the end of 2013. Credit growth has once again picked up reaching 31.3 year-on-year at the end of 2014.

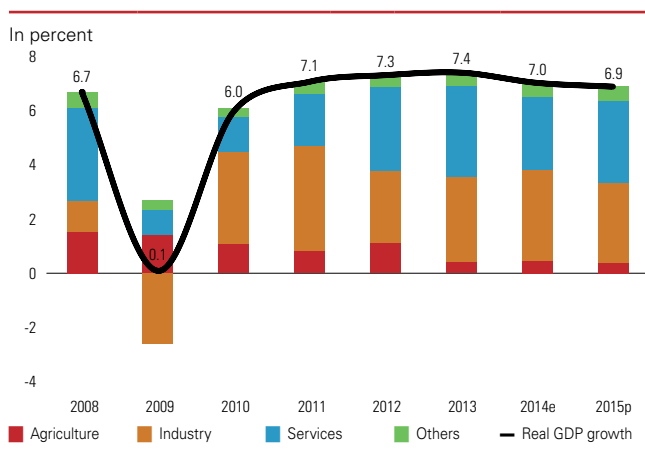
Fiscal consolidation continues. Collection improved, reaching an estimated 16.1 percent of GDP in 2014, compared to 15.1 percent in 2013. Expenditure remains contained at 20.5 percent of GDP. However, the overall fiscal deficit (including grants) only improved slightly to 2.5 percent of GDP because of a dwindling grants component. Cambodia's debt

distress rating in the WB/IMF Debt Sustainability Analysis (2013) remained low.

Overall, growth has been pro-poor. Resulting mainly from a dynamic agricultural sector, consumption for the bottom 40 percent of the consumption distribution grew at an average annual rate of 7 percent during 2007–2012, compared to 3.6 percent for the total population. Consistently, inequality improved: the Gini coefficient declined from 32 in 2008 to 28 in 2012. Nonetheless, progress in equality has slowed down in the last years.

Between 2004 and 2012, poverty incidence declined significantly from 50.2 percent to 17.7 percent, according to the national poverty line. Most of the poverty reduction occurred between 2007 and 2009 (more than twenty percentage points), mostly explained by the remarkable increase in the price of rice, the main agricultural product of the country. Rural poverty remained more prevalent than urban poverty as of 2012: the headcount rate was 21 percent in urban areas versus 8.6 percent in urban areas (in Phnom Penh only 3.8 percent of the population is poor).

Figure 1. Contributions to real GDP growth



Source: Authorities, and Bank staff estimate and projection.
Notes: e = estimate; p = projection

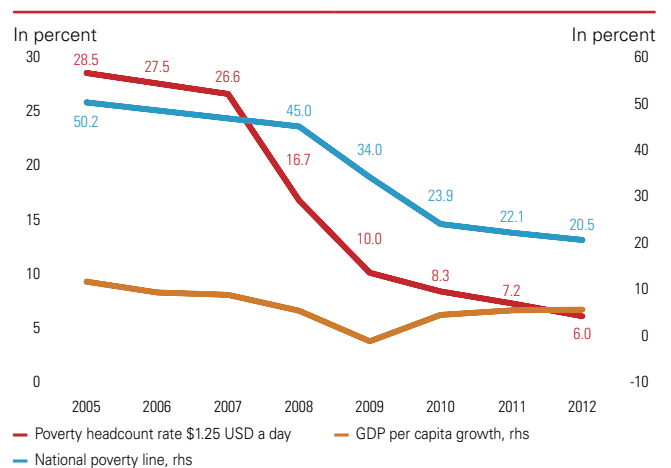
Outlook

Growth is projected to slightly moderate to 6.9 percent in 2015. Reduced competitiveness due to increased costs, dollar appreciation, and new competitors will continue to affect garment export growth while the return to a double-digit tourist arrival growth rate is yet uncertain. Agricultural growth will likely continue to be modest affected by dampened agricultural commodity prices and slow crop yield improvements.

The expected positive effects of the recent oil price decline are significant on growth (0.5 percentage points in GDP growth this year) but very moderate on poverty. The 20 percent fall in local prices will at most translate into a 1.5 percent consumption gain for the average household, and smaller for poor households whose budgets have lesser share of fuel consumption.

Downside risks include potential renewed labor unrest, a delay in economic recovery in Europe, and the further dampening of rice prices with the reentry of Thailand and Myanmar.

Figure 2. GDP per capita growth and poverty headcount rate



Source: Authorities and World Bank staff estimates using CSES data.
Notes: f = forecast

Challenges

Revitalizing the drivers of growth—garments, tourism and rice—is key. Addressing high energy costs, automating business processes, and improving the investment climate will improve competitiveness and diversification. Improved road transportation and central-local coordination will help diversify tourist destinations. Increased yield and quality, and reduced milling and logistics costs would raise the competitiveness of Cambodian rice.

Safeguarding stability in the rapidly expanding financial sector will require enhanced banking supervision, which helps prevent a construction bubble.

Further investments in health, education, and social protection will help increase productivity and welfare. Malnutrition and low education attainment remain more prevalent among the poor population.

Further strengthening tax administration and efficiency of spending is crucial. Linking pay increase with improved human resource management will improve service delivery while closely monitoring the rising wage bill will help ensure its affordability.

Box. Poverty trend measured under the international US\$ 1.25/day Purchasing Power Parity (PPP)

Poverty in Cambodia under the US\$ 1.25 PPP a day measure (which allows for international comparisons) was 6.0 percent in 2012 (Figure 2), compared to 28.8 percent in Lao PDR, 15.4 percent in the Philippines, and 10.9 percent in Indonesia; all countries with a GDP per capita at least 1.5 times that of Cambodia. While the US\$1.25 PPP poverty declined at an impressive annual average of 5.8 percentage points between 2007 and 2009, it slowed down to 1.36 percentage points between 2010 and 2012. Poverty has fallen steadily to 4.2 percent in 2014. The slower pace of poverty reduction in the recent years stems largely from a decelerating agricultural sector, on which the poor are dependent.

Cambodia / Selected Economic and Social Indicators

	2012	2013	2014e	2015p	2016f	2017f
Real GDP (% change yoy)	7.3	7.4	7.0	6.9	6.9	6.8
GDP, at market prices (% change yoy)	8.9	8.3	7.5	7.9	8.2	8.6
Agriculture	5.6	2.0	2.2	2.3	2.8	3.3
Industry	13.0	13.8	13.0	11.6	10.8	9.7
Services	9.6	10.2	8.0	9.7	10.2	11.2
Inflation (eop, % change)	2.5	4.6	1.2	1.5	2.0	2.5
Fiscal balance including grants (% of GDP)	-3.3	-2.7	-2.5	-3.8	-4.9	-4.7
Exports, goods & services (% change yoy)	13.7	17.6	8.9	10.6	13.0	12.7
Imports, goods & services (% change yoy)	16.6	16.9	11.6	11.2	11.8	11.8
Current account balance excluding official transfers (% of GDP)	-9.6	-10.7	-11.2	-11.7	-11.6	-10.9
Foreign direct investment, mln of US\$	1,697.9	1,826.1	1,717.4	1,660	1,620	1,590
Poverty rate (national poverty line)	17.7					
Poverty rate (\$1.25 PPP a day)	6.0					
Poverty rate (\$2.00 PPP a day)	36.2					

Source: Authorities and World Bank staff (and EAP Poverty) estimates and projections.

Notes: e = estimate, p = projection, f=forecast



	2013
Population, mn	1,357.38
GDP, US\$, bn	9,240.27
GDP per Capita, US\$	6,807.43
GDP per Capita, US\$ PPP	11,906.51
Poverty headcount ratio at \$1.25 a day, PPP, % of population ^{1/}	12.3
Poverty headcount ratio at \$2 a day, PPP, % of population ^{1/}	35.5
Gini coefficient, household income ^{2/}	0.479
Life expectancy (2012)	75.2
School enrollment rate, secondary	88.98
School enrollment rate, tertiary	26.7

Sources: Statistics China, World Development Indicators, 2014.

^{1/}The data is for Rural China 2011.

^{2/}Official data released by National Bureau of Statistics in China.

China growth moderated to 7.4 percent in 2014 reflecting policy steps to put economic growth on a more sustainable footing. Weak domestic demand, capital outflows, structural adjustments in sluggish real estate sector, and deflationary pressures have added additional pressures to economic activity. The growth is expected to decelerate to 7.1 percent in 2015 and 6.9 percent by 2017 as the structural adjustment continues. Poverty is expected to decline further—poverty rates in rural areas are projected to decline from 6.4 in 2014 to 2.8 percent in 2017 (the World Bank poverty line of US\$ 1.25/day PPP).

Recent developments

China growth moderated to 7.4 percent in 2014 as policy efforts to tighten credit growth, reduce overcapacity, internalize the cost of industrial

pollution and harden budget constraints of local governments intensified in 2014. On the supply side, weak domestic demand and policy tightening in energy-intensive sectors continued to weigh on industrial activity. In contrast, services remained upbeat as the structure of economic growth continued to evolve from an industrial to a service base. On the demand side, domestic rebalancing from reliance on investment continues. Fixed asset investment grew by 15.2 percent (yoy) in 2014, down from 19.4 in the previous year.

Household income growth, the main determinant of poverty reduction, is showing some signs of deceleration. Average disposable income in urban households grew at real annual rates above 8 percent between 2010 and 2012, but only at 4.9 percent in 2014. Similarly, real growth in average net income in rural households went from 12.1 percent in 2011 to 9.4 percent in 2014. The combination of falling real urban wages with flat unemployment rates and growing migration indicates that the deceleration of the economy has translated into price (wages) rather than quantity (jobs) adjustment in urban labor markets.

Targeted support measures have limited the growth slowdown. The central bank announced three targeted cuts in the required reserve ratio (RRR) during 2014, and two rate cuts in February 2015 followed the one in November 2014. Despite the stimulus measures, broad money (M2) and credit growth has slowed down in 2014, mainly due to moderating credit growth in the shadow banking sector, as authorities continued to limit off-balance sheet credit expansion. China's overall fiscal position remains strong, but a slowdown in real estate translated into slower revenue growth.

On the external front, merchandise exports growth was only 4.9 percent in nominal terms, although import growth remained weak, reflecting weakening domestic demand and declining commodity prices, with nominal growth rate at 0.5 percent in 2014. Net FDI stayed robust at US\$32.2 billion in Q4. Net non-FDI capital outflows reached an estimated

US\$90 billion in Q2, and widened to US\$117 billion and US\$152 billion, in Q3 and Q4, respectively.

Outlook

The growth is expected to gradually moderate from 7.1 percent in 2015 and 6.9 percent in 2017, reflecting intensified policy efforts to address financial vulnerabilities and structural constraints and to make growth more sustainable. But progress in rebalancing the sources of growth in domestic demand will remain gradual. Investment growth will continue to decelerate due to credit tightening and ongoing adjustments in the real estate sector. And economic growth will continue to evolve from an industrial to a services base.

Both monetary and fiscal policy stance is expected to remain accommodative to limit risks of too rapid growth slowdown that could trigger disorderly adjustments in accumulated imbalances.

A slower pace of economic growth will bring slower household income growth and hence a deceleration, but not a stop, in the fall of rural poverty. Poverty is expected to decline further—poverty rates in rural areas are projected to decline from 6.4 in 2014 to 2.8 percent in 2017 (the World Bank poverty line

of US\$ 1.25/day). Narrowing of the gap between rural and urban average incomes will help reducing overall inequality, but shared prosperity, particularly in urban areas, will depend on more widespread employment and education opportunities.

Challenges

The structural adjustments are expected to be orderly and gradual—although an abrupt unwinding of accumulated imbalances cannot be completely ruled out. First, a failure to strengthen the vulnerabilities in the financial sector could leave the economy increasingly saddled with inefficient firms, bad loans and weaker financial institutions. This could reduce economic activity by undermining productivity growth and increasing capital misallocation. Second, the housing sector might not bottom out, instead continuing to decelerate, further undermining consumer confidence and economic activity. Third, managing local government debt remains a challenge. While policy initiatives to refinance local government debt are targeted to address specific vulnerabilities, accommodative policies if not accompanied with structural reforms will make it more challenging to implement the policies necessary to shift growth to a more sustainable medium-term path.

Figure 1. Contributions to annual GDP growth

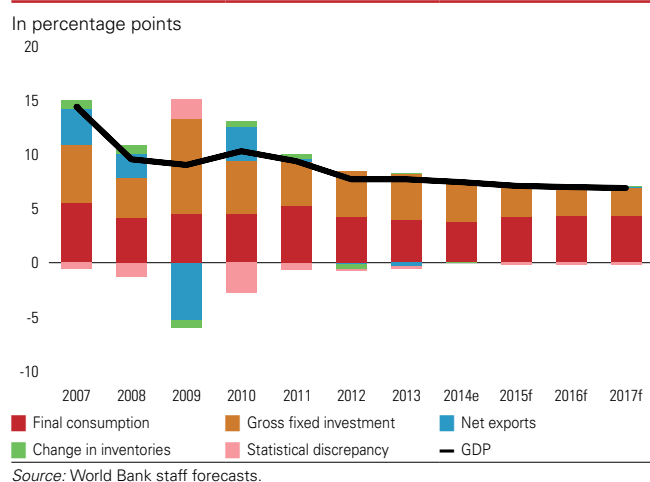
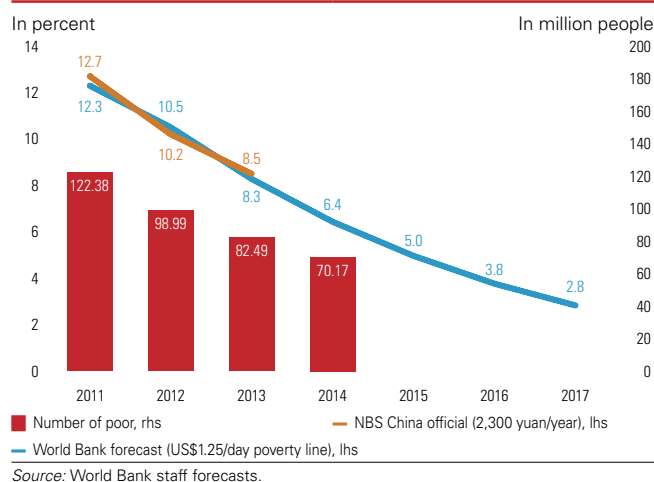


Figure 2. Poverty in rural China

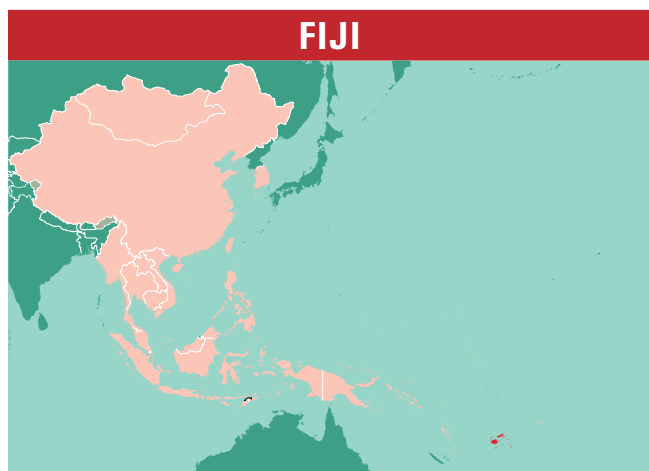


China / Selected Economic and Social Indicators^{1/}

	2012	2013	2014	2015 e	2016 f	2017 f
Real gross domestic product	7.7	7.7	7.4	7.1	7.0	6.9
Private consumption	8.4	7.8	7.6	8.6	8.6	8.6
Government consumption	8.6	8.1	7.2	8.1	8.0	7.9
Gross fixed capital investment	9.5	9.5	8.1	6.5	6.1	5.7
Change in inventories, % contribution	2.0	1.9	1.8	1.6	1.5	1.5
Statistical discrepancy (% GDP)	-2.7	-2.7	-2.5	-2.5	-2.5	-2.5
Exports, goods & services	3.9	6.9	6.8	5.4	5.7	6.0
Imports, goods & services	3.3	7.2	5.9	3.9	4.2	4.5
GDP, at market prices	7.7	7.7	7.4	7.1	7.0	6.9
Agriculture	4.7	4.0	4.1	4.0	4.1	4.2
Industry	8.1	7.8	7.2	7.0	6.8	6.7
Services	8.4	8.7	8.7	8.9	9.1	9.3
Output Gap	2.0	1.1	0.3	-0.6	-1.3	-2.0
CPI Inflation , period average	4.1	3.6	2.5	2.5	2.3	2.3
Current account balance, % of GDP	2.6	1.8	2.1	2.3	2.0	1.6
Fiscal balance, % of GDP	0.2	-0.9	-2.1	-2.4	-2.5	-2.5
Poverty rate in rural areas, \$1.25 a day, PPP term ^{2/}	10.5	8.3	6.4	5.0	3.8	2.8
Poverty rate in rural areas, \$2 a day, PPP terms	32.6	28.7	25.1	21.9	18.9	16.2
Gini coefficient, household disposable income	0.474	0.473	0.469			

Sources: Statistics China, World Bank staff forecasts.

Notes: f = forecast. 1/ in annual percentage change percent, unless otherwise noted. 2/ China has an official rural poverty rate which is slightly above the \$1.25/day PPP mark.



	2014
Population, mn	0.88
GDP, US\$, bn	4.028
GDP per Capita, US\$	4,572
GDP per Capita, US\$ PPP	7,501
Poverty rate (2008), US\$1.25	5.9
Poverty rate (2008), US\$2.00	21.8
Gini coefficient, consumption	0.4
Life expectancy	72
School enrolment rate, primary	99

Sources: Fiji Bureau of Statistics, World Development Indicators, 2014.

Fiji's economy is benefiting from an ongoing program of public capital investment and recent transition to democracy. Risks associated with required fiscal consolidation and emerging inflationary pressures need to be carefully addressed. Over the medium-term, poverty reduction is reliant on improvements in the business environment and successful diversification away from the declining sugar sector.

Recent developments

Democratic transition and job growth Fiji held democratic elections in September 2014, ending 8 years of military rule. This transition has been positively viewed by the private sector. GDP grew 3.8 percent in 2014 (Figure 1) supported by strong public investment. Job advertisements increased by 12.8 percent in 2014, with improved confidence expected to support increased economic opportunities, especially in urban areas.

Macroeconomic management has been sound overall. Inflation fell to 1.2 percent during 2014, and the current account deficit declined to 10 percent of GDP. Imports declined by 13.8 percent to 51 percent of GDP in 2014 despite robust consumption and investment, and export earnings remained steady at 25.9 percent of GDP. At the end of 2014, foreign exchange reserves stood at US\$750 million, equal to four months of import cover. Budgeted revenues from asset sales were not realized, but debt financing of the 2014 deficit remained within budgeted levels (around 1.9 percent of GDP) due to weak execution of the capital budget.

Incidence of extreme \$1.25 poverty is low in Fiji with only about 5.9 % of the population living below this poverty line in 2008, the latest year for which poverty data is available. About a fifth of the population lived under \$2/day poverty and it is assessed that the incidence of both \$2 and \$1.25 poverty has declined very little over recent years (Figure 2). Some poverty reduction has been achieved in urban areas, where service sector growth has generated new opportunities. Stubborn rural poverty reflects weak agricultural growth and a stagnant sugar sector. The government places considerable importance in accelerating poverty reduction efforts through a combination of transfer programs like the Poverty Benefit Scheme and supporting income-generating activities in remoter islands.

Outlook

Growth is expected to slow. Growth of 2.5 percent is expected in 2015, returning to potential following the sharp increase in credit growth and investment over the election period. The current account deficit is expected to narrow to nine percent of GDP over 2015 as investment-driven imports slow and tourism exports strengthen.

Poverty is expected to continue to decline only very gradually over coming years. Growth in services sectors will continue to reduce urban poverty. Rural poverty may increase with the loss of preferential

access to European markets, with falling sugar prices undermining the viability of sugar production in some areas where poverty is already concentrated.

External balance and price stability face risks over the medium-term. Foreign exchange reserves are expected to decline over coming years and greater flexibility in exchange rate policy may be required to ensure external balance over the long-term. Inflation of around 3 percent is expected in 2015 and over the medium-term, driven by strong consumption and investment, significant growth in donor inflows, and the Reserve Bank of Fiji's accommodative monetary stance.

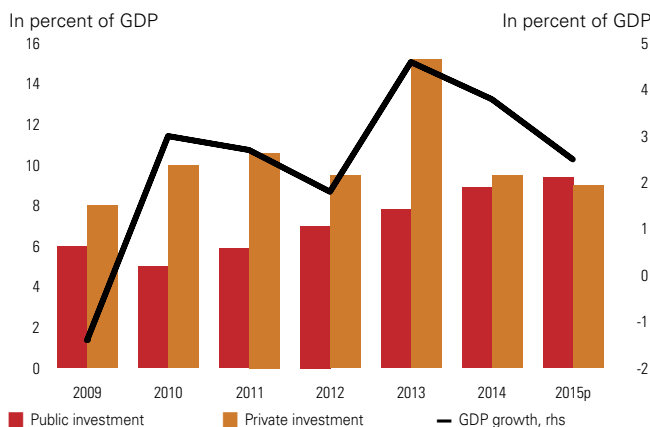
Challenges

Fiji faces important challenges in sustaining recent growth rates over the medium-term. A business environment more conducive to investment is required for necessarily reorientation of the economy towards new growth sources, including tourism. Maintaining public debt at sustainable levels will require expenditure restraint. Tightened monetary policy may be required if credit growth continues and inflationary pressures become more pronounced.

Macroeconomic adjustments may be required. Monetary tightening may be required if continued private sector credit growth accelerates inflationary pressures. High levels of expenditure under the 2015 budget are supported by projected once-off asset sale receipts of FJ\$507 million. Realizing projected asset sale receipts will be important if the deficit is to be constrained to budgeted levels and debt levels reduced. Financing repayment of a US\$250 million global bond in March 2016 presents additional challenges.

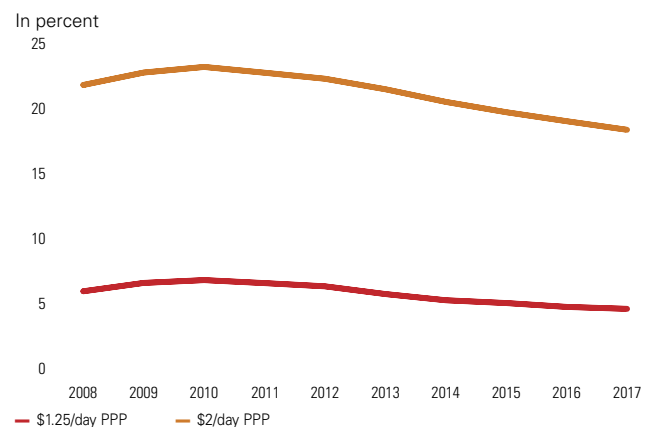
Poverty reduction requires increased attention to rural areas in addition to income transfers. Expected job and income losses in the sugar sector present challenges to achieving poverty reduction goals. Infrastructure investments and business environment reforms are required to facilitate diversification away from sugar and ensure rural populations have access to new opportunities.

Figure 1. Recent growth has been supported by public investment



Source: World Bank staff estimates.

Figure 2. Poverty has only gradually declined



Source: World Bank staff projections based on household survey data.

Fiji / Macro Poverty Outlook Indicators

	2012	2013	2014	2015 e	2016 f	2017 f
Real gross domestic product	1.8	4.6	3.8	2.5	2.4	2.6
Private consumption						
Government consumption	0.5	-2.8	3.8	0.0	-1.4	0.0
Gross fixed capital investment	0.0	39.7	-20.2	0.0	0.5	0.0
Change in inventories, % contribution						
Statistical discrepancy (% GDP)						
Exports, goods & services	14.3	-5.0	5.3	4.2	1.5	4.3
Imports, goods & services	2.9	34.0	-16.4	4.4	3.9	4.3
GDP, at market prices	1.8	4.6	3.8	2.5	2.4	2.6
Output Gap	-1.5	1.3	3.3	2.2	1.2	0.1
CPI Inflation , period average	3.4	2.9	1.2	3.0	3.0	3.0
Current account balance, % of GDP	-1.8	-20.7	-10	-8.7	-8.9	-9.1
Fiscal balance, % of GDP	-1.1	-0.5	-2.1	-2.7	-1.7	-1.7
Poverty rate (\$ 1.25 PPP)	6.3	5.7	5.2	5.0	4.7	4.6
Poverty rate (\$ 2.00 PPP)	22.3	21.5	20.5	19.7	19.0	18.3
Gini coefficient of consumption (2010)	0.41					

Notes: 1/n annual percentage change percent, unless otherwise noted; e = estimation; f = forecast. Projections under revision in preparation for March Indonesia Economic Quarterly.



2014

Population, mln	250
GDP, US\$, bn	889
GDP per Capita, US\$	3,524
GDP per Capita, US\$ PPP	9,561
Poverty rate, US\$1.25/day PPP ^{1/}	9.1
Poverty rate, US\$2.00/day PPP ^{1/}	36.8
Gini coefficient	0.4
Life expectancy	72
School enrolment rate, primary	93

Sources: Indonesia National Statistics Agency, World Development Indicators, 2014.

Notes: Authors are Alex Sienaert and Matthew Wai-Poi. 1/World Bank estimate.

Indonesia's real GDP grew 5 percent in 2014, still solid despite commodity price headwinds and the policy tightening required by previous external financing constraints, but not fast and inclusive enough to arrest the recent trend of slower poverty reduction. Growth is projected to remain just above 5 percent in 2015 and, while a mild growth pick-up is expected over the forecast horizon, achieving the new government's ambitious development goals will require successful implementation of a wide range of policy reforms and budget plans to strengthen Indonesia's economic capacity and competitiveness.

Recent developments

Growth and poverty reduction have been slowing. Indonesia's GDP growth slowed for the fourth consecutive year in 2014, to 5 percent. Weaker global commodity prices and demand, and tighter financing conditions, have weighed on the economy, with investment growth halving since 2012 (up

4.1 percent in 2014) and exports increasing by only 1 percent. Consumption growth also softened in 2014, to 4.8 percent from 5.6 percent in 2013. Consistent with slower output growth since 2012, net job creation has slowed, to an annual average of 0.9 percent, only just enough to keep the share of working age Indonesians in employment stable, at 62.6 percent (based on the most recent two labor force surveys, conducted in August 2013 and 2014). Poverty reduction has also been slowing, with the \$1.25 poverty rate falling by an average of 1.7 percentage points between 2011 and 2013, but slowing to 0.6 percentage points in 2014, to stand at 9.1 percent. This trend is consistent with the national poverty rate, which is falling even more slowly, as prices for the poor have risen faster than CPI.

Sound macroeconomic management has supported Indonesia's adjustment to less favorable external conditions, including an approximately 40 percent reduction in the prices of its key export commodities since their 2011 peak, helping to prevent a more pronounced slowdown in growth and poverty reduction. Bank Indonesia tightened monetary policy up until November 2014, contributing to a halving of credit growth. Exchange rate flexibility has helped to cushion the trade shock for exporters and facilitate a rise in international reserves and the Rupiah has trended lower against the US dollar, by approximately 10 percent since the middle of 2014. However, US dollar strength has been broad-based and Indonesia's domestic prices have increased at a relatively faster pace, so the Rupiah has in fact again strengthened significantly in real trade-weighted terms since mid-2014.

The fiscal sector has felt the effects of slower economic growth and lower commodity prices, but benefits from a major fuel subsidy reform. Total revenues rose by an anemic 7.1 percent in 2014. The fiscal deficit was capped at 2.2 percent of GDP, but this required sweeping budget and expenditure reductions, including a 25 percent contraction in capital spending. After taking office in October 2014, Indonesia's new administration moved quickly to shore up the fiscal position by raising subsidized

gasoline and diesel prices by an average of 34 percent in November. This was followed in January by a bold move to a regulated price system with monthly adjustments, removing the explicit subsidy for gasoline and capping the diesel subsidy to a low Rp. 1,000 per liter. Gasoline and diesel prices have consequently been lowered from their November levels, by 18 percent as of March 1, 2015, driving a sharp drop in headline CPI inflation to 6.3 percent yoy in February, from 8.4 percent yoy in December. The impact of the November increase and subsequent January decreases on poverty is not yet known, but is expected to be small due to cash compensation to 15m households.

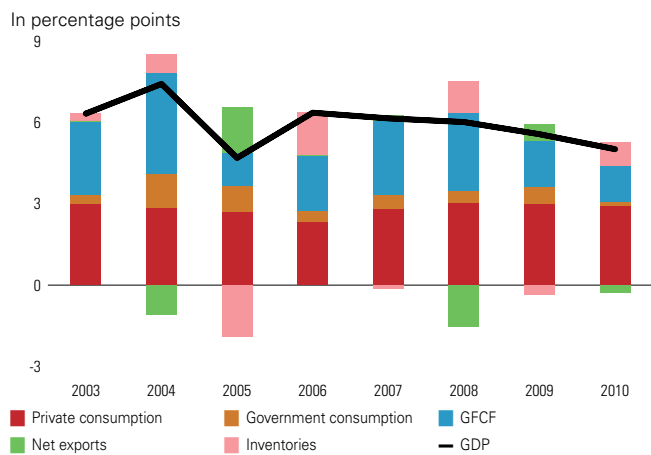
Outlook

Growth is expected to pick up but only modestly, with slowing poverty reduction likely to continue. The World Bank expects GDP growth for 2015 of 5.2 percent, picking up to 5.5 percent in 2016, based on stronger fixed investment and a gradual recovery in exports. The current account deficit is expected to remain relatively sticky, at 3 percent of GDP on average in 2015, despite lower oil prices which are a positive for the trade balance (net oil and gas imports were a significant 1.3 percent of

GDP in 2014). Inflation is expected in the absence of major shocks to drift lower, ending 2015 close to the central bank's 5 percent target ceiling. With growth remaining under 6 percent, food inflation exceeding headline inflation, and the remaining poor being further and further below the poverty line, the slow pace of poverty reduction is expected to continue. \$1.25 poverty is projected to fall to 8.5 percent in 2015 and 8 percent in 2016.

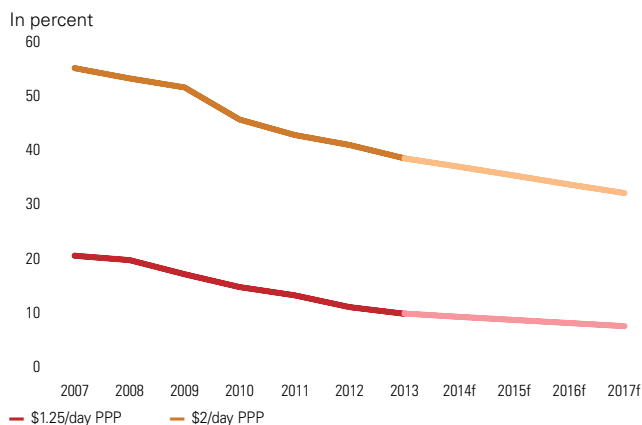
The revised 2015 budget, passed in February, redirects spending towards development priorities, but execution and revenue constraints mean the benefits will take time to flow through. Fuel subsidy cost savings of close to 2 percent of GDP are allocated mainly to capital expenditures, which are budgeted to double from the 2014 outturn. Spending on social assistance has also been increased for 2015, but it remains low and implementation issues will likely limit its potential impact on accelerating poverty reduction, at least in the near-term. While the increased allocative efficiency of the budget is a major positive, overall spending levels are based on extremely large increases in revenue targets. Revenues will therefore likely fall significantly short of budgeted levels, pushing the fiscal deficit above the budgeted 1.9 percent of GDP, and requiring budgeted spending to be curtailed, in 2015.

Figure 1. Indonesia's GDP growth has been moderating, driven by weakening investment growth



Sources: National statistics agency, World Bank.

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



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

Challenges

Tackling the structural impediments to more rapid and inclusive growth, high quality job creation, and poverty reduction is an urgent task, especially as these have become more exposed by the end of the commodity boom. Successful implementation of existing economic policy reforms will entail transparent, consistent application of the new fuel pricing system, encouraging more private investment, including foreign investment, and executing more and better quality public infrastructure spending. Generating the high quality jobs needed for more inclusive growth will also require labor market and education reforms, to accelerate formal jobs growth (only 23 percent of workers have written contracts and only 14 percent contribute to social security), raise female labor participation (the female employment rate is below 50 percent), and reduce youth inactivity levels (one third of people aged 15–24 are not in education, employment or training). Moreover, with the remaining poor increasingly further below the poverty line, the recent pattern of

growth favoring the wealthiest Indonesians needs to be addressed, if slowing poverty and rising inequality are to be tackled.

Indonesia / Macro Poverty Outlook Indicators

	2012	2013	2014	2015 f	2016 f	2017 f
Real gross domestic product	6.3	5.6	5.0	5.2	5.5	5.5
Private consumption	5.5	5.4	5.3	4.7	5.2	5.2
Government consumption	4.5	6.9	2.0	3.8	3.2	4.5
Gross fixed capital investment	9.1	5.3	4.1	5.2	6.1	6.0
Stat. discrepancy and change in inventories, % contribution	1.2	-0.4	0.9	0.8	0.4	0.2
Exports, goods & services	1.6	4.2	1.0	2.6	5.7	6.2
Imports, goods & services	8.0	1.9	2.2	4.0	6.1	6.0
GDP, at market prices						
Agriculture	4.6	4.2	4.2	4.2	4.3	4.1
Industry	5.3	4.2	4.2	5.1	4.9	5.4
Services	6.8	6.5	6.1	5.6	6.4	6.0
Output gap	-0.1	-0.1	-0.4	-0.3	0.0	0.0
CPI inflation, period average	4.0	6.4	6.4	6.5	5.1	5.0
Current account balance, % of GDP	-2.8	-3.2	-3.0	-3.0	-3.2	-2.5
Fiscal balance, % of GDP	-1.8	-2.2	-2.2	-2.5		
Poverty rate, \$PPP 1.25	10.9	9.7	9.1	8.5	8.0	7.4
Poverty rate, \$PPP 2.00	40.9	38.4	36.8	35.25	33.6	32
Gini coefficient of consumption	0.4	0.4	0.4	0.4	0.4	

Source: World Bank.

Note: Historical poverty data, include data emanating from individual surveys and World Bank estimates derived from POVCALNET for intervening years and recent history.

a. Annual percentage change; f=forecast.

b. Projection using Elasticity, with pass-through= 1.00 based on GDP constant pc



	2014
Population, mn	6.7
GDP, US\$, bn	11.7
GNI per capita, US\$ ^{1/}	1,570
Poverty rate, US\$1.25 ^{2/}	28.8
Gini coefficient ^{3/}	0.36
Life expectancy	66
School enrollment rate, primary	121

Sources: Authorities and staff estimates and projections
 1/ Preliminary estimate; 2/ Staff estimate; 3/ data as of 2012

Growth in Lao PDR remained strong in 2014 at 7.5 percent as domestic demand was fueled by robust FDI and continued expansion in the construction sector. These trends are expected to continue in 2015; however, further containment of the fiscal deficit and a soft outlook for commodities will slow growth to 6.4 percent, with risks on the downside and the upside. Despite some improvement in living conditions, in the absence of reforms, the strong growth rates will have only a marginal impact over job creation and poverty reduction while growing inequality could test the sustainability of the country's growth model.

Recent developments

Economic activity remained robust in 2014 with preliminary estimates putting the growth rate at 7.5 percent in 2014, slightly below the 8 percent average during 2011–13. Construction continued to drive growth as FDI remained buoyant and the real estate sector continued to expand. Exports growth was also driven by an increase in wood exports,

which may not be sustained going forward. Still, lower gold prices reduced output in gold mining while cuts to government spending and a slowdown in credit growth affected domestic demand. Average annual inflation in 2014 decelerated to 4.2 percent from 6.4 percent a year earlier, due to slower growth in food prices and a decline in fuel prices.

High economic growth has been accompanied by a less than proportionate decline in poverty and rising inequality. Poverty (based on the PPP 1.25-day) fell to 28.8 percent in 2012/13, down from 34.9 percent five years ago, but remains disproportionately higher among ethnic minorities. Insufficient creation of high-quality jobs reduced benefits of growth to the poor and widened inequality; while an inadequate social protection system left people vulnerable to shocks (half of the poor in 2012/13 were non-poor in 2007/8). The Gini coefficient increased to 0.36 from 0.33 in 2002/3, driven by widening disparities between rural-urban areas and within urban areas. Most jobs are in subsistence agriculture which grew slower than the rest of the economy while creation of manufacturing jobs is hampered by a difficult business environment and stagnant labor productivity. The current growth path therefore offered limited opportunities for the poor. The authorities have taken early steps to consolidate the fiscal position in FY2013/14 and moderate credit growth.

Revenues remained at about 23 percent of GDP with improved non-resource revenues (VAT, excise, import duties) compensating for lower mining revenues and grants. Total expenditures declined to 27.3 percent of GDP from 29 percent as payroll benefits were cuts, recurrent spending was tightly controlled and some externally financed investment projects were completed. As a result, the deficit fell to 4.3 percent in FY 2013/14. Public debt is estimated at 60 percent of GDP by end-2014. At the same time, stricter enforcement of the policy to limit lending in foreign exchange and some fiscal consolidation resulted in credit growth moderating to 14 percent, year-over-year, by December 2014, compared to 35 percent a year earlier; however, the banks' balance sheets appear to have weakened.

The current account deficit is estimated to have narrowed slightly to 11 percent of GDP. Mining exports declined in response to lower prices but were offset by higher wood exports. Still, strong domestic demand kept imports high, including due to FDI-related investment. Capital and financial inflows exceeded the current account deficit reflecting robust FDI performance as well as increased borrowing with the external debt projected to have increased to around 90 percent of GDP. Foreign exchange reserves increased to US\$ 815 million; however, still cover less than 2 months of goods and services imports and only 28 percent of foreign currency deposits in banks. The authorities continued to tightly manage the exchange rate resulting in further appreciation of the real exchange rate.

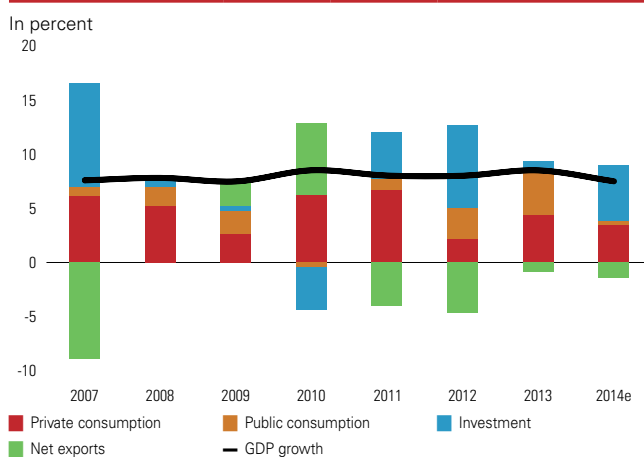
Outlook

The economic outlook for the medium term remains broadly positive due to a favorable regional economic outlook, but growth will remain dominated by the resource sectors. China's growth rates are expected to moderate but remain high and Thailand is expected to recover. Also, after declining in recent years, gold and copper prices are expected to remain stable. This should ensure a robust outturn for Lao PDR exports (power, copper) as well as FDI. The non-resource sector is expected to remain dynamic as

rents from the resource sector trickle down into higher domestic demand. Growth is projected to initially dip to about 6.4 percent in 2015 as continued strong investment in the power sector is partly offset by flat output in mining, the slowdown in credit as well as in wood exports from an unusually high level last year. Growth should pick up to 7 percent in 2016 and 2017 as a few power projects are expected to come on stream. Inflation is projected to average 4–5 percent as robust domestic demand is offset by gradual fiscal consolidation and favorable world food and energy prices. The growth elasticity of poverty is expected to remain low over the medium-term given the continued dominance of the resource sector to economic growth. Thus poverty is projected to decline only gradually to 24.2 percent by 2017.

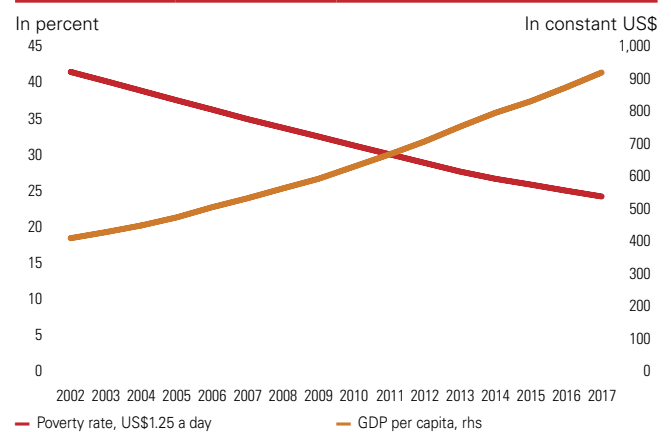
The fiscal balance is expected to improve but the external current account deficit will remain high. The fiscal deficit will decline to 4.2 percent of GDP in 2015 and further to 3.5 percent of GDP in 2017 as authorities plan to improve tax administration and increase excises while tightening expenditures by introducing tight control over new investment projects in 2015, a wage freeze and recruitment controls. On the external side, strong FDI inflows to hydropower projects will keep imports high is expected to offset gains from lower fuel prices and electricity exports from new power projects.

Figure 1. Contributions to annual GDP growth



Source: Staff estimates based on national statistics.

Figure 2. Trends in poverty and GDP per capita



Sources: Staff Calculations based on LECS 4–5.

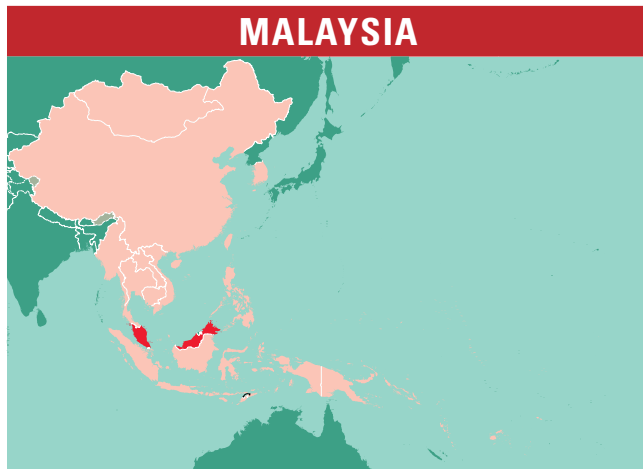
Challenges

The outlook is subject to both downside and upward risks but is likely to be associated with rising inequality. Further instability in Thailand, a sharper correction in economic activity in China or materializing risks in the fiscal and financial sectors could hurt growth. Despite slowdown in credit growth, systemic risks in the financial sector are yet to be addressed. Furthermore, the low level of reserves undermines the ability to mitigate adverse shocks. On the other hand, lower oil prices and faster coming on stream of some hydropower projects could push growth rates upwards. Continuation of the current growth pattern would create relatively few productive jobs, increase inequality and fail to address critical human development outcomes where the country is lagging. This may dent further gains in poverty reduction.

Lao PDR / Selected Economic and Social Indicators

	2012	2013	2014	2015 e	2016 f	2017 f
Real gross domestic product	8.0	8.5	7.5	6.4	7.0	7.0
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	6.3	7.5	7.7
Change in inventories, % contribution						
Statistical discrepancy (% GDP)						
Exports, goods & services	12.9	14.0	16.0	8.4	9.0	9.0
Imports, goods & services	21.9	13.0	15.8	7.0	7.2	7.3
GDP, at market prices	8.0	8.5	7.5	6.4	7.0	7.0
Agriculture	2.8	6.4	7.9	0.4	1.3	2.9
Industry	12.7	11.0	6.9	9.4	10.9	9.4
Services	7.5	7.7	7.7	7.6	7.0	7.1
CPI Inflation , period average	4.3	6.4	4.2	5.0	5.0	5.0
Current account balance, % of GDP	-12.7	-11.5	-11.2	-11.5	-11.9	-12.0
Fiscal balance, % of GDP	-1.2	-6.0	-4.3	-4.2	-3.7	-3.5
Poverty rate (\$1.25 a day, PPP terms)	28.8	27.6	26.6			
Poverty rate (\$2.00 a day, PPP terms)	62.0	60.6	59.4			
Gini coefficient of consumption	36.2					

Sources: National Statistics Agency, Ministry of Finance and Bank staff estimates
Notes: e = estimate; f = forecast. */ Poverty rate for 2013 is estimate



MALAYSIA

	2013
Population, mn	29.7
GDP, US\$, bn	311.2
GDP per capita (PPP, int'l US\$)	23,298
Poverty rate (US\$4.00 a day, PPP) ^{2/}	6.77
Gini coefficient, disposable income ^{1/}	0.41
Life expectancy	74.8
School enrolment rate, primary ^{3/}	101.4

Sources: World Development Indicators, 2014.

^{1/}Household Income and Expenditure Survey (2014, preliminary).

^{2/}As of 2014 (preliminary).

^{3/}UNESCO Institute for Statistics. Refers to gross enrolment ratio in 2005.

Growth in Malaysia surprised on the upside in 2014 on a pick-up of exports and robust private consumption. As a net hydrocarbon exporter, lower oil prices will dampen the outlook for investments and growth. The outlook for 2016 and beyond is clouded by uncertainty in the direction of commodity prices and the pace of structural reforms to move investments decisively to skills-intensive sectors. Investing in human capital formation to narrow skills and income-based achievement gaps is essential to ensure further gains in reducing poverty and inequality.

Recent developments

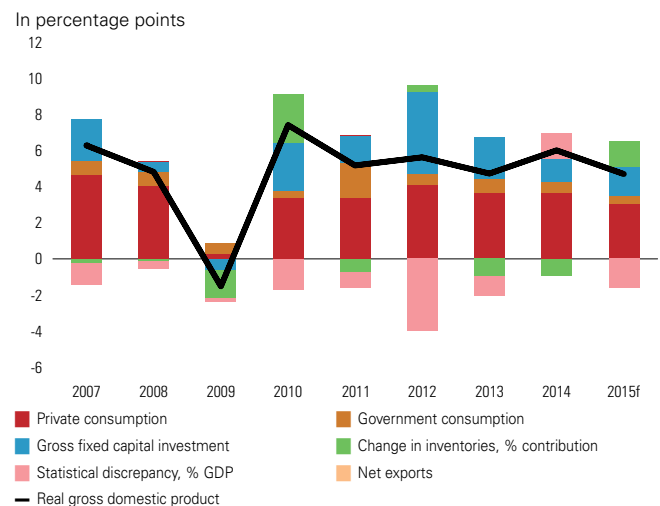
Malaysia's economy expanded by 6 percent in 2014, while poverty declined further. Private consumption was resilient in the face of slower growth in consumer credit as the Central Bank implemented macro-prudential measures to rein in high household debt (87.9 percent of GDP at end-2014). Fast growth in household incomes at the bottom of the

distribution contributed to resilient consumption and led to further poverty reduction. Despite picking up towards the end of the year, fixed investment expanded by only 4.7 percent from 2013 due to lower public investments and investments in machinery/equipment on slow disbursements from the capital budget and lower equipment-intensive investments in transportation and mining.

Exports showed signs of recovery and the current account posted a higher surplus. Real exports of goods and services grew by 5.1 percent in 2014, mostly linked to strength in the electrical and electronics (E&E) sector but also boosted by higher export volumes of crude petroleum as new oil fields have come onstream. Higher nominal exports (also helped by the slow pass-through of oil prices to LNG prices) were not matched by higher imports of intermediate goods, compensating for wider deficits in services and net income and transfers. Portfolio outflows and offshore investments by residents (both direct and portfolio) surged (2014:7.1; 2013:1.6 percent), keeping the financial account in deficit and leading to a decline in reserves by 18 percent in 2014 (sufficient to finance 8.4 months of retained imports and 1.1 times short-term external debt).

Adequate macroeconomic management helped the economy adjust. The decline in reserves would have

Figure 1. Contributions to annual growth



Sources: Department of Statistics, Malaysia, and World Bank Staff calculations.

been larger had the Ringgit not depreciated by 6.5 percent against the dollar. The Central Bank raised the policy rate in July but has since returned to a holding pattern. Restraint in personnel expenditure, fuel subsidy cuts and fast growth helped offset lower oil-related revenues and the government is likely to meet its 2014 deficit target of 3.5 percent of GDP. Subsidies for gasoline and diesel were cut in October and the government eliminated them entirely from December.

Robust economic growth has translated into shared prosperity. Average household income rose at a compounded annualized rate of 8.6 percent between 2012 and 2014, with growth faster at the bottom of the distribution. 6.8 percent of households were below the US\$4.00 a day (PPP) poverty line in 2014, a substantial reduction from 10.3 percent in 2012. Steady job growth and modest but continued increases in real wages helped achieve these outcomes. With the Gini coefficient for disposable incomes at 0.41 in 2014, inequality is in line with regional peers but high compared to OECD countries due to limited redistribution in fiscal policy.

Outlook

Growth is expected to slow to 4.7 percent in 2015 before normalizing to 5.0 percent in 2016, while the current account will remain in a small surplus. Lower oil prices will dampen growth through delays in capital expenditures in the oil and gas sector, a key driver of the recent investment boom. Private consumption will moderate on tighter credit and a small impact from the introduction of the GST, before rebounding in 2016. A slight uptick in inflation is therefore expected despite low readings in the first half as lower oil prices are reflected throughout the economy. LNG exports, primarily to Japan, are a major component of the current account surplus and the 4–5 month lag in the transmission of oil prices to LNG prices is starting to be felt. Moreover, it is possible that Japan may restart its nuclear reactors sooner than expected, reducing LNG imports. The current account is thus expected to narrow, although upside is possible if manufacturing export growth retains momentum from Q4.

Further declines in oil prices is the key risk to near-term growth, fiscal and external accounts. Although the government announced a slew of expenditure

Malaysia / Macro Poverty Outlook Indicators

	2012	2013	2014	2015f	2016f	2017f
GDP, at constant market prices	5.6	4.7	6.0	4.7	5.0	5.1
Private Consumption	8.2	7.2	7.1	5.9	6.4	6.5
Government Consumption	5.0	6.3	4.4	2.7	4.0	5.0
Gross Fixed Capital Investment	19.2	8.5	4.7	5.9	6.3	6.0
Change in Inventories, % contribution	0.3	-0.9	-0.9	1.4	-0.1	-0.2
Exports, Goods and Services	-1.8	0.6	5.1	5.5	5.5	5.4
Imports, Goods and Services	2.5	2.0	3.9	8.1	6.5	6.3
GDP, at constant factor prices	5.5	4.7	6.0	4.7	5.0	5.1
Agriculture	1.3	2.1	2.6	...	...	...
Manufacturing	5.1	3.6	6.1	...	...	...
Services	6.4	5.9	6.3	...	...	...
Inflation (Household Consumption Deflator)	1.8	2.0	2.7	3.4	2.8	2.0
Inflation (Consumer Price Index)	1.7	2.1	3.1	...	...	...
Current Account Balance, % of GDP	5.8	4.1	4.6	3.1	3.3	3.5
Fiscal Balance, % of GDP	-4.5	-3.9	-3.5	-3.2	-2.9	-2.5

cuts to remain on a consolidation path, over a fifth of revenues depend on oil, including a yearly dividend from PETRONAS. If oil prices remain low, PETRONAS will be hard-pressed to maintain this dividend, especially if it is to continue its large investment program. Other risks include weakness in the global economy that would dampen export demand, renewed volatility in capital flows, and the realization of contingent liabilities, which have increased since the global financial crisis.

Favorable economic prospects will support overall household income growth. In the near term, falling palm oil revenues (driven by oil prices and the floods in late 2014) will pose a challenge to the livelihoods of smallholders. While the introduction of GST may impact low-income urban households, most goods consumed by this group have been exempted or zero-rated. Labor markets are expected to remain robust but not buoyant, in line with economic performance. Therefore, household income growth will remain on an upward, if somewhat slower, trend, with the share of the population earning less than US\$ 4 per day expected to decline further.

Challenges

To support long-term growth and boost shared prosperity, productivity-enhancing reforms are critical. These include: modernizing social policies towards 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.



	2014
Population, mn	2.99
GDP, US\$, bn	12.0
GDP per Capita, US\$	4055
GDP per Capita, US\$ PPP	
Gini coefficient, consumption (2012)	0.34
Life expectancy	69.1
School enrolment rate, primary	97

Mongolia's economic growth is slowing amidst an unfavorable external environment and unsustainable economic imbalances. The external account is becoming vulnerable on account of declining FDI and international reserves. Actions are urgently needed to avert possible economic shocks from the vulnerable external situation. Poverty reduction will likely stagnate in the coming years in the course of economic and fiscal adjustment.

Recent developments

In 2014, a sharp drop in investment dampened economic growth to 7.8% from 11.6% in 2013. Investment dropped 34.5% and final consumption growth also moderated. Non-mining sector growth fell to 3.6% from 9.8% the previous year. Mining production rose 24.2% in 2014 due to a 34% increase in copper concentrates production on account of new Oyu Tolgoi mine.

Current account deficit narrowed to 8.2% of GDP in 2014 from 25.4% the previous year due to

strong copper concentrates exports and import compression.

Balance of payments deficit reached \$427 million in 2014, reducing gross international reserves to around 3 months' worth of imports. The bilateral currency swap line with China provided buffers to the intensifying balance of payments and declining reserves. The local currency value remained under pressure, depreciating 13% in 2014.

Fiscal policy remained loose in 2014 with the consolidated budget deficit reaching 11% of GDP, including off-budget expenditures of the Development Bank of Mongolia (DBM). Actions were taken to consolidate budget deficit. The Fiscal Stability Law (FSL) was amended to mandate reducing by 2018 the structural deficit to 2% of GDP and the NPV debt to GDP to 40%.

Monetary policy became tighter. The BoM phased out some of its policy lending programs in 2014 and raised its policy rate twice to 13%. BoM's claim on non-bank sectors, however, increased since the last quarter of 2014 reflecting its purchase of mortgage-backed securities and liquidity support to companies.

Poverty declined by a smaller margin in 2012–14, compared with the reduction between 2010 and 2012. The large reduction in 2010–12 was largely due to one off transfers from the Human Development Fund to all citizens in 2011–12 and growth in employment and average wages. Untargeted and highly dependent on volatile mining revenues, however, the HDF transfers proved unsustainable and their contribution to poverty reduction lasted only temporarily.

Outlook

Economic growth will likely remain sluggish in the coming years. Mining growth will continue to slow on account of lower production schedule of key commodities. Non-mining growth will likely slow

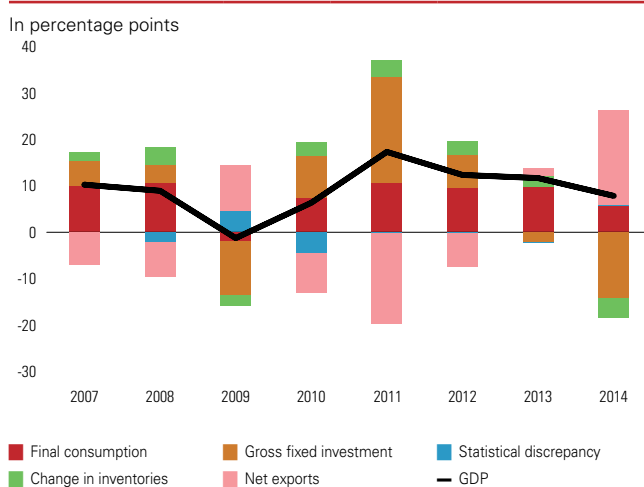
in 2015 and gradually pick up in 2016–17, assuming recovery in FDI for key investment projects.

The current account deficit is expected to widen in 2015 and further increase in 2016–17 amidst weakening mineral exports. The balance of payments is expected to remain in large deficit in 2015 due to weak FDI recovery, which will weigh on international reserves and the exchange rate while the remaining swap line with China may provide buffers.

The Comprehensive Macro Adjustment Plan (CMAP) approved by parliament in February announced measures to overcome economic difficulties. The CMAP called for fiscal consolidation and transferring BoM's outstanding loans under the Price Stabilization Program to the government. It also called for strengthening financial supervision and enhancing the investment climate.

Social transfers and growth in real wages and employment have been the major drivers of poverty reduction. Growth in both factors will likely be sluggish due to tighter fiscal conditions, political difficulties of improving poverty targeting of social transfers, and weak growth prospects.

Figure 1. Contributions to annual GDP growth: 2007–14

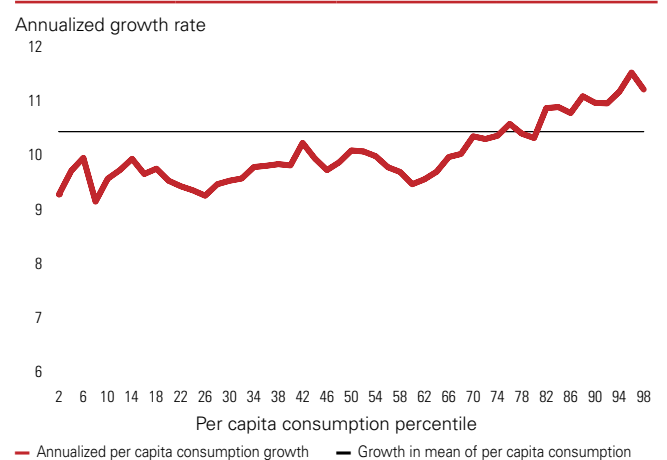


Challenges

The economic outlook is subject to downside risks from persistent balance of payments pressure and recovery in FDI. The external account will remain vulnerable to shocks amidst large current account deficit and declining reserves. Slower recovery in FDI and further dampening of minerals market would further weigh on the growth outlook and external imbalances. Vulnerable external situations call for reversing previous loose policies and further actions are needed. The consolidated budget deficit will likely reach close to 10% of GDP in 2015 due to over-estimated revenue projections and DBM's off-budget commercial spending. All of the BoM's unconventional lending programs should be phased out and need to be transferred to the budget if needed.

Increasing household vulnerability in the course of economic adjustment will be a major social challenge. Current social protection mechanisms should be adapted to address transitory poverty and provide an adequate social safety net. This requires creating fiscal space for a more poverty focused social safety net by channeling a larger share of social transfers through poverty targeted means.

Figure 2. Annualized percentile consumption growth, 2010–12

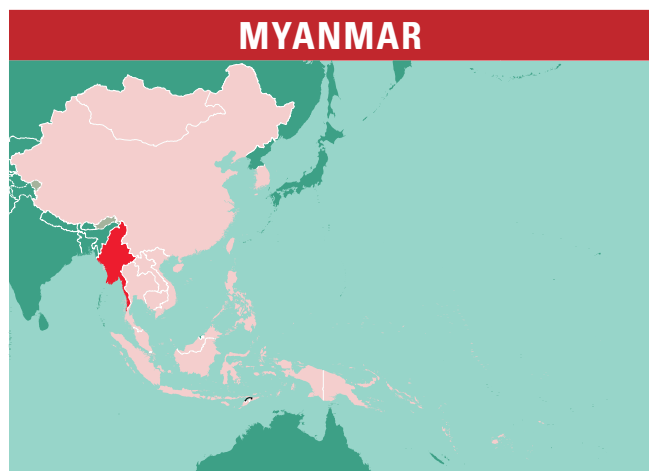


Mongolia / Macro Poverty Outlook Indicators

	2012	2013	2014	2015 e	2016 f	2017 f
Real gross domestic product	12.3	11.6	7.8	4.4	4.2	3.9
Private consumption	13.3	14.1	10.6	7.0	8.3	9.1
Government consumption	18.5	15.2	-1.9	6.1	5.2	4.5
Gross fixed capital investment	14.7	-4.3	-33.5	8.2	43.6	2.6
Change in inventories, % contribution	31.5	22.8	7.6	7.3	7.1	6.9
Statistical discrepancy (% GDP)	89.0	17.2	0.0	0.0	0.0	0.0
Exports, goods & services	8.3	13.7	51.4	-2.9	-3.7	-4.6
Imports, goods & services	15.4	6.3	4.9	1.0	16.6	0.9
GDP, at market prices	12.3	11.6	7.8	4.4	4.2	3.9
Agriculture	21.1	19.3	14.4	11.1	9.1	8.4
Industry (incl. mining)	14.8	15.3	16.1	7.3	2.2	-0.6
Services	10.3	6.8	4.8	2.4	4.4	6.1
Output Gap	0.8	2.5	2.9	0.4	-2.9	-5.8
CPI Inflation, period average	14.3	10.4	12.8	8.5	7.8	7.3
Current account balance, % of GDP	-27.4	-25.4	-8.2	-10.8	-19.0	-19.4
Fiscal balance, % of GDP ^{1/}	-9.1	-8.9	-11.0	-9.8	-6.4	-6.2
Gini coefficient of consumption	0.34					

Sources: NSO, MoF, BoM, World Bank staff forecasts.

Notes: f=forecast; 1/ Fiscal balance includes all off-budget expenditures of the DBM.

2014 ^{1/}

Population, mn ^{2/}	51.4
GDP, US\$, bn	56.8
GDP per Capita, US\$	1,105
GDP per Capita, US\$ PPP	
Poverty rate, US\$1.25	
Poverty rate, US\$2.00	
Gini coefficient, consumption	
Life expectancy	65
School enrolment rate, primary	114

Sources: World Bank staff estimates. IMF staff estimates. World Development Indicators, 2014.

^{1/}2013/14 fiscal year (April 1–March 31).

^{2/}Provisional Census Results, 2014, Ministry of Immigration and Population, Myanmar.

Myanmar is expected to continue to grow at a strong pace in 2014/15. The rapid pace of expansion however is also contributing to inflationary pressure. Rapidly rising demand is leading to a widening of the current account deficit, with downward pressure on foreign exchange. Fiscal policy has been expansionary, which could pose challenges to fiscal sustainability. Growth is likely to remain strong, but there are downside risks including a sustained downturn in gas prices.

Recent developments

Myanmar continues to grow at a strong pace on the back of reforms that are gradually opening up the space for investment. The economy is estimated to grow at 8.5 percent in real terms in 2014/15. This is driven largely by the ongoing construction-related boom, continued rebound in manufacturing output, and the resulting expansion in the service sector. Increased demand for commercial, office

and residential space has attracted new investment in the property sector in 2014/15. There are signs of expanding manufacturing activity, which has been accompanied by growth in the services sector (e.g. trade and logistics, hospitality, telecommunications, and banking).

On the demand side, Myanmar in 2014/15 continues to see rapidly rising public and private investments. Public sector spending (more below) is expected to increase from 26.5 percent of GDP in 2013/14 to roughly 28.7 percent of GDP in 2014/15. Around 35 percent of this will be public investment going to fill a major infrastructure gap left by many years of under-investment.

Foreign Direct Investment in 2014/15 is expected to reach \$5 billion, with some estimating more, bringing cumulative stock of FDI to over \$50 billion. Around a third of FDI is in the gas sector, which has become vulnerable to commodity price developments. Aside from oil and gas, major global companies have also begun to enter Myanmar in the manufacturing sector in the past year.

The rapid pace of change however is stretching Myanmar's supply side capacity, which, together with currency depreciation, is contributing to inflationary pressure. After reaching a record low in 2012/13 (2.8 percent), pressures have mounted. Although prices stabilized in the first half of 2014, inflation rose by 2.2 percent in November (6.1 percent y-o-y) due to further depreciation of the Kyat.

Rapidly rising demand coupled with removal of trade and foreign exchange restrictions have also contributed to widening trade and current account deficits. The current account deficit in 2014/15 is expected to reach 5.3 percent of GDP. Capital account inflows, especially FDI and one-off license fees paid by telecom operators, have been sufficient to finance the growing current account deficit.

The widening current account deficit has put downward pressure on the Kyat. Efforts to defend the Kyat have reportedly reduced foreign exchange

reserves to just below three months of import cover in late 2014. Whilst this is below prudential levels for an opening economy like Myanmar, the currency depreciation is expected to have a positive impact on export competitiveness, and capital inflows are expected to remain strong on the back of FDI.

The government went through a period of fiscal consolidation between 2010/11 and 2013/14, but has more recently adopted an expansionary fiscal policy. The consolidated public sector deficit fell from 5.4 percent of GDP in 2010/11 to 1.6 percent in 2013/14. This was largely due to a sharp increase in revenue from one-off receipts (e.g. telecom licenses) amounting to roughly 2 percent of GDP and exchange rate liberalization, which led to a more accurate accounting of Kyat denominated receipts from gas exports.

One very important step initiated in 2015 is the first ever Treasury Bill auction. Although uptake has been lower than expected, it will take time to develop domestic debt markets. This should further contribute to the eventual elimination of monetary financing of the budget deficit.

Outlook

Assuming continued growth in gas sector investment and output, and accelerated service sector growth resulting from the gradual liberalization of the telecom and banking sectors, Myanmar could continue growing at around 8 percent, like other countries in their early stages of transition to a market-based economy.

Myanmar's real exchange rate has appreciated since November, which will dampen export competitiveness. There has been significant progress in anchoring exchange rate and inflation expectations. Continued progress in developing institutional capacity for exchange rate management will be important.

The poverty rate in 2010 was estimated at between 25.6 and 37.5 percent, with the lower rate reflecting the Government's methodology—which showed a 20 percent decline since 2005—and the higher rate reflecting a more broad based methodology used by the World Bank. In 2011, a group of international technical experts and advisors, working closely with the Government of Myanmar and international organizations, estimated absolute poverty in Myanmar to have stood at 25.6 percent in 2009/10. In 2014, the World Bank estimated the poverty rate in 2010 at 37.5 percent. This higher estimate is based on a broader welfare aggregate that includes spending

Figure 1. Real GDP growth and output shares

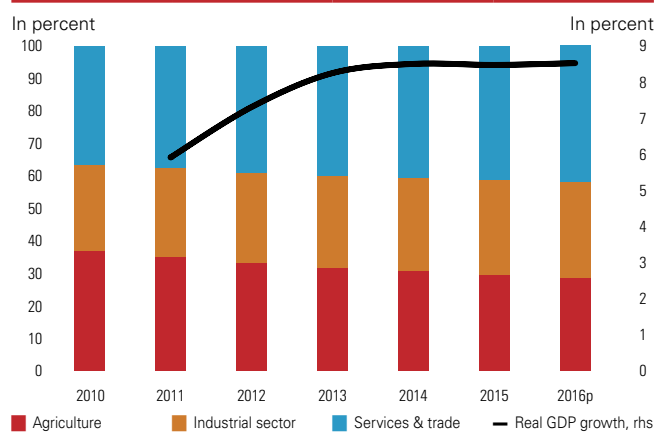
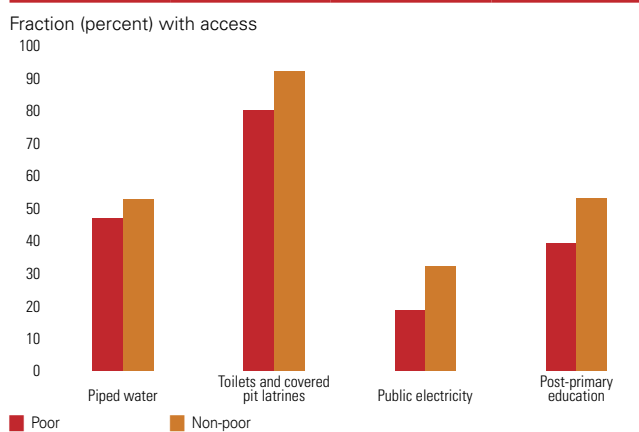


Figure 2. Access to basic services



on health care and the use value of assets, and on alternative assumptions on adult equivalence scales and spatial price deflators. Poverty in Myanmar is largely a rural phenomenon, with at least 70 percent of the country's poor living in rural areas.

Challenges

Although growth is expected to remain relatively strong over the medium-term on the back of continued structural reforms, downside risks have also increased. If government spending growth continues along current trends, Myanmar may face fiscal sustainability challenges. Although external public debt is still within sustainability thresholds, overall public debt sustainability is vulnerable to lower real GDP growth and fiscal slippages.

This risk is heightened by recent international commodity price developments. Although the effects of these have not yet transmitted through to Myanmar, there is a major risk that natural gas prices will follow the same trend as oil prices. A sustained downturn would adversely impact government revenues and export earnings, and may negatively affect future investments in the oil and gas sectors.

Myanmar / Macro Poverty Outlook Indicators ^{1/}

	2012 ^{2/}	2013	2014e	2015 f	2016 f	2017 f
Real gross domestic product	5.9	7.3	8.3	8.5	8.5	8.2
Government consumption	11.3	50.7	7.0	24.5	18.2	11.3
Exports, goods & services	15.8	1.0	18.1	22.4	11.2	
Imports, goods & services	27.5	19.4	19.4	17.2	13.9	
GDP, at market prices	8.8	10.3	14.4	15.6	15.3	15.4
CPI inflation, period average	2.8	2.8	5.7	7.7	7.0	7.0
Current account balance, % of GDP	-2.1	-4.4	-4.9	-5.1	-4.8	
Fiscal balance, % of GDP	-4.6	-3.4	-1.6	-4.5	-6.1	-6.3

Sources: Myanmar Central Statistical Organization; Ministry of Finance; Central Bank of Myanmar; IMF staff estimates; World Bank staff estimates.

Notes: 1/ In annual percentage change percent, unless otherwise noted; 2/ Fiscal year, April 1–March 31; e = estimation; f = forecast



PAPUA NEW GUINEA

	2013
Population, mn	7.3
GDP, US\$ bn	15.4
GDP per capita, US\$	2098.1
GDP per capita, US\$, PPP	2290.2
Poverty rate, national poverty line, percent (2010)	39.9
Gini coefficient, consumption (2010)	0.44
Life expectancy	62.3
Primary school enrollment rate, gross percent (2012)	114

Sources: IMF WEO 2014, WDI 2014, World Bank staff estimates

Papua New Guinea's economy is currently progressing through a period of transition with the ExxonMobil-led PNG-LNG project having moved from the construction to the production phase in 2014, resulting in smaller spillovers to the rest of the economy.

Recent developments

In 2014, growth is estimated to be 7.5 percent lower than originally forecast in the Budget 2015 at 8.4 percent due to the sustained decline in LNG Japan prices by 6 percent over the year. However, GDP growth in 2014 is 2.5 percentage points above 2013. The pickup in growth was primarily due the commencement of PNG LNG production, supported by favorable gold production and the rebound in copra production due to abnormally high copra prices in the second half of last year.

Growth in activity in the non-mining sector has been relatively weak in 2014 at 1.4 percent, compared to 4.9 percent in 2013. Cocoa and coffee production

was lower than anticipated, due in part to the effects of the cocoa pod borer and low yields from ageing and poorly managed coffee trees.

The national poverty rate in 2010 is 39.9 percent, with poverty more prevalent in rural areas vis-à-vis urban centers at 42 percent and 29 percent, respectively. The level of consumption inequality, measured by the Gini coefficient, is 0.4 in 2010.

Fiscal buffers remain thin due to expansionary fiscal policy over the last couple of years triggering an increase in the level of public debt. Budget 2015 expects the overall budget deficit for 2014 to be 5.9 percent. However, using a more recent methodology to calculate government finance statistics (GFS 2001 rather than GFS 1986), the overall budget deficit is anticipated to increase from 7.8 percent to 8 percent between 2013 and 2014 while the non-mineral budget deficit-to-non-mineral GDP is expected to increase to 14.6 percent from 11.5 percent.

Although revenue-to-GDP has increased to 31.1 percent in 2014 from 28.4 percent, the previous year, average revenue-to-GDP over the last five years (2010–14) has been 4 percentage points lower than the previous five years (2005–09).

Debt-servicing costs have increased by 55 percent in 2014, driven by rising yields on domestic debt in response to increased borrowing by the central government to finance the deficit coupled with a shallow domestic financial market.

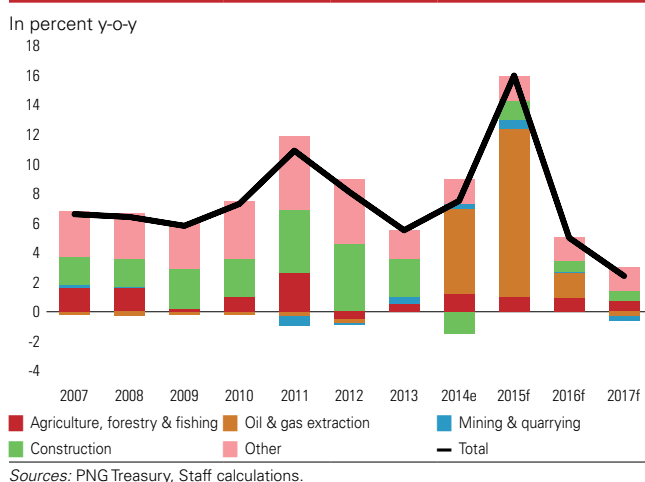
In order to finance the deficit, GoPNG has shifted toward issuing a greater proportion of longer-term debt instruments to reduce roll-over risk. The central bank has also begun purchasing government securities in the primary market with limited on-selling to the public, which is akin to debt monetization or direct central bank financing of the deficit. The country remains at a low risk of debt distress although, in 2014, debt-to-GDP rose to 35.5 percent, breaching the 35 percent debt ceiling set by the medium-term fiscal strategy.

The current account deficit narrowed in the first half of 2014, due mainly to a decline in goods imports associated with the tapering of PNG-LNG construction. The commencement of LNG production is expected to boost exports substantially in the second half of 2014 resulting in an improvement in the current account balance to -8.5 percent of GDP from -30.8 percent the previous year. The level of gross foreign exchange reserves have remained relatively stable reaching US\$2,342.1 million by the end of December, sufficient for 8.2 months of total imports or 11.3 months of non-mineral imports.

An instruction issued by BPNG to banks and foreign exchange dealers to trade foreign currency within a 150 basis point band around Bank of PNG's official reference rate led to an effective revaluation of the kina in June 2014 by 17 percent against the US dollar. Indications of foreign currency shortages have also surface after the revaluation. The official rate has declined modestly in the period since the revaluation.

Headline CPI inflation has been rising over the course of 2014 from 3.8 percent in Q1 to 6.6 percent in Q4. Rising food, housing, and transport prices continue to be the major drivers of inflation over the year. Underlying inflation (excluding seasonal items and customs, excise taxes, and price controls) has also increased from 3.4 percent to 7.4 percent.

Figure 1. Contributions to GDP growth



Outlook

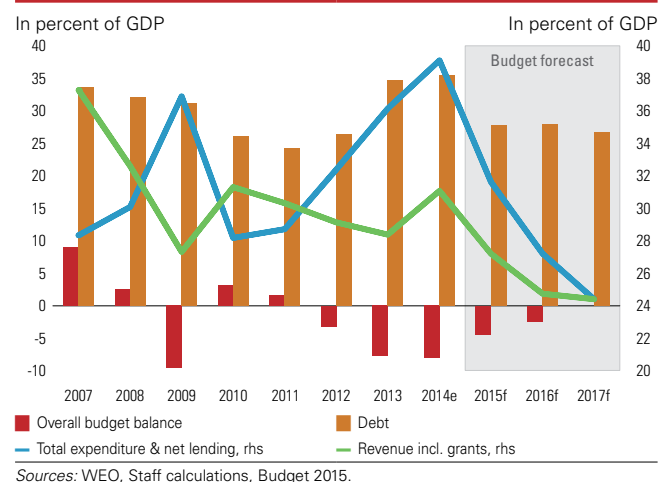
The World Bank forecast expects the GDP growth rate to be 16 percent with LNG production expected to peak 2016 rather than 2015.

Non-mining GDP is forecast to grow by 4 percent in 2015, supported by a rebound in the construction sector driven by increased infrastructure expenditure associated with the 2015 Pacific Games facilities, and the ongoing maintenance and upgrading of the roads. Coffee and cocoa production is anticipated to rebound somewhat as supply constraints are addressed, while copra oil production is expected to increase substantially due to the recommencement of processing mills in East New Britain after fires in 2013.

Looking ahead, inflation is likely to slow somewhat in 2015, given the global disinflationary environment and the recent sharp declines in commodity prices. At the same time, the purchase of government securities by the central bank in the primary market coupled with limited on-selling of these assets to the public heightens the risk of inflation.

The current account balance is expected to move into a surplus of 12.5 percent of GDP driven by LNG exports.

Figure 2. Key budget indicators



Challenges

Papua New Guinea faces four major macroeconomic challenges in the near future: (i) improving the fiscal balance, (ii) financing the budget deficit and managing the composition of public debt, (iii) improving the effectiveness of monetary policy, and (iv) improving exchange rate management.

With the expected implementation of a sovereign wealth fund in the coming year, a further challenge for the GoPNG is to ensure that the fund is prudently administered to maintain macroeconomic stability and fiscal rectitude.

In the longer term PNG faces the following challenges: (i) the further diversification of national assets by investing in both high quality human and physical capital, (ii) the acceleration of the development of robust institutions, and (iii) continued integration into the global economy by capitalizing on PNG's respective comparative advantages.

Papua New Guinea / Macro Poverty Outlook Indicators

	2012	2013	2014	2015 e	2016 f	2017 f
GDP, at market prices	8.1	5.5	7.5	16	5	2.4
CPI Inflation, period average	4.5	5	6.3	5	5.5	5.5
Current account balance, % of GDP	-53.6	-30.8	-8.5	12.5	10.8	9.5
Fiscal balance, % of GDP	-3.3	-7.8	-8.0	-4.4	-2.5	0.0

Notes: Projections under revision in preparation for March Indonesia Economic Quarterly. 1/ In annual percentage change percent, unless otherwise noted; e = estimation; f = forecast



PHILIPPINES

	2013
Population, mn	98.4
GDP, US\$, billion	257.5
GDP per Capita, US\$	2,670
Poverty rate, US\$1.25 PPP ^{1/}	15.4
Poverty rate, US\$2 PPP ^{1/}	37.2
Gini coefficient, income ^{1/}	0.46
Life expectancy	68.5
School enrolment rate, primary	95.2

Sources: Philippine Statistics Authority, World Development Indicators.

Notes: 1/ Data is for 2012 (income based).

Philippine GDP growth decelerated in 2014, but should pick up to 6.5 percent over the next few years if the government executes its budget and Typhoon Yolanda master plan. Reductions in underemployment and well-targeted social transfers helped lower the poverty rate from 15.4 percent in 2012 to 14.2 in 2013. This trend can be sustained if the government continues to increase investments in infrastructure, health, and education; boosts competition in the economy; simplifies regulations for doing business, especially for SMEs; and secures property rights for the majority of the population.

Recent developments

In 2014, Philippine economic growth decelerated to 6.1 percent. This came after strong growth of 6.8 and 7.2 percent, respectively, in 2012 and 2013. Growth continued to be driven by private consumption with net exports also contributing substantially to growth. However, a slowdown in government consumption and a contraction in infrastructure spending pulled

down overall growth. On the supply side, industry grew fastest at 7.5 percent, driven by strong growth of construction and manufacturing. Services slowed down to 6 percent from 7.5 percent in the previous year but remained the driver of growth on the production side. Agriculture continued to underperform, albeit with improving performance to 1.9 percent growth from 1.1 percent in the previous year. Despite the GDP slowdown, Philippine growth is still one of the fastest among the major economies in the East Asia region, trailing only China.

Inflation continued to moderate, with positive impact on both households and businesses. Lower inflation towards the end of 2014 and early 2015 was driven by monetary tightening on the demand side and falling prices of key commodities on the supply side. Food prices are still rising, but at a slower pace than before. The deceleration in food inflation was driven by stabilizing rice prices on account of stable supply following the importation of 1.8 million metric tons (MMT) over the past year—the largest in 4 years, with additional planned importation of 0.5 MMT in 2015. Weaker global demand for oil, stable production of oil, and more competition from natural gas also contributed substantially to lower oil prices. These have strongly benefited households and businesses as the Philippines is a major importer of oil.

Economic growth has become more inclusive in recent years as it is translating into stronger job creation and likely faster poverty reduction. Between January 2014 and 2015, more than a million jobs were created and the unemployment rate fell to 6.6 percent, significantly lower than the 7.5 percent recorded in January 2014. Efforts at reconciling different household surveys suggest that poverty likely decreased strongly between 2012 and 2013, after a decrease of only 0.8 percentage points between 2009 and 2012 to 15.4 percent. The 2013 Annual Poverty Indicators Survey (APIS) suggests that the real income of the bottom 20 percent grew much faster than the rest of the population, through substantial growth of domestic cash transfers to this quintile—confirming that the government's conditional cash transfer

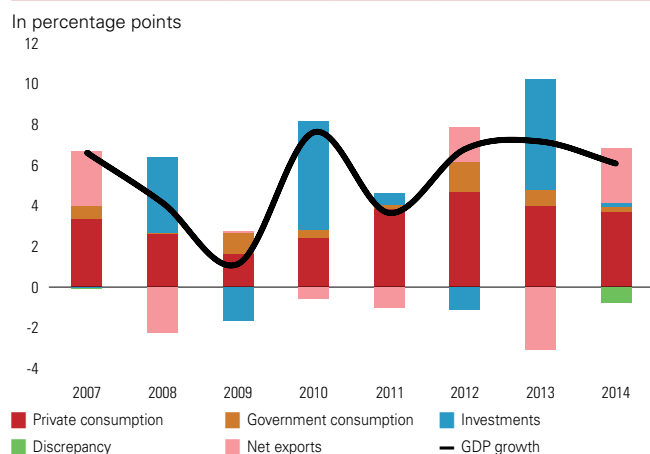
(CCT) program is well targeted and reaching the poor. Moreover, underemployment among the poor significantly decreased in the same period. However, in 2014, preliminary data show an increase in poverty, attributed to Typhoon Yolanda (a one time, unprecedented event) and artificially high rice prices, which offset income growth of the poor.

Outlook

Economic growth can rebound to 6.5 percent in both 2015 and 2016. For 2015, 6.5 percent growth is not out of reach if the government fully executes the 2015 budget and the recently approved Typhoon Yolanda master plan. Moreover, strong remittances, falling oil prices, and upbeat consumer and business sentiments indicate stronger growth in 2015. For 2016, growth will be supported by election-related spending. Historically first half domestic demand growth is around 2.4 percentage points higher in an election year compared to a non-election year. Risks to near-term growth include delays in planned execution of the budget, delays in investment (in particular those under private-public partnership projects), and a tepid global economy.

Going forward, poverty reduction is expected to continue if the Government maintains job creation, economic growth, and its current poverty alleviation

Figure 1. Demand side: contribution to annual GDP growth



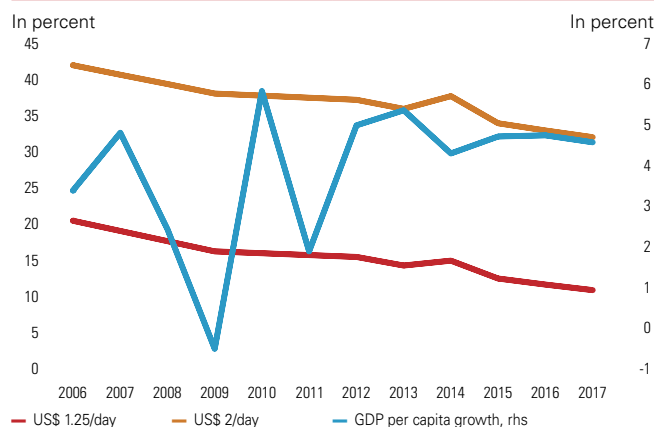
Source: Philippine Statistics Authority.

efforts. Poverty is projected to decrease from 15.4 in 2012 to 10.9 percent in 2017 (using the international poverty line of USD 1.25/day PPP) under the above assumptions, and the expectation that food inflation will not revert to early 2014 (post-Yolanda) levels. The Philippines needs to accelerate reforms that can translate higher growth into even more inclusive growth—the type that creates more and better jobs—and improve the impact of social sector spending.

Challenges

Eradicating poverty and boosting shared prosperity requires implementing an already well-known policy agenda of structural reforms. The key reform areas are: i) increasing investments in infrastructure, health, and education; ii) enhancing competition to level the playing field; iii) simplifying regulations to promote job creation, especially by micro and small enterprises; and iv) protecting property rights to encourage more investments. In the near-term, attention is needed in raising revenues equitably and efficiently to finance the much needed investment in physical and human capital. Attention is also needed in expanding the scope and ensuring the impact of the universal health coverage and conditional cash transfer programs.

Figure 2. Poverty headcount rates



Sources: National household consumption survey (SUSENAS), World Bank.

Over the medium to long-term, higher investments in infrastructure, health, and education are key to achieving inclusive growth. Overall, the country has an investment gap (both physical and human capital) of around 6.8 percent of GDP as of 2014. Improvements in tax administration (i.e., efficiently collecting existing taxes) can generate about 3.8 percent of GDP in fiscal space over the medium-term to finance the investment gap. The balance of 3 percent needs to come from tax policy reforms for a more equitable, efficient, and simpler tax system. For example, tax incentives need to be more targeted, transparent, performance-based, and temporary. Tax rates and valuations which have not kept up with inflation need to be adjusted to improve the equity of the tax system. Reforms to improve the transparency and accountability of government spending and to strengthen tax administration are also essential. Key reforms include passage of the Freedom of Information Bill, institutionalization of “open data,” which means making government data publicly available in user-friendly forms, and enhancing budget reporting to allow the public and the government itself to track spending.

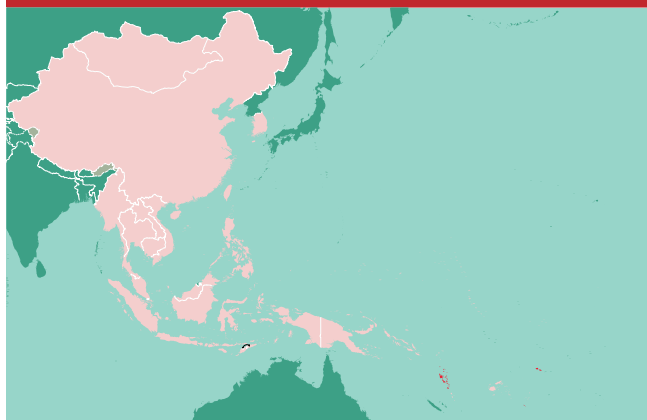
Philippines / Macro Poverty Outlook Indicators

	2012	2013	2014	2015 e	2016 f	2017 f
Real gross domestic product	6.8	7.2	6.1	6.5	6.5	6.3
Private consumption	6.6	5.7	5.4	5.6	5.8	5.6
Government consumption	15.5	7.7	1.8	9.0	8.0	5.1
Gross fixed capital investment	-5.3	29.9	1.1	10.0	10.1	10.6
Change in inventories, % contribution	-2.7	2.7	-1.6	0.3	0.0	0.0
Statistical discrepancy (% GDP)	0.0	0.0	0.0	0.0	0.0	0.0
Exports, goods & services	8.9	-1.1	12.1	5.5	7.8	7.8
Imports, goods & services	5.3	5.4	5.8	8.9	8.8	8.5
GDP, at market prices						
Agriculture	2.8	1.1	1.9	3.6	4.1	3.9
Industry	7.3	9.3	7.5	7.6	7.9	7.3
Services	7.4	7.2	6.0	6.3	6.4	6.0
Output gap	-1.0	0.2	0.4	0.9	1.5	1.8
CPI inflation, period average	3.2	3.0	4.1	3.0	3.5	3.5
Current account balance, % of GDP	2.8	4.2	4.4	2.7	2.4	1.7
Fiscal balance, % of GDP	-2.3	-1.4	-0.6	-2.0	-2.0	-2.0
Poverty rate, (\$1.25 a day, PPP terms)	15.4	14.2	14.9	12.5	11.6	10.9
Poverty rate, \$2 a day, PPP terms)	37.2	36.0	37.7	34.0	33.0	32.0
Gini coefficient of consumption	46.2					

Sources: Philippine Statistics Authority, World Bank staff projections.

Note: NG fiscal balance and current account balance projections are preliminary and determined outside the model.

SMALL PACIFIC ISLANDS



Most of the Small Pacific Island economies (Federated States of Micronesia, Kiribati, Palau, Republic of Marshall Islands, Samoa, Tonga, Tuvalu, and Vanuatu) experienced moderate growth during 2014, driven by stimulus from donor-financed aid projects and recovery from recent natural disasters. Falling commodity prices have reduced inflationary pressures and supported the current account positions of heavily import-dependent economies. Fiscal sustainability remains a common challenge, despite revenue gains from strengthened fishing license revenue receipts experienced by some countries.

Recent developments

Economic activity in the **Federated States of Micronesia** consists primarily of subsistence farming and fishing. Real GDP growth was estimated at -4.0 percent in FY2013, and is expected to remain low going forward. Rapid growth in the fishery sector during the year was offset by contraction in the construction and wholesale and retail sectors. The construction sector has ceased to be a source of growth, as the U.S.-funded airport improvement projects have come to an end and plans for other donor-funded infrastructure projects are delayed. In the medium term, declining public sector demand resulting from reduced Compact of Free Association (COFA) grants is also expected to drag on output, with limited private sector growth not fully offsetting this.

Inflation continued to decline from the recent peak in FY2011 to around $\frac{3}{4}$ of a percent in FY2014 as food and fuel prices are contained. Although strong fish exports continued to support the decline in the trade deficit in FY2013 and FY2014, the current account deficit is expected to remain at around 10 percent of GDP in the medium term, and largely financed by the inflow of official transfers. The FSM has been registering rising fiscal surpluses in recent years on account of strong growth in fishing license fees paid by foreign vessels and fiscal consolidation as part of the long term fiscal framework adjustments.

The economy of **Kiribati** continued to grow at a moderate 2.9 percent in 2014, driven by donor-financed infrastructure projects and continued growth in the services sector. Medium-term growth prospects heavily reliant on continued implementation of major infrastructure projects. Consumer prices inflation increased from -1.5 percent in 2013 to 3.4 percent in 2014, driven by the depreciation of the Australian dollar and the implementation of a new value-added tax.

Government achieved another large fiscal surplus in 2014 (11.6 percent of GDP compared to 9.7 percent of GDP in 2013) driven by continued strong fishing license receipts. Government is taking an appropriately prudent approach to management of recent revenue growth, with the majority of the surplus used to replenish the Revenue Equalization and Reserve trust fund (used for budget support and intergenerational transfer of phosphate mining proceeds) which has been substantially depleted over recent years. The 2015 budget is prudent, despite expectations of continued strong fishing license performance, with total government expenditure allocations declining (due to large one-off items such as SOE debt repayments in 2014) and limited nominal growth in recurrent expenditure and payroll (less than 2 percent). There has been no significant improvements in tax revenues despite strong imports and retail and commercial activity, largely due to weaknesses in compliance and enforcement. A VAT was implemented in 2014, but potential for expected improvements in revenue

performance have been partially undermined by the introduction of several ad hoc exemptions in response to concerns regarding price impacts.

The current account deficit (including official transfers) remained well below historical levels at 26.9 percent of GDP in 2014, reflecting continued high fishing license fees offsetting higher imports associated with major infrastructure projects.

Palau's economy is heavily reliant on tourism and grants. After a 2 percent contraction in the fiscal year (FY) ending September 2013, economic growth surged to 8 percent in FY2014 on the back of an unexpected rise in tourist arrivals from China, with new foreign investment also contributing to growth. Inflation remained moderate at 4 percent (period end) in FY2014, driven by stable international food and fuel prices. The current account deficit widened from 8¾ percent of GDP in FY2013 to 13 percent of GDP in FY2014, largely reflecting imports from the construction and tourism sector. A fiscal surplus equivalent to 1¼ percent of GDP is estimated for FY2014. Tax revenue continued to rise thanks to increases in the volume and rates of tourism-related taxes, higher prices in the tourism industry, and improved tax compliance. Recurrent expenditure, on the other hand, fell given careful management of the public sector. With the scheduled end of COFA grants in FY2024, fiscal adjustment over the medium term remains necessary to build adequate government deposits and ensure long-term fiscal sustainability.

Economic activity in the **Republic of Marshall Islands** consists primarily of subsistence farming and fishing. Real GDP growth is estimated to have flattened out in FY2014 after an estimated 3.0 percent growth in FY2013. The economy continued to be supported by increasing fishery output, partially offset by the near completion of grant funded airport project and the continued under-utilization of COFA infrastructure grants. Growth is expected to pick-up to around 1½ percent in 2015, given pipeline construction projects and planned fiscal stimulus. Inflation is estimated to have continued its

declining trend with year on year growth estimated at ½ percent in FY2014, due to subdued global commodity prices. The current account deficit including official transfers remained elevated, as high imports (including construction related imports for the airport project) more than offset a pickup in exports and an increase in receipts from fishing license fees. The government is estimated to have achieved a small fiscal surplus equivalent to around 1.2 percent of GDP in FY2014 on the back of strong fishing revenues, with large transfers to poorly performing state-owned enterprises (SOEs) continuing to be a major drain on public finances.

Samoa's economy is slowly recovering from the effects of Tropical Cyclone Evan in December 2012. Real GDP grew by 1.9 percent in FY2014, led by construction activity associated with cyclone reconstruction and the hosting of the UN Small Island Developing States (SIDS) conference in September, as well as a recovery in agriculture. This is an improvement from FY2013, during which the economy is estimated to have contracted by 1.1 percent, following the losses and damage to production capacity inflicted by the cyclone. Economic growth is projected to continue in FY2015, with real GDP expected to increase by around 2.5 to 3 percent. Consumer prices fell by 0.4 percent in 2014 (in year-on-year terms), driven primarily by a reversal of the cyclone-related spike in food and non-alcoholic beverages prices. However, these declines look to have run their course and the CPI is expected to rise in 2015.

The current account moved to deficit in FY2014 from a small surplus in FY2013, with import demand from cyclone-recovery and other construction activities pushing up the import bill. These same factors also drove an increase in the fiscal deficit from 3.8 percent of GDP in FY2013 to 5.4 percent of GDP in FY2014. However, the budget estimates suggest a fiscal deficit of 4.2 percent of GDP in FY2015, with the less expansionary stance attributable to the winding down of cyclone-related works and the forecast continuation of a broader economic recovery this year. From FY2016 onwards, the Fiscal Strategy

Statement anticipates that fiscal expenditures will be curtailed once construction activities associated with the Commonwealth Youth Games (to be held in September this year) have been completed.

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 52 percent at end FY2014. As a result, it will be important that fiscal consolidation proceeds as planned in the period ahead, including through a sustained focus on ensuring value-for-money across all public sector expenditure.

Economic performance in **Tonga** continues to be driven by public investment cycles and natural disasters. The economy is estimated to have contracted by just over 2 percent in FY2013 as the completion of major public construction projects dragged down growth. The devastating cyclone that hit Tonga’s Haapai’i island group in January 2014 has had a manifest impact on the economy in FY2014. The impact of the cyclone led to economic losses and dampened growth, but the subsequently donor-supported programme to rebuild and repair stimulated growth. The net effect is positive, with growth over FY2014 estimated at around 2 percent, largely due to recovery-related construction but also

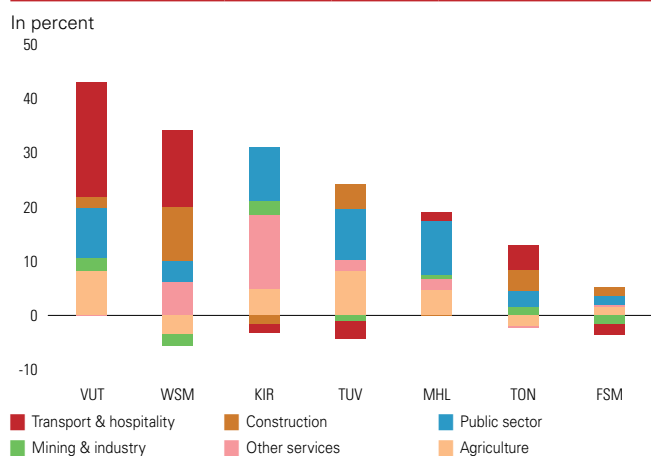
robust agricultural harvests in parts of the country unaffected by the cyclone.

The fiscal accounts continue to be ably managed. The government has successfully been able to mobilize grant and concessional credit financing whilst gradually improving domestic revenue collection which has risen from 18.4 percent in FY2012 to 19.8 percent in FY2014. 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 year-on-year in over 2014 as consumers benefit from falling energy and transport prices. Despite accommodative monetary policy and high liquidity, credit growth has yet to move into positive territory after years of decline. 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.

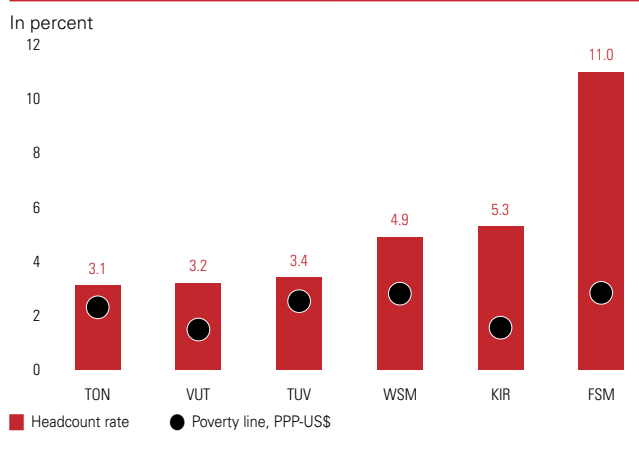
Economic growth in **Tuvalu** was estimated at 2.2 percent in 2014 and is expected to be somewhat higher in 2015 owing to large donor funded airport and road upgrading projects which are anticipated

Figure 1. Value added growth in constant local currency prices over 10 years



Source: World Bank.
Note: Average for 2010–12 versus 2000–02.

Figure 2. Food poverty line measured in PPP-US\$ a day (calorific values vary)



Source: World Bank.

to be implemented over the next several years. Inflation has been moderate thanks to benign food and oil prices, however, rapidly growing government expenditure and the weakening Australian dollar could exert upward pressure on prices. Preliminary data suggest a large surplus achieved by the Government of Tuvalu for 2014. Higher than expected fishing revenues and one-off grants is expected to more than offset rising expenditures. Vulnerabilities in State owned banks and public enterprises could however result in substantial contingent liabilities going forward. With the recovery of global financial markets, the national Trust Fund made distributions to rebuild government reserves to a more sustainable level. This is an important buffer given Tuvalu's extreme vulnerability to external shocks. The balance of payments was strong in 2014 reflecting large inflows of fishing license fees and foreign aid, as well as distributions from the Tuvalu Trust Fund.

In **Vanuatu**, engines of growth have slackened in 2014, but are likely to fire again in 2015. Following moderate growth in 2013, the crucial tourism sector flat-lined in 2014 with air arrivals 2 percent lower over the year to November, and cruise tourism 15 percent down over the same period. At the same time, a resurgent market for coconut products will make a contribution to growth as total exports jumped 64 percent in the year to October 2014, partly in response to market shortages as Philippines production was hit by Typhoon Haiyan.

Overall consumer price growth flattened out, with year-on-year inflation to September 2014 at 0.8 percent, compared to 1.4 percent over the same period the previous year. The expected slackening of growth is likely to be temporary as major new public infrastructure works break ground in 2015 and increase economic activity. Monetary policy remains loose with the yield on 91 days central bank notes 190 basis points and private sector credit growth expected to end 2014 only marginally positive. Foreign exchange reserves remain ample at just under seven months of import cover. Vanuatu's basket peg exchange rate regime is considered appropriate.

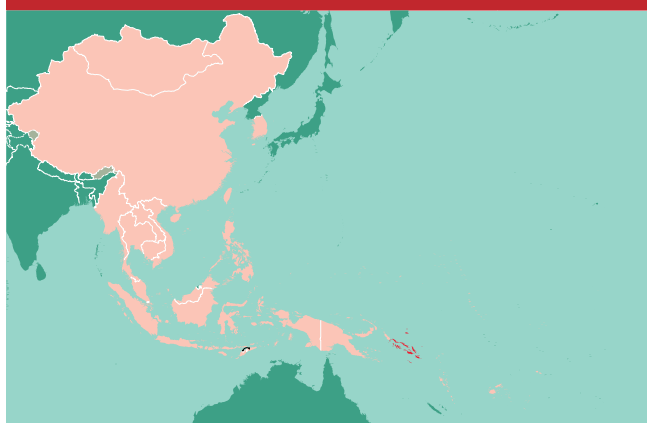
The Government of Vanuatu's Annual Budget for 2015 marks a significant change for fiscal policy. The budget has remained around balance for a number of years with a budget surplus of 0.8 percent of GDP projected for 2014, but the country will now embark on a substantial infrastructure development programme including new roads, seaports and airports, financed with a mix of development grants and investment loans. As a result a budget deficit in the region of 6 to 7 percent of GDP is expected for at least the next three years, 2015 through 2017. However, public debts sit at low levels at present, and the public finances are capable of taking on moderate levels of financing that supports economic growth, particularly at concessional rates. The overall fiscal deficit in 2013 was just 0.2 percent of GDP. Vanuatu's risk of debt distress is low, with total public external debt standing at 13 percent of GDP.

Outlook and Emerging Challenges

On balance, the outlook for most Small Pacific Island Countries is positive, but subject to significant risk and reliant on appropriate fiscal management. Continued strong demand for the region's fish resources and effective implementation of appropriate regional regulatory settings are already delivering tangible benefits to several Pacific countries. Steady and moderate growth in nearby large economies bodes well for tourism and remittance flows, with the recent growth of the China tourism market presenting longer-term opportunities. Heavily dependent on imported food and fuel, and with structural current account deficits, small Pacific island countries will unambiguously benefit from falling global commodity prices.

Immediate or medium-term fiscal sustainability challenges remain to be addressed in several countries, most pressingly in the COFA countries of the North Pacific. The current, relatively benign, global climate may present opportunities to pursue much-needed consolidation.

THE SOLOMON ISLANDS



	2014
Population, mn	0.63
GDP, US\$, bn	1.26
GDP per Capita, US\$	2,146
GDP per Capita, US\$ PPP	1,877
Poverty rate, US\$1.25	
Basic Needs Poverty rate, percent (2006)	22.7
Gini coefficient (2006)	0.36
Life expectancy	68.0
School enrolment rate, primary	83.3

Sources: Solomon Islands National Statistics Office, IMF 2014 World Economic Outlook, World Development Indicators 2014, UNICEF.

Economic growth in the Solomon Islands for 2014 was downgraded from 4 percent to near zero due to flash flooding in April 2014 which disrupted livelihoods and business activity. Given the anticipated subdued medium-term outlook, 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 developments

Solomon Islands remains one of the poorest countries in the Pacific, is reliant on aid and natural resource extraction, and is heavily exposed to external shocks. Growth since 'the tension' period in the early 2000's has primarily been driven by logging and Official Development Assistance (ODA).

While official employment levels in Solomon Islands are difficult to measure, employment indicators from the Solomon Islands National Provident Fund (NPF) exhibited strong growth, with the average number of active contributors rising by 6 percent year-on-year to by Q3 2014. In 2006, the poverty rate is 22,7 percent while income inequality is estimated to be lower than most countries at similar levels of income (Gini coefficient of 0.36) with inequality slightly higher in rural areas (Gini of 0.32) compared to urban areas (Gini of 0.29).

Flash flooding in April 2014 resulted in direct income losses due to the flooding in the agricultural, retail and transport sectors, as well as the loss of gold production, following the closure of Solomon Islands' only operating (gold) mine. This necessitated a downward revision in growth projections for the year (from 4 percent to 0.1 percent), representing a decline in GDP growth of 2.9 percentage points over the previous year. Timber production, one of the key drivers of economic growth in recent years, accelerated over the second half of 2014, such that 2014 output surpassed that of 2013 by 12 percent. Copra production and fish catch both saw substantial increases in output in 2014, increasing by 37 percent and 17 percent, respectively.

Cocoa, gold and silver were the only major commodities to see a decrease in output year-on-year.

Despite the flooding and subsequent slow growth, the Solomon Islands Government's (SIG) fiscal position surprised on the upside in end-2014 from a projected deficit of 1.6 percent of GDP to a surplus of 1.2 percent of GDP. Total official debt (domestic and external) fell by 8.5 percent in 2014 and Solomon Islands enjoys one of the lowest debt-to-GDP ratios in the region at an estimated 11 percent. According to the most recent Debt Sustainability Analysis (DSA) Solomon Islands continues to face 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\$492 million in Q4 2014, amounting to around 10 months of imports of

goods and services. The current account deficit is expected to widen to 14.7 percent of GDP in 2014, following the cessation of gold production and lower cash crop exports, as well as reflecting a generally weaker external environment. Lower expected log production in future years poses a medium-term risk to the current account, however lower oil and rice prices should soften some of the pressure. The Honiara CPI index continued to fall from late 2013 throughout January 2014, before accelerating throughout the first half of the year to 7.2 percent. The second half of 2014 saw inflation ease to 5.1 percent, driven primarily by the decline in prices for food, transport and communications, and fuel.

Outlook

The Solomon Islands economy is projected to grow by 3.5 percent over the medium term, however, this baseline scenario is based on i) foreign direct investment of above 9 percent of GDP in the next two years; ii) resumed mining activity; iii) significant donor investment in infrastructure; iv) the development of a new fish processing plant; and v) broader diversification of the economy in the context of public investment in new ICT infrastructure.

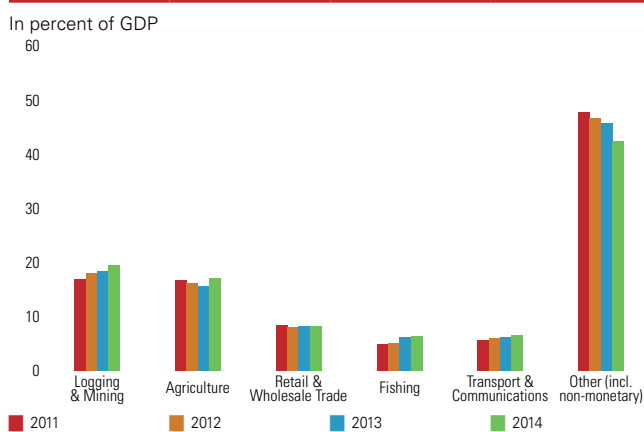
Unsustainable utilization of forest stocks has proceeded at pace, with logging estimated to account for 15 percent of GDP in 2013 and log

export duties 14 percent of domestically-sourced government revenues in 2014. With accessible logging sources expected to be fully depleted over coming years, and uncertainty around the exploitation of the country's mining potential, Solomon Islands faces the challenge of developing new sources of growth in a challenging fiscal environment. In 2015, domestically-sourced revenue is projected to increase by 3.7 percent, driven by taxes on income and profit, as well as on goods and services. Taxes on trade are expected to decrease by 0.5 percent, and non-tax revenue is projected to remain flat. Overall government spending in 2015 is anticipated to increase on 2014 levels, driven by an increase in development expenditures (with recurrent spending expected to remain around the same levels as in 2014). The Honiara Consumer Price Index (period average) is projected to remain fairly constant at around 5.5 percent, in line with lower global food and fuel prices. The current account deficit is expected to widen by a further 0.8 percentage points in 2015 to 15.5 percent of GDP, reflecting the underlying long-run decline in logging exports and an overall increase in capital imports.

Challenges

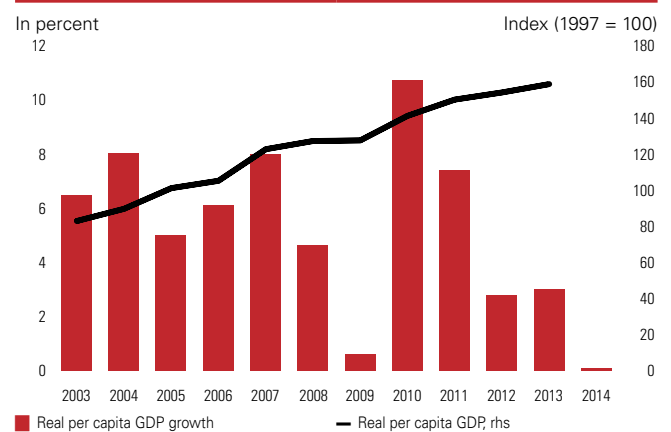
This outlook is subject to considerable downside risk, especially in relation to mining, in that future developments hinge on the development of a legal

Figure 1. Sectoral contribution to real GDP



Sources: Central Bank of Solomon Islands and World Bank staff calculations.

Figure 2. Real GDP growth, per capita



Sources: Central Bank of Solomon Islands and World Bank staff calculations.

and regulatory framework conducive to mining, as well as 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 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 Solomon Islands. Tourism, which is projected to increase by 5–6 percent per year in the Pacific region until 2020, could also make an important contribution to broad-based growth. Overall, an outlook involving lower levels of investment and growth remains possible, with the baseline reliant on a number of assumptions regarding policy measures and factors beyond SIG control. Further, should economic opportunities remain concentrated in the capital, this may exacerbate challenges associated with urbanization and the growth of urban squatter settlements.

The Solomon Islands / Selected Economic Indicators

	2012	2013	2014	2015 e	2016 f	2017 f
Real gross domestic product	3.8	3.0	0.1	3.5	3.5	3.5
Exports, goods & services	63.7	53.4	42.7	44.2	39.4	35.6
Imports, goods & services	65.2	63.2	62.5	62.8	58.0	51.5
CPI inflation , period average	5.1	3.1	6.0	6.0	5.5	5.5
Current account balance, % of GDP	0.2	-8.4	-14.7	-15.5	-14.6	-11.9

Sources: World Bank, IMF



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
Poverty rate, \$2 a day PPP (2012)	1.6
Poverty rate, \$4.00 a day PPP (2012)	21.9
Gini coefficient consumption (2012)	0.39
Life expectancy (2012)	74
School enrolment primary, gross (2013)	93

Sources: Thailand Government Authorities and World Development Indicators 2014.

Thailand's economy grew slowly in 2014 but is expected to pick up in 2015–17. With political turmoil in the first half of 2014, domestic demand and investment were significantly affected. Domestic demand and exports which have been weak last year is expected to pick up this year with the fall in oil prices, recovery in major export markets, albeit slowly, and the revival of tourism. Further recovery in growth is expected for 2016–17 as large public investment projects are implemented while inflation and interest rates will remain low. The rate of the recovery, however, will depend on the competitiveness of Thai export products and political stability in the years to come. Poverty rates are expected to continue to fall as the poor would benefit from the recovery of domestic demand, although they will also be affected by falling agricultural prices.

Recent developments

The Thai economy expanded by 0.7 percent yoy in 2014. After contracting in the first half, the economy

grew in the second half of the year as domestic demand began to recover. Exports of goods, the largest engine of the Thai economy remained weak throughout the year as auto-parts, hard disk drives, rice, and rubber were particularly weak. Exports of services, primarily tourism receipts (10 percent of Thailand's GDP), recovered in the final quarter of 2014. With weak domestic demand and exports, manufacturing volume contracted by 1.1 percent yoy in 2014. With capacity utilization at 60 percent at the end of 2014, private investment contracted by 1.9 percent.

With the fall in imports, the current account in 2014 was in a surplus of US\$14.2 billion (3.8 percent of GDP) compared to a deficit of 0.6 percent in 2013. Due largely to portfolio outflows, the overall balance was an outflow of US\$1.2 billion (US\$5 billion outflow in 2013). At end-2014, international reserves were US\$157 billion, or 2.7 times the short-term external debt (US\$167 billion at end-2013). The baht appreciated by 0.1 percent from the end of 2013, while the REER appreciated by 3.2 percent. Inflation remained subdued at 1.9 percent.

Public investment contracted in 2014 by 6.1 percent and the fiscal deficit was 1.7 percent of GDP. Public debt stood at 46.4 percent of GDP at end-June, a slight increase from 45.7 percent at end-2013.

The weak performance of export goods and decline in investment have directly impacted urban households, who work disproportionately as low-skilled workers in labor-intensive non-agricultural sectors. The rural poor are also affected through the impact on remittances. The elderly and child dependents in rural areas are particularly susceptible to the remittance effect. Over half of the rural poor work in lower-productivity agriculture, leaving them susceptible to lower prices of major agricultural commodities such as rice and rubber. The fraction of the population living under the national poverty line in 2013 was 10.9 percent and 20.8 percent at the poverty line of \$4 (PPP terms).

Outlook

In 2015, real GDP growth is projected at 3.5 percent with exports picking up slightly as the economies of major markets in high income countries recover slowly. Imports will likely continue to fall from 2014 as oil prices remain low. Tourism receipts should recover in 2015 after contracting in 2014. Tourist arrivals are projected to rise by 10 percent this year.

Domestic demand is expected to recover in 2015 after contracting in 2014. Private consumption will grow but only slightly from the rise in export receipts and lower oil prices, inflation and interest rates (the Bank of Thailand reduced its policy rate by 0.25 percent in March), but farm incomes will be negatively affected by drought and lower commodity prices. Household debt, which remains high (85 percent of GDP), will continue to limit consumption growth. Private investments which contracted last year pick up this year as capacity utilization slowly increases and political stability spurs confidence. Public investment is projected to increase as Government is focused on raising disbursements in public investments this year.

In 2016 and 2017, high income economies are projected to continue to recover, and oil prices to remain low. These will support Thai domestic consumption and exports. Large public infrastructure

projects (dual track rail and rail upgrading) will also start to be implemented in 2016. This will support growth in private investments as well. Imports will also rise with these developments leading to lower current account surpluses in 2016 and 2017. We project the Thai economy in 2016 and 2017 to grow by 4.0 percent.

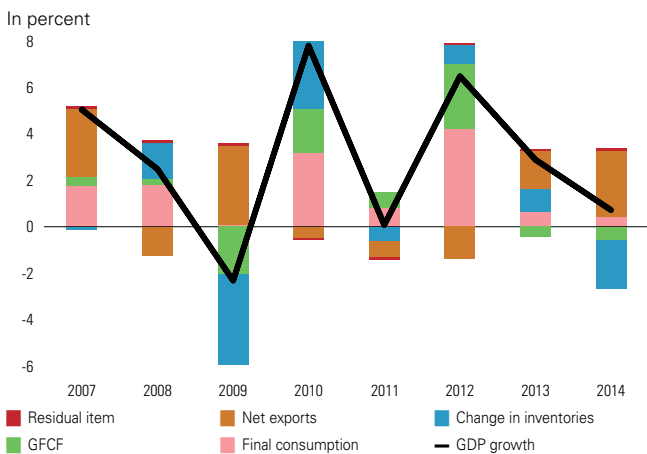
Challenges

The main risks to the outlook continue to be the uncertain global environment affecting Thai exports and the slow recovery of Thailand’s exports relative to neighboring countries. For Thailand to sustain high levels of growth, the private sector will have to regain a competitive edge in its export product mix and quality.

The Government’s ability to implement long delayed public investment will also be important. The extent to which government’s reforms will be implemented and sustained will depend on the policy stability in 2016 and 2017 which remains fluid with the new Constitution being drafted this year and elections expected to be held next year.

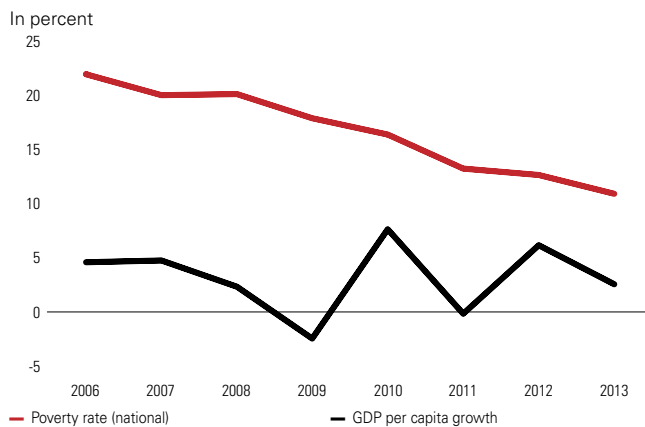
Inequality remains a major challenge in Thailand, differentiating the country regionally and across rural and urban areas. Poverty is becoming increasingly

Figure 1. Contributions to annual GDP growth



Sources: World Bank & NESDB.

Figure 2. Poverty rate & GDP per capita growth



Sources: World Bank & NESDB.

Note: 2013 national poverty rate is preliminary data.

structural in nature, consisting of the non-productive poor who place a substantial reliance on familial transfers and community support. These challenges are likely to become more pressing as the population ages should the planned reforms to address inequality not materialize.

Thailand / Selected Economic and Social Indicator

	2012	2013	2014	2015 f	2016 f	2017 f
Real gross domestic product (%)	6.5	2.9	0.7	3.5	4.0	4.0
Private consumption	6.7	0.3	0.3	1.0	1.2	1.5
Government consumption	7.5	4.9	2.8	4.0	4.0	3.0
Gross fixed capital investment	13.2	-2.0	-2.8	6.0	5.4	6.6
Change in inventories, % contribution	0.8	1.0	-2.1	-0.1	0.1	0.1
Statistical discrepancy (% GDP)	0.6	0.6	0.7	0.6	0.5	0.5
Exports, goods & services	3.1	4.2	0.0	3.5	4.2	5.1
Imports, goods & services	6.2	2.3	-4.8	3.2	2.6	4.3
GDP, at market prices (%)	7.9	4.6	2.0	4.0	5.5	6.0
Agriculture	-0.7	2.2	-0.9	1.2	1.3	1.5
Industry	9.4	2.2	0.8	3.0	5.0	5.5
Services	9.1	7.7	4.0	5.5	6.0	6.5
CPI Inflation, period average	3.0	2.2	1.9	0.5	1.5	2.0
Current account balance, % of GDP	-0.4	-0.6	3.8	5.3	5.0	4.6
Fiscal Balance, % of GDP	-3.6	-1.6	-1.7	-1.8	-2.0	-2.3
Poverty rate, \$2 a day (PPP terms)	1.6	1.4	..	..	..	..
Poverty rate, \$4 a day (PPP terms)	21.9	20.8	..	..	..	..
Gini coefficient of consumption	0.39	..	..	..	..	..



TIMOR-LESTE

	2012
Population, mn ^{1/}	1.1
GDP, US\$, bn ^{2/}	1.3
GDP per Capita, US\$	1,058
GDP per Capita, US\$ PPP	2,076
Life expectancy (2012)	62.5

Sources: World Development Indicators; Timor-Leste Ministry of Finance.

Notes: 1/ 2012. 2/ 2012. Non-oil. 3/ Gross school enrollment, primary, 2011.

Timor-Leste's economy remains heavily dependent on petroleum. The FY15 budget is US\$1.57 billion, just US\$70 million higher than FY14, but with higher recurrent spending and lower capital spending, and higher medium term spending plans than FY14. The government has lowered medium term growth forecasts. Estimates of petroleum production from current fields have been reduced, which lowers estimates of petroleum wealth and the sustainable income from that wealth. However, the Petroleum Fund passed US\$16.5 billion in December 2014. Headline inflation dropped in 2014.

Recent developments

In May 2014, the government released 2012 GDP numbers, and revised upwards the 2011 non-oil real GDP growth from 12.1 percent to 14.7 percent, as adjustments were made to deflators in the construction sector. In 2012 non-oil GDP growth nearly halved to 7.8 percent, confirming the sensitivity of growth to slowing public spending and slow growth in private activity. The 2013 and 2014 estimates for non-oil GDP growth have similarly been reduced from 8 percent and 8.8 percent

respectively, to 5.6 percent and 7.1 percent. The steep increase in 2014 budget execution resulting in a 27 percent nominal increase in public spending between 2013 and 2014, may improve the final 2014 growth outturn. Other upside factors include growing vehicle ownership, which by Q3 2014 was 63 percent higher than the total for 2013, driven largely by heavy vehicles. Household electricity consumption also grew in 2014. Credit to the private sector grew 1.7 percent in Q4, after two consecutive drops in previous quarters, albeit still from a low level of 11 percent of GDP, relative to the region.

The good and services trade deficit widened by 11 percent relative to 2013 to 59 percent of non-oil GDP. The Petroleum Fund, Timor-Leste's Sovereign Wealth Fund, reached a value of US\$16.5 billion at the end of 2014, 11 times the estimated 2014 non-oil GDP, and together with official Central Bank reserves capable of covering up to 200 months of imports.

Inflation remained low in 2014, at an average of 0.4 percent year-on-year following a dramatic drop in Q4 2013 from 12 percent year on year. Food items dominate the CPI basket (now 64 percent). Slower public spending, and hence domestic demand pressures, and lower oil prices may also have contributed.

Prime Minister Kay Rala Xanana Gusmao resigned from his post in the first week of February 2015. Dr. Rui Araujo, a leading member of the opposition Fretilin party and a former Deputy Prime Minister and Health Minister, replaced him. The government has been reduced from 55 members to 38, and includes Xanana Gusmao as minister for a new Ministry of Development Planning and Strategic Investment.

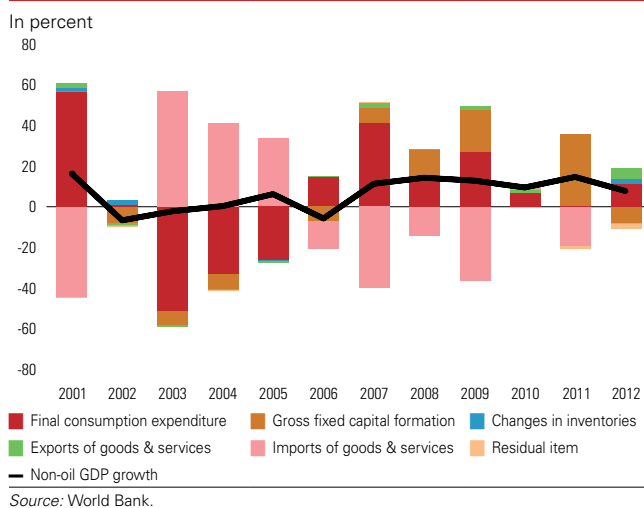
Outlook

Global oil prices and domestic oil production, public spending, and the timing of a private sector pick-up dominate the outlook for Timor-Leste—one of the World's most petroleum dependent economies. In 2014, petroleum represented 99 percent of Timor-

Leste's export earnings, 93 percent of its fiscal revenue, and 80 percent of its overall GDP, and financed 85 percent of the budget. However, the impact of the recent collapse in oil prices is dampened by the fact that the government uses conservative estimates for oil production and prices in fiscal and economic forecasts; roughly 70 percent of petroleum in fields currently under production have already been exploited; and the off-shore Petroleum Fund and associated fiscal rule provide a buffer against volatile petroleum revenues.

While impacts on total GDP will be significant as the value of oil production and income falls, there is little impact on non-oil GDP. The new government decided not to use post-reshuffle rectification budget to cut planned spending, a significant determinant of aggregate demand, to align with lower ESI. As a rule of thumb, ESI may fall by roughly US\$20 million for each permanent US\$10 dollar reduction in global oil price. The current fall in prices could lower ESI by an amount equivalent to the Education recurrent budget, or three times the agriculture budget. The fall in the cost of imported diesel fuel for publicly provided electricity, currently 7 percent of the state budget, may partially offset the fall in ESI.

Figure 1. Contributions to annual GDP growth



The 2015 estimate for non-oil GDP growth has been reduced from 9.4 to 7 percent as prospects for a pick-up in the private sector remain uncertain. A new investment law under preparation could accelerate investor friendly policies.

Petroleum fields currently under development are expected to end by 2021. Prospects for the rapid development of the Greater Sunrise oil and gas field remain uncertain, with the recent fall in oil prices being factored in to development options.

An ongoing nationwide household living standards survey is expected to provide an estimate of poverty in 2015, comparable with the incidence measured in 2007.

Challenges

The main challenge remains translating public spending into long-term private sector driven growth and improved living standards. Investment in human capital remains critical, alongside careful selection of physical infrastructure projects, at the right scale, and with adequate maintenance.

Fiscal sustainability remains a challenge. The FY15 budget is 20 percent larger than the fiscal envelope and spending is forecast to peak at US\$1.99 billion in 2017. More of the budgets are being executed—increasing from 66 percent in 2013 to 90 percent in 2014. The share of recurrent spending is increasing driven in 2015 by a 21 percent planned increase in transfers for social assistance programs. At the same time growth in domestic revenues will slow to 2.5 percent in 2015. Withdrawals in excess of ESI will be required to finance not just capital spending, but also recurrent spending. A mix of tax policy and administration measures are urgently required. A VAT is being considered.

The FY15 budget transfers US\$81.9 million to a new Administrative Authority for Oecusse as a Special Zone for Social Market Economy, established by law in July 2014. Development plans for the 65,000

inhabitants now include agriculture and agro-forestry. Systems for spending the appropriated budget are being finalized.

Timor-Leste / Macro Poverty Outlook Indicators

	2012	2013	2014	2015 e	2016 f
Real gross domestic product	-10.4	-10.7	-10.2	10.3	-1.1
Exports, goods & services	33	16	13	30	37
Imports, goods & services	672	843	934	800	867
CPI Inflation , period average	11.8	11.3	0.4	4.0	3.7
Current account balance, % of GDP	2,668	2,224	1,090	1,445	1,499



2014

Population, mn	90.7
GDP, US\$, bn	184.4
GDP per Capita, US\$	2,040
GDP per Capita, US\$ PPP (2013)	5,294
Poverty rate, US\$1.25 (2012)	2.9
Poverty rate, US\$2.0 (2012)	12.1
Gini coefficient, consumption (2012)	0.36
Life expectancy (2012)	76
School enrolment rate, primary (2012)	105

Sources: Vietnam Government Authorities, World Development Indicators 2014.

After some turbulence in mid-2014, Vietnam's economic performance rebounded and year-end growth exceeded expectations. At the heart of this were stronger macroeconomic fundamentals, solid FDI in manufacturing sector and exports from the sector, and key reforms to the business climate. Poverty has continued to decline markedly, to the point that extreme poverty has been all but eliminated. Despite the improved growth, Vietnam still performs below its potential, due to slow-moving structural reforms and global uncertainty. Moreover, important questions remain as to how Vietnam would contain increasing public debt levels, demonstrate greater credibility in implementing the government's ambitious reform agenda (especially in the areas of banking sector and SOEs), and ensure a more conducive environment for domestic enterprises.

Recent developments

There are positive signs of firming economic activities in Vietnam. GDP growth picked up to 7 percent in 2014Q4, contributing to growth rate of 6 percent for the year—the fastest rate since 2011. The pick-up in economic activity was led by the manufacturing and agriculture sectors. The services sector grew by 6 percent, slightly lower than in 2013. Vietnam still performs below its potential, due to slow-moving structural reforms, especially in the areas of banking sector and SOEs.

Economic growth in Vietnam has been equitable, leading to significant poverty reduction and shared prosperity. Inequality using the Gini rose modestly from the early 1990s through 2004 and then stabilized before dropping slightly in the most recent data 2010–2012. Poverty has declined continuously and markedly, to the point that extreme poverty has been all but eliminated. Poverty is largely a rural phenomenon (95 percent of the poor live in rural areas) and concentrated in the North West and North East, in the border areas of the North Central and South Central Coast and in parts of the Central Highlands.

With the overall decline in poverty, the concentration of ethnic minorities among the poor has increased. Members of ethnic minority groups make up 15 percent of the population but account for more than 70 percent of the extreme poor measured using a national extreme poverty line. The poorest areas in Vietnam have a substantial ethnic minority presence. It is important to recognize, however, that with overall economic growth, the welfare of ethnic minorities has improved substantially over time; ethnic minority poverty rate fell from 66 to 59 percent in 2010–12.

Improved macroeconomic stability underpinned recent years' growth. CPI inflation has stabilized, averaging 4.1 percent in 2014 (the lowest level since 2003), on account of weak global energy and food prices. Solid exports, sustained inflows of FDI and private remittances and soft imports helped

strengthen external balances, allowing foreign exchange reserves to build up to an import cover of 3 months in 2014, up from 2.4 months in December 2013. These positive developments contributed to improved sovereign risk ratings and allowed Vietnam to successfully float a US\$ 1 billion bond issue in international markets at favorable terms.

Rising public debt is becoming a concern for the government. The main driver is the budget deficit, financed mostly domestically. Total outstanding public and publicly-guaranteed debt stood at 61 percent of GDP by end-2014, with domestic debt having risen from 23 percent of GDP in 2010 to 32 percent in 2014. Contingent liabilities in the banking and SOE sectors are placing additional pressure on public debt sustainability.

The fiscal deficit rose from 1.1 percent of GDP in 2011 to an average of 5.9 percent during 2012–14, reflecting a countercyclical fiscal stance. The fiscal stimulus has been driven by both a decline in revenue collection and an increase in recurrent spending.

Despite a pick-up in momentum, SOE reforms are lagging behind planned targets. 148 SOEs were equitized in 2014—double the number in 2013 but it still falls behind the target of 200 equitized SOEs in 2014. SOE equitization alone will not suffice, however. The focus of the reforms has to be on

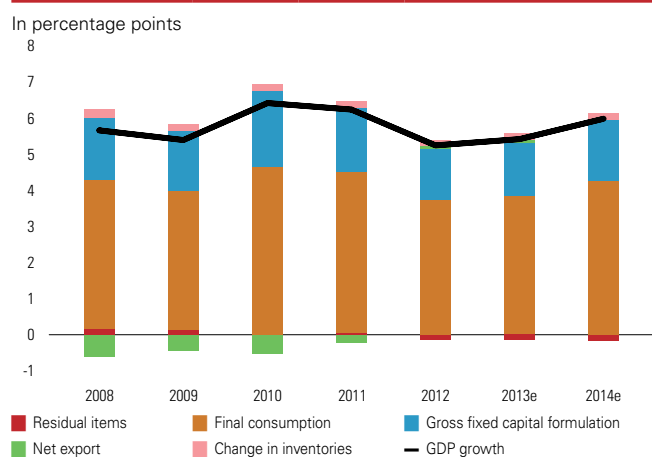
improving the efficiency and level of competition within the enterprise sector, with targeted measures to strengthen corporate governance, contract enforcement, and reduce barriers to entry. Special attention has to be given to promoting a level playing field for public and private enterprises.

The monetary policy stance remained accommodative throughout 2014. However, credit growth was constrained by banks' impaired balance sheets, concerns over the financial health of borrowers and weak demand for credit on account of low consumer and investor confidence.

Outlook

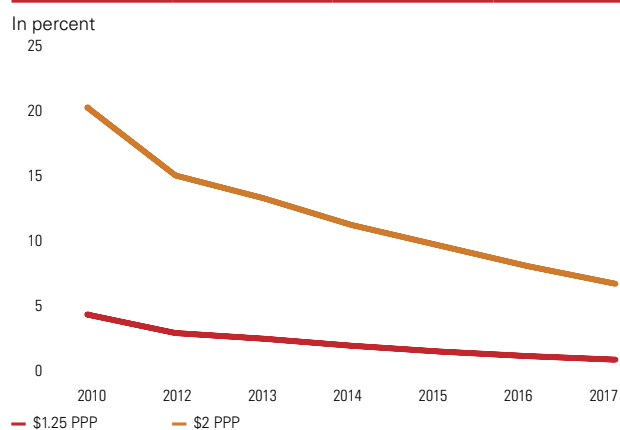
Medium term projections reflect gradual improvement in GDP growth and macroeconomic stability confronting growing pressures from rising public debt. Inflation is projected to be moderate in 2015 on account of low global energy and food prices, and gradual recovery in domestic private demand. Strong exports and robust remittances will keep the current account in surplus, albeit of diminishing amount as stronger domestic economic activity stokes import growth. The fiscal deficit would decline to under 4 percent of GDP by 2017, underscoring the need for fiscal consolidation over the medium term together with a credible plan to

Figure 1. Contribution to annual GDP growth



Sources: General Statistical Office (GSO).

Figure 2. Poverty headcount rate 2010–17



strengthen the finances of the SOEs and state-owned banking sector to preserve public debt sustainability.

Poverty is expected to continue to decline. Extreme poverty (\$1.25 a day, PPP) is expected to decline from 2.9 percent in 2012 to less than 1 percent in 2017 while the percentage of population living with below \$2 a day would fall from 12.1 percent in 2012 to 5.8 percent in 2017.

Challenges

Risks to the medium-term outlook remain mostly on the downside. Weak global prices of rice and other agricultural products may adversely affect rural household income and consumption and widen the urban-rural gap. Falling oil prices could also put additional pressure on the budget revenues. Domestic private investment is still weighed down by the subdued business confidence. On the external front, global growth remains sluggish and

subject to much uncertainty. This risks dampening Vietnam's exports and FDI inflows. On the upside, emerging trade agreements provide opportunity for Vietnamese enterprises to reach out to much bigger and richer markets. Domestic reforms, including medium-term fiscal consolidation, further improvements in the business climate and more credible and visible SOE and banking sector reforms will send important signals to domestic and international investors and lay the groundwork for stronger future growth.

Vietnam / Selected Economic and Social Indicators

	2012	2013	2014	2015 e	2016 f	2017 f
Real gross domestic product	5.2	5.5	6.0	6.0	6.2	6.5
Private consumption	4.7	5.1	6.1	6.1	6.2	6.7
Government consumption	7.2	7.6	7.0	6.5	6.2	6.2
Gross fixed capital investment	2.0	5.2	8.9	6.8	6.6	6.4
Change in inventories, % contribution	0.2	0.2	0.3	0.2	0.2	0.2
Statistical discrepancy (% GDP)	-2.6	-2.8	-2.8	-2.8	-2.8	-2.8
Exports, goods & services	15.7	17.5	11.6	11.2	11.2	10.3
Imports, goods & services	9.4	17.1	12.8	11.5	11.4	10.4
GDP, at market prices						
Agriculture	2.6	2.7	3.5	3.2	3.0	3.0
Industry	5.8	5.4	7.1	6.9	7.0	7.4
Services	5.9	6.6	6.0	6.2	6.6	6.9
Output Gap	-0.8	-0.7	-0.5	-0.4	0.0	0.4
CPI Inflation, period average	9.1	6.6	4.1	4.5	5.0	5.0
Current account balance, % of GDP	6.0	5.5	5.0	3.6	2.7	1.2
Fiscal balance, % of GDP	-6.8	-5.6	-5.3	-5.3	-4.4	-3.8
Poverty rate, \$1.25 a day, PPP terms)	2.9	2.5	1.9	1.5	1.1	0.8
Poverty rate, \$2.00 a day, PPP terms)	12.1	10.8	9.3	8.2	6.9	5.8
Gini coefficient of consumption	0.36					

Sources: Vietnam Government Authorities and World Bank staff forecasts.

Note: e = estimate; f = forecast.

Adjusting to a Changing World