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Balancing Act

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WORLD BANK **EAST ASIA AND PACIFIC ECONOMIC UPDATE** OCTOBER 2017

Balancing Act

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ISBN (electronic): 978-1-4648-1209-5

DOI: 10.1596/ 978-1-4648-1209-5

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List of Abbreviations

AHDI	Augmented Human Development Index
ASEAN	Association of Southeast Asian Nations
BRI	Belt and Road Initiative
CBRC	China Banking Regulatory Commission
CIT	corporate income tax
CSRC	China Securities Regulatory Commission
ECB	European Central Bank
EMDEs	emerging market and developing economies
eop	end of period
FDI	foreign direct investment
FSB	Financial Stability Board
FY	fiscal year
GDP	gross domestic product
GEP	growth elasticity of poverty
IBRD	International Bank for Reconstruction and Development
ICT	information and communications technology
IDA	International Development Association
ILHCA	Integrated Household Living Conditions Assessment
IMF	International Monetary Fund
IPL	international poverty line
ITMP	integrated tourism master plans
LCU	local currency unit
LMIC	lower-middle-income country
M&A	mergers & acquisitions
MICE	meetings incentive travel, conferences, and exhibitions (Singapore)
NBS	National Bureau of Statistics (China)
NPLs	nonperforming loans
OFIs	other financial intermediaries
OPEC	Organization of the Petroleum Exporting Countries
PBOC	People's Bank of China
pc	per capita
PCE	per capita daily consumption expenditures
PMI	Purchasing Managers' Index
PPI	Producer Price Index
PPP	purchasing power parity
P2P	Peer-to-Peer
Q1	first quarter
Q2	second quarter
Q3	third quarter
Q4	fourth quarter
q/q	quarter-on-quarter
SAAR	seasonally adjusted annual rate
SOEs	state-owned enterprises
STB	Singapore Tourism Board
UMIC	upper-middle-income country
VAR	vector autoregression
VAT	value-added tax
WBG	World Bank Group
WEF TTCI	World Economic Forum's Travel & Tourism Competitiveness Index
WHO	World Health Organization
WMPs	wealth management products
WTO	World Trade Organization
WTTC	World Travel & Tourism Council
yoy	year-over-year
RERF	Kiribati's sovereign wealth fund
SAAR	Seasonally Adjusted Annual Rate
SEZ	Special Economic Zone
SOEs	state-owned enterprises
SPGs	South Pacific Games
tCO2-e	tonnes of carbon dioxide equivalents
TCP	Tropical Cyclone Pam
TFP	total factor productivity
TTF	Tuvalu Trust Fund
UNFCCC	United Nations Framework Convention on Climate Change
VAT	value-added tax
WBG	World Bank Group
WTO	World Trade Organization
yoy	year-over-year

List of Abbreviations continued

Regions, World Bank Classification and Country Groups	
EAP	East Asia and Pacific
ECA	Eastern Europe and Central Asia
LAC	Latin America and the Caribbean
MENA	Middle East and North Africa
PICs	Pacific Island Countries
SAR	South Asia
SSA	Sub-Saharan Africa

Country Abbreviations	
CAN	Canada
CHN	China
CYM	Cayman Islands
FJI	Fiji
FSM	Federation States of Micronesia
GBR	United Kingdom
IDN	Indonesia
JPN	Japan
KHM	Cambodia
KIR	Kiribati
KOR	Korea, Rep.
LAO	Laos People's Democratic Republic
MHL	Marshall Islands
MMR	Myanmar
MNG	Mongolia
MYS	Malaysia
PHL	Philippines
PLW	Palau
PNG	Papua New Guinea
RMI	Republic of Marshall Islands
SGP	Singapore
SLB	Solomon Islands
THA	Thailand
TLS	Timor-Leste
TON	Tonga
TUV	Tuvalu
USA	United States
VNM	Vietnam
VUT	Vanuatu
WSM	Samoa

Currency Units	
$A	Kiribati (Australian dollar)
$NZ	New Zealand dollar
B	Thai baht
CR	Cambodian riel
D	Vietnamese dong
F$	Fiji dollar
K	Myanmar kyat
K	Papua New Guinea kina
Kip	Lao kip
₱	Philippine peso
RM	Malaysian ringgit
RMB	Chinese renminbi
Rp	Indonesian rupiah
SI$	Solomon Islands dollar
Tog	Mongolian togrog
US$	Timor-Leste (U.S. dollar)
US$	United States dollar

Preface and Acknowledgments

The *East Asia and Pacific Economic Update* is a joint product of the World Bank Office of the Chief Economist, East Asia and Pacific Region, and the Macroeconomic and Fiscal Management Global Practice, prepared in collaboration with the Poverty and Equity Global Practice, the Development Prospects Group, and the Finance and Markets Global Practice. The report was prepared by Congyan Tan (Task Team Leader) and Philip M. Schuler (Co-Task Team Leader), under the guidance of Sudhir Shetty (Chief Economist, East Asia and Pacific Region).

Chapter I was prepared by Philip M. Schuler (lead), Ekaterine Vashakmadze, and Vera Kehayova. Contributions were received from the Chapter III team (listed below), Ana Maria Aviles, Reena Badiani-Magnusson, Monika Blaszkiewicz, Reno Dewina, Kim Alan Edwards, Samuel Freije-Rodriguez, Zhi (Ken) Gan, Raju Huidrom, Elisabeth Hyun Kim, Tuan Minh Le, John Litwack, Keita Miyaki, Antonio M. Ollero, Jose Ramon Perea, Haocong Ren, Changyi Shao, Diego M. Sourrouille, Naotaka Sugawara, Congyan Tan, Radu Tatucu, Judy Yang, Luan Zhao, and Nan Zhou.

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Assistance with communications and outreach was provided by Alejandro Cedeno Ulloa, Diana Ya-Wai Chung, Dini Sari Djalal, Livia Pontes, and Anissa Amador Tria (External Communications, East Asia and Pacific Region). The report was edited by Diane Stamm, and designed and typeset by Budy Wirasmo. Administrative support was provided by Cecile Wodon.

Preface continued

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 September 22, 2017, inclusive.

Executive Summary

Global economic growth has strengthened since the April 2017 *East Asia and Pacific Economic Update*. This improvement reflects a congruence of positive trends, with growth picking up simultaneously across country groupings. Obstacles to activity in commodity exporters have receded against a backdrop of resilient growth in major commodity importers. Growth in the Euro Area and Japan in the first half of 2017 has exceeded expectations, and U.S. growth rebounded strongly. World trade appears on track to expand at its fastest pace since 2010. Interest rates remain low as the U.S. Federal Reserve and the European Central Bank move gradually to retreat from loose monetary policy.

Growth in developing East Asia and Pacific (EAP) accelerated slightly in the first half of 2017, relative to expectations six months ago. Domestic demand continues to drive the region's performance. Consumption made the greatest contribution to growth in most large economies. Fiscal deficits have narrowed or held steady in most large countries, while remaining significant in many of the smaller economies. Consumer price inflation generally remained low and has allowed authorities to maintain generally accommodative monetary policies so far in 2017.

The growth outlook for the region remains positive. With China's growth stronger than previously expected, developing EAP as a whole is projected to grow at 6.4 percent in 2017, a modest improvement over 2016 as well as relative to expectations in the April 2017 *East Asia and Pacific Economic Update*. Domestic demand will remain the primary contributor to growth in most countries. Growing world trade, sustained recovery in advanced countries, and accelerating growth in emerging markets and developing economies will strengthen external demand. Commodity prices are expected to recover at a moderate pace. Global financing conditions are expected to tighten gradually.

China's growth moderation and gradual rebalancing are expected to continue despite the uptick in 2017. With more rapid growth in the first half of the year, the Chinese economy is expected to grow at 6.7 percent in 2017. Growth is projected to moderate to around 6.4 percent in 2018–19 as the economy rebalances away from investment and external demand toward domestic consumption.

In most of the large Association of Southeast Asian Nations (ASEAN) economies in the region, growth is projected to increase in 2017 and 2018. Malaysia is expected to grow more rapidly, reflecting improved confidence, higher investment, and the recovery in world trade. Thailand's growth is also expected to increase due to stronger recovery in merchandise exports and tourism. Gradual increases in growth are foreseen for Indonesia and Vietnam in 2017 and 2018. In Indonesia, private consumption is projected to strengthen in line with gains in real wages. And, in Vietnam, rebounding agricultural production and strong export-oriented manufacturing will contribute to higher growth. Growth in the Philippines is likely to expand at a slightly slower pace in 2017–18, due in part to slower-than-expected implementation of public investment projects. Nevertheless, it is expected to continue to be the fastest growing of the large ASEAN economies.

The outlook for the smaller regional economies is more mixed. Several, including Mongolia, Fiji, and Myanmar are projected to grow more rapidly in 2017–18. Mongolia's macroeconomic stabilization program is encouraging new foreign direct investment (FDI) in mining and transport. Infrastructure investment is likely to rise in Fiji and Myanmar. Implementation of new natural resource projects is expected to underpin a gradual recovery in Papua

New Guinea in 2018. Cambodia and Lao People's Democratic Republic are both expected to maintain their rapid growth, albeit at a slightly slower pace than in 2016. The power sector in Lao PDR and growth in trade and FDI in Cambodia will be the main contributors. Volatility in the pace of government spending caused by elections and the change of government in Timor-Leste will likely contribute to reduced growth in 2017, followed by a pickup in 2018. Expanding tourism, low world commodity prices, high levels of revenue from fishing fees, and rising construction activity support moderate GDP growth rates in most of the small Pacific Island Countries.

Poverty has declined across most of the region and poverty rates are projected to continue falling. Projections indicate that some of the region's larger countries (China, Vietnam) have already been successful in eliminating extreme poverty (defined as those below the international poverty line of US$1.90-a-day in 2011 purchasing power parity terms). The share of the region's population living in moderate poverty (defined as US$3.10-a-day in 2011 purchasing power parity terms) has declined to around 10 percent and is projected to drop to around 8 percent by 2019. The pace of poverty reduction across countries depends on efforts to make growth more inclusive. In the Philippines and other countries where income inequality has limited past progress in poverty reduction, accelerating the pace of poverty reduction will require more attention to tackling inequalities of opportunity and wealth. Poverty is concentrated among ethnic minorities in some countries—in Vietnam, for example, ethnic minorities account for 15 percent of the total population, but most of the extreme poor—and inclusion should be a major focus of poverty reduction efforts.

This generally positive outlook is subject to significant downside risks. First, continued uncertainty about economic policies in some advanced economies and the escalation of geopolitical tensions could jeopardize growth prospects. Rising protectionism and economic nationalism, in particular, could have a chilling effect on world trade, to which countries in the region are disproportionately vulnerable because of their integration into global value chains. Increased geopolitical tensions in the region could generate volatility in global financial markets that could cause capital outflows for developing EAP, put pressure on exchange rates, and raise world interest rates. And the region's central role in global shipping and manufacturing supply chains means that further escalation of these tensions could disrupt global trade flows and economic activity.

Second, financial sector vulnerabilities in many countries could be exacerbated by tightening in global financial markets. Private sector indebtedness has reached a level in EAP countries that is well above other regions. In China, lending to the nonfinancial sector has grown to exceptionally high levels for a middle-income country. Many banking systems in the region are already highly leveraged with deteriorating asset quality. Household indebtedness is also growing in several of the large regional economies. If world interest rates were to rise rapidly, loan defaults and capital outflows from the region could be triggered, undermining the stability of banking systems. Furthermore, particularly in China, a substantial share of new debt has involved credit intermediation through entities outside the regular banking system, that is, so-called "shadow banking." The increased complexity of shadow banking makes supervision and risk assessment more difficult, creating additional vulnerabilities in the financial sector.

Third, budget deficits remain high or are expected to rise in most countries over 2017–19. These deficits are especially worrying in countries where public debt is also high or rising, as this combination narrows governments' policy space for responding to shocks. The deterioration of debt dynamics has been more pronounced among the region's commodity-exporting countries, and the worsening of their fiscal positions has been substantial and

persistent since the sharp decline in oil prices in 2014. The prospect of tighter global financing conditions in the future heightens the need to improve fiscal discipline. Governments must rebuild fiscal buffers so as to be able to deploy countercyclical fiscal policy in the event of financial stress or other shocks.

The improved outlook for global growth provides a window of opportunity for countries to reduce their vulnerabilities and strengthen the foundations for sustained and inclusive growth in the medium term. The favorable environment offers the space to move away from policies aimed at stimulating short-term growth toward measures that address underlying vulnerabilities. Improvements in supervision and prudential regulation can help contain risks in economies that have experienced rapid credit growth and debt accumulation. Reform of tax administration and regional tax policy cooperation can help countries address common weaknesses in their tax systems that have resulted in lower revenue collection in EAP than in other regions, including high compliance costs, aggressive incentives, and outdated tax laws and treaties. The prospects of tightening external financing and rising inflation may require monetary policy adjustment. In anticipation of the spillovers from the eventual normalization of monetary policy in advanced economies, developing EAP countries also need to further strengthen the transparency of their central banks and improve their monetary policy regimes, while refining their operational frameworks.

Countries in the region should continue to pursue structural reforms that can yield long-term economic benefits. Across the region, there is still a need to strengthen competitiveness and raise productivity. Reform agendas need to be prioritized and tailored to country circumstances. In countries that are undertaking large public infrastructure programs, such as the Philippines, Thailand, Cambodia, and Lao PDR, efforts to improve public investment management systems need to be deepened. China and Vietnam have initiated measures to tackle problems in their state-owned enterprise sectors, which will need to be sustained. Recent measures to tighten regulation of shadow banking activities in China need to be continued.

Developing tourism sustainably and promoting further regional integration offer opportunities for the region to offset the risk of rising protectionism. The growth in tourism that the region has seen will likely accelerate in coming years. This trend has the potential to provide substantial economic benefits to developing EAP. If this growth is not well managed, however, it could mean challenges for economic, social, and environmental sustainability. To reap the gains from tourism, countries in developing East Asia must address key market and policy failures by focusing on priorities that include a stronger emphasis on integrated investment planning, improvements in the enabling business environment for tourism, enforcement of more robust environmental quality standards, and better links with local economies. More broadly, there is a need to build on existing regional integration initiatives by further opening up markets and harmonizing standards and the business environment. ASEAN, which is celebrating its 50th anniversary in 2017, and in particular, the ASEAN Economic Community, which was launched in 2015, offer one avenue for such an effort, especially with regard to liberalizing services trade and reducing nontariff barriers.

A new set of policy challenges has emerged in ensuring the continued inclusiveness of growth and development. While the policy mix aimed at achieving broad-based growth was effective in lifting most of those at the very bottom of the income distribution over the last three decades, new concerns are now emerging across the region beyond a focus on reducing poverty. Public perceptions now point to growing concerns among the regions' citizens about high and rising inequality, falling mobility, and growing economic insecurity. And some of the long-

term trends that supported the region's growth with equity model in the past—such as the demographic transition and rapid urbanization—need to be better managed. Governments in the region can adapt to these changing needs by raising the bar on policy priorities—going beyond an exclusive focus on reducing poverty to a broader emphasis on ensuring economic mobility and security for all. Such an emphasis will entail tailoring interventions to address the heterogeneity of extreme poverty at the country level, fostering mobility by closing gaps in access to jobs and services and seeking to improve the quality and productivity of those jobs, and increasing economic security by putting in place mechanisms that can help reduce households' exposure to risks while enhancing their ability to cope with the consequences of shocks when they do occur.

In the Pacific Island Countries (PICs), reforms in some areas could provide significant opportunities over the medium term. Tourism, labor mobility, fisheries, and the knowledge economy are all sectors in which policy and institutional reforms over the medium term could allow the PICs to exploit economic opportunities. In turn, these reforms could lead to significantly higher incomes and employment by 2040. The higher government revenues from increases in fishing license fees and the broadening of the tax revenue base, if combined with improvements in the quality of public spending, could help PIC governments finance significant progress in human development outcomes.

Part I. Recent Developments and Outlook

I.A. Recent Developments

Developing East Asia and the Pacific has continued to perform well in the first half of 2017. The region grew more rapidly than almost all other developing regions. Improved global economic performance contributed to the region's growing exports and favorable financing conditions. China's economy grew more rapidly in the first half of 2017 than was anticipated. GDP growth in Thailand and Malaysia accelerated, and other large economies continued to grow rapidly. Fiji and Mongolia have seen growth pick up in the first half of 2017. Consumption and investment have remained the main drivers of growth thus far this year. Several governments have succeeded in reducing fiscal deficits in 2017, notably Mongolia and Malaysia, but deficits remain high or are on track to increase in many others. Inflation remained moderate for the most part. Several major countries that experienced net outflows of capital in 2016 have seen net inflows to date in 2017, and net outflows appear to have stabilized in China. Spreads on international sovereign bonds have been declining, and most currencies have appreciated against the U.S. dollar. With sustained growth, poverty continues to decline across the region.

A favorable global environment has contributed to improved economic performance in 2017 in developing East Asia and the Pacific

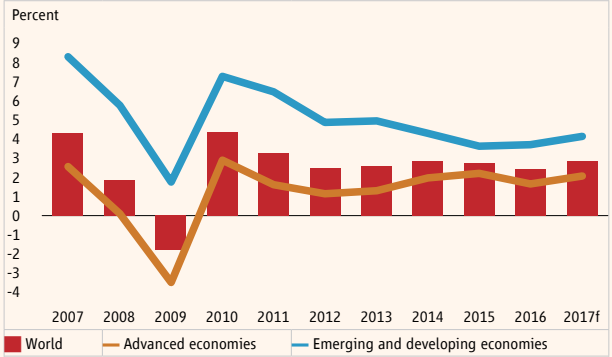
The world economy continued to strengthen during the first half of 2017 and high-frequency data continue to suggest an ongoing recovery in global activity (Box I.A.1). Global growth accelerated to an average of 3.1 percent (quarter-over-quarter, seasonally adjusted annual rate [q/q, saar]) during the first two quarters of 2017. Industrial production has been growing at annualized rates of 4.8 percent on average between January and July. These developments reflect an acceleration of activity in the advanced economies, improved conditions in major commodity exporters, especially in Brazil and Russia, and continued fast growth in China, India, and other major commodity importers. The global composite Purchasing Managers' Index remained firmly expansionary, in July and August, suggesting continued momentum in Q3 2017. Global trade has regained momentum in 2017 on the strength of these developments, after two years of weak growth. Oil prices rose above US$52 per barrel in September, as international oil markets continue to slowly rebalance, metal prices have recovered some of their earlier losses in 2017 on improved demand conditions, while agricultural prices have softened on well-supplied markets.

International financial conditions remained favorable. Financial market volatility has remained low in 2017 despite uncertainty over the pace of advanced countries' monetary policy normalization and heightened geopolitical concerns. U.S. bond yields have declined in recent months as expectations of an early fiscal stimulus and rapid interest rate hikes dissipated. Meanwhile, the European Central Bank (ECB) announced in September that it was making plans to begin scaling back asset purchases. Continued low interest rates and the depreciation of the U.S. dollar against major currencies in 2017 strengthened demand for emerging market assets. During the first five months of 2017, emerging market bond issuance was 48 percent above the level during same period last year, while spreads remain near low levels not seen since 2014.

Box I.A.1. Recent Global Developments

The global economy is strengthening. The recovery in global growth, which has been underway since mid-2016, continued in the first half of 2017 (Figure BI.A.1.1). Continued positive momentum in Q3 2017 was highlighted by the July and August global manufacturing PMI surveys, which remained firmly in expansionary territory. In the first two quarters of 2017, global growth is estimated at 3.1 percent (q/q saar) on average, somewhat up from 2.9 percent (q/q saar) in the final two quarters of 2016. The expected improvement in growth this year reflects two developments against the backdrop of resilient growth in commodity-importing emerging market and developing economies (EMDEs) led by China and India: an investment-led recovery in advanced economies, and receding obstacles to activity among major commodity-exporting EMDEs. Among advanced economies, growth in the United States in the first half of 2017 has been in line with expectations (2.1 percent [q/q saar] on average), while growth in the Euro Area (2.4 percent) and Japan (1.9 percent) has been stronger than expected in the April 2017 issue of the *East Asia and Pacific Economic Update*. Among the EMDEs, growth in the first half of 2017 has been resilient in China, and appears to have picked up in most major commodity-exporting EMDEs led by Brazil and Russia.

Figure BI.A.1.1. Global GDP growth, 2007–17f



Sources: World Development Indicators, Haver Analytics, World Bank.
Note: Data for 2017 for all regions are preliminary working assumptions to be finalized and published in the January 2018 issue of the World Bank's *Global Economic Prospects*. f = forecasts.

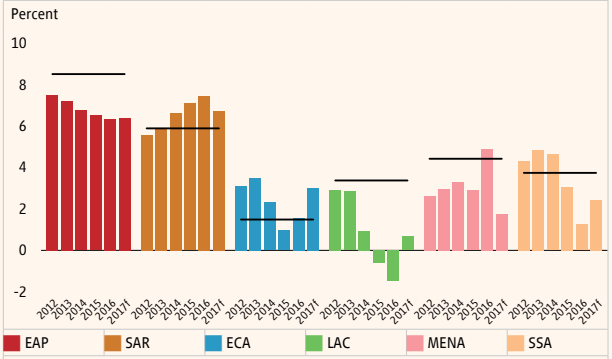
Prospects for advanced economies are improving. In the United States, growth rebounded in Q2 2017 to 3 percent (q/q saar), following a temporary consumption-led slowdown in Q1 2017 (1.2 percent). Labor market conditions improved further in Q2 2017 and at the start of Q3 2017, but core inflation moderated up to August, and market-based inflation expectations have declined. The U.S. Federal Reserve hiked policy interest rates in June, stressing the temporary nature of the inflation slowdown. The central bank also announced that it plans to start gradually reducing the size of its balance sheet in October. In the Euro Area, growth reached 2.6 percent (q/q saar) in Q2 2017—the highest rate since Q1 2015, with high-frequency indicators suggesting continued strength in Q3 2017. Headline inflation increased to 1.5 percent in August after dropping to 1.3 percent in June and July. Core inflation also recovered slightly to 1.2 percent in July and August. The ECB left its policy stance unchanged in July, but highlighted a shifting balance of risks and signaled that the recovery might warrant further policy normalization.

Growth in EMDEs is accelerating. Major commodity exporters continue to experience modest pickup in activity. Export orders in most commodity exporters continued to recover in Q3 2017, partly supported by positive momentum in global trade. GDP growth in Brazil rebounded strongly to 2.6 percent on average (q/q saar) in the first two quarters of 2017, after eight quarters of contraction. Activity in Russia accelerated sharply to more than a five-year high of 5.7 percent (q/q saar) in Q2 2017 (2.5 percent y/y). Performance

(continued)

(Box I.A.1 continued)

Figure BI.A.1.2. Regional GDP growth, 2012–17f

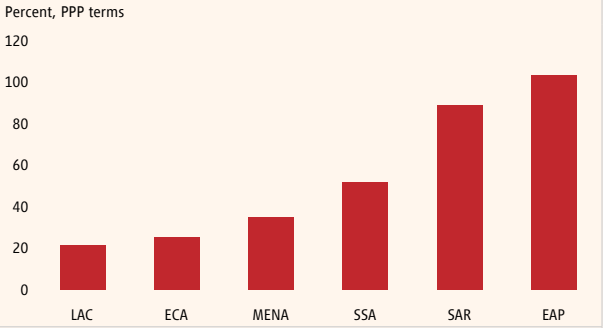


Sources: World Development Indicators, Haver Analytics, World Bank.
Note: Lines denote long-run precrisis (1990–2008) average growth. Data for 2017 for all regions are preliminary working assumptions to be finalized and published in the January 2018 issue of the World Bank's *Global Economic Prospects*. f = forecasts.

in major commodity importers has been strong, although activity in India in 2017 appears to have been somewhat disrupted due to the new Goods and Services Tax. Commodity importers in the Eastern Europe and Central Asia region continue to benefit from the recovery in the Euro Area, while strong domestic demand combined with an uptick in global trade is helping sustain robust growth in many East Asia and Pacific commodity importing economies (Figure BI.A.1.2 and Figure BI.A.1.3).

Global trade is growing again. Global trade, which regained momentum in Q1 2017, following two years of pronounced weakness, remained robust in the second quarter of 2017 (Figure BI.A.1.4). The upswing was driven by strengthening investment in advanced economies, increased trade flows to and from China, and improved import demand from commodity-exporting emerging market and developing economies. PMI surveys point to sustained gains in global export orders during Q3 2017. Trade performance so far is consistent with the 2017 growth forecast for global trade (about 4 percent), which will be the fastest pace since 2010. Although the number of newly introduced protectionist measures has declined over the course of 2017, sectors including iron and steel products are affected by more anti-dumping, anti-subsidy, and public procurement localization measures.

Figure BI.A.1.3. Regional GDP: Cumulative change, 2007–17f



Sources: World Development Indicators, Haver Analytics, World Bank.
Note: Based on the actual numbers for 1990–2016 and preliminary working assumptions for 2017 for all regions to be finalized and published in the January 2018 issue of the World Bank's *Global Economic Prospects*. f = forecasts.

Figure BI.A.1.4. Global trade growth

Source: Netherlands Bureau for Economic Policy Analysis, World Bank.
Note: Last observation is June 2017.

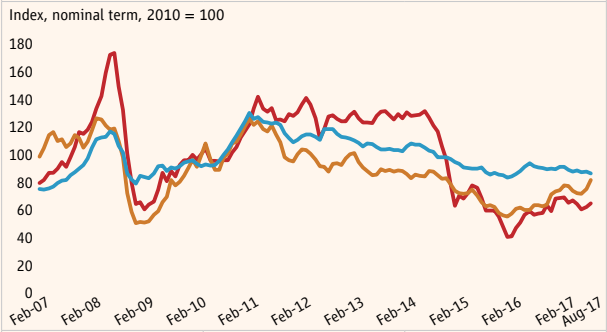
Commodity prices remain generally stable. Oil prices averaged over US$52 per barrel in September, up from US$50 per barrel in August. The market continues to rebalance, with the Organization of the Petroleum Exporting Countries' (OPEC) improved compliance in August and the implementation of previously agreed

(continued)

(Box I.A.1 continued)

production cuts in Libya (Figure BI.A.1.5). Inventories continued to fall from record high levels, while the Brent futures-price curve steepened, indicating a tightening market. Metal prices surged due to strong demand and tightening supply due to China's environmental restrictions for aluminum and zinc mines and processing plants. Meanwhile agricultural prices weakened slightly on well-supplied key grain and oilseed markets.

Figure BI.A.1.5. International commodity prices

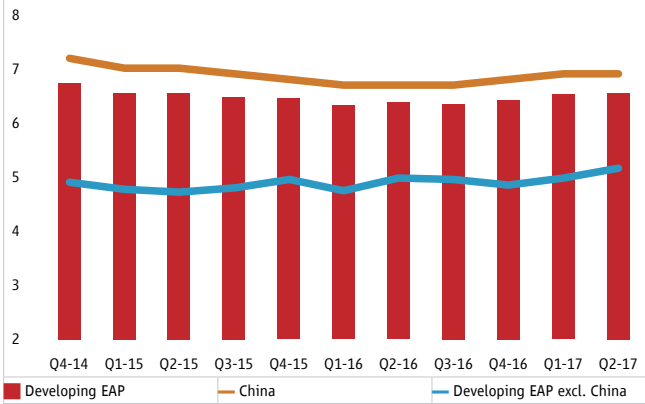


Source: World Bank.
Note: Last observation is August 2017.

Global financing conditions remain favorable. Global financing conditions remain benign, benefiting from improved global growth prospects and expectations of persistently low interest rates despite ongoing monetary policy normalization in the United States. U.S. long-term yields decreased through much of Q2 2017, mainly reflecting disappointing inflation outcomes and diminished market expectations of fiscal stimulus. As the recovery continues in the Euro Area, the European Central Bank could further reduce its asset purchase program in coming months, but the reaction of Euro Area and global bond markets has been relatively muted so far. Among emerging markets, asset prices and capital flows remained buoyant during most of Q3 2017. Net capital inflows to EMDE bond and equity mutual funds were stable in September, with the weakness in the U.S. dollar helping to sustain inflows.

Growth in developing East Asia and Pacific (EAP) has accelerated slightly in the first half of 2017, relative to expectations six months ago. The region grew by 6.6 percent year-over-year (y/y) in Q2 2017, continuing a trend of small but steady increases in growth rates since Q1 2016 (Figure I.A.1). After diverging during 2016, growth accelerated in both China and in the rest of the region. The region's growth rate lagged slightly behind South Asia's in 2016, but continues to be higher than other developing regions. Over the last decade, developing EAP's output has grown by 90 percent, more than any other developing region's.

Figure I.A.1. Growth in developing EAP continued to prove resilient

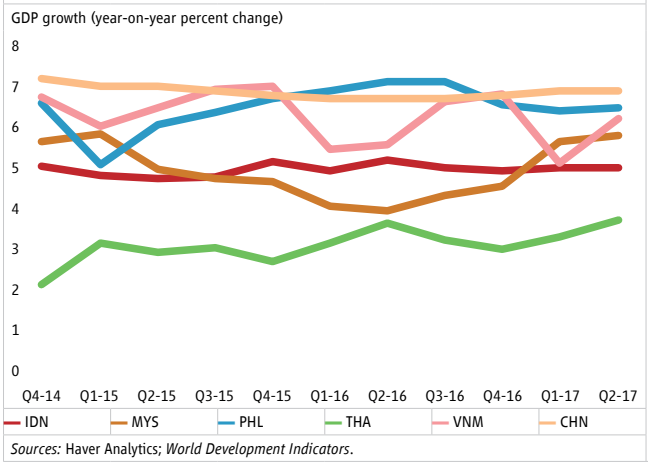


Sources: Haver Analytics; *World Development Indicators*.

Supported by consumption and improving external conditions, China's GDP grew by 6.9 percent y/y in the first half of 2017, up from 6.7 percent during 2016. Consumption contributed 4.4 percentage points of this growth, and for the first time since mid-2015, net exports contributed positively to total GDP growth.

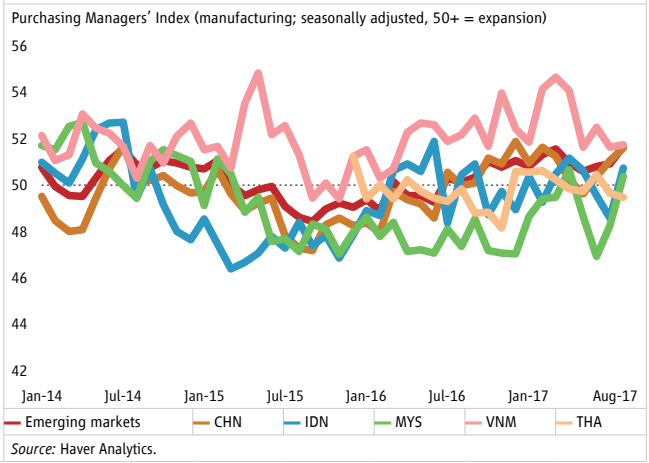
Output growth continues to be led by services, although the growth in real estate and finance moderated somewhat in the first half of 2017 relative to 2016.

Figure I.A.2. The region's large economies continued to perform strongly



Sources: Haver Analytics; *World Development Indicators*.

Figure I.A.3. The manufacturing Purchasing Managers' Index points toward continued expansion in most major countries



Source: Haver Analytics.

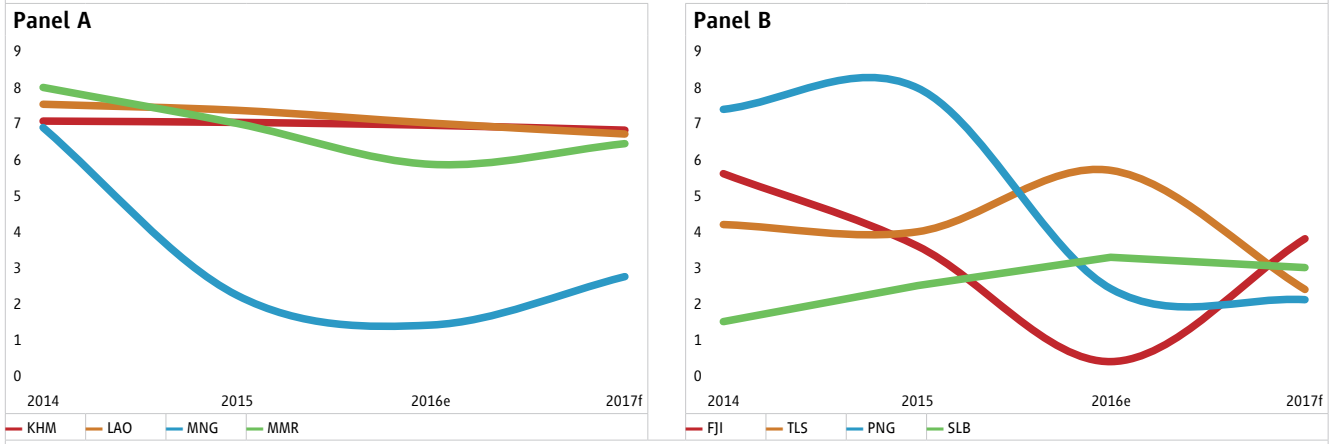
Most other major economies in the region have been growing by 5 percent or faster thus far in 2017 (Figure I.A.2). The manufacturing Purchasing Managers' Index points toward continued expansion (Figure I.A.3). Private consumption made the largest contribution to GDP growth during recent quarters in all but Thailand, where investment was the principal contributor. Growth in private consumption spending and rising exports of both primary commodities and manufactures contributed to *Malaysia's* accelerating growth. GDP grew by 5.6 percent in Q1 2017 and 5.8 percent in Q2—its best performance since Q1 2015. Improved weather allowed the agriculture sector to rebound by a seasonally adjusted annualized rate of 24 percent in the first quarter, outperforming other productive sectors of the economy. *Thailand's* economic recovery continued to broaden and gain momentum due to external demand amid global growth as well as recovery from severe drought. The economy grew by 3.3 percent in Q1 2017, exceeding market expectations, due to recovery in farm income from drought, an upturn in merchandise and tourism exports, and continued fiscal stimulus. Real GDP expanded by 5.7 percent y/y during the first half of 2017 in *Vietnam* (about the same pace as in the first half of 2016). Strong momentum in domestic consumption, export-oriented manufacturing, and the services sector compensated for a contraction in the oil sector. *Indonesia* grew by 5.0 percent in both Q1 and Q2 2017. Stronger investment offset contracting government consumption and slower net export growth. *The Philippines* continued to show strong growth in the first half of 2017, although its pace—6.4 and 6.5 percent in the first two quarters—lagged behind those of the first half of 2016. High consumer and business confidence, modest inflation, robust remittance growth, and improving real wages led to sustained domestic demand in the Philippines, while the recovering external environment led to an improvement in net exports.

Performance has been mixed in the region's smaller economies, reflecting their diverse circumstances. Fiji and Mongolia are rebounding from challenging conditions experienced in 2016. Construction and increased tourist arrivals in the wake of 2016's Cyclone Winston have stimulated consumer spending, boosting *Fiji's* GDP growth to a projected 3.8 percent in 2017 from 0.4 percent in 2016. *Mongolia's* macroeconomic stabilization program,

foreign direct investment (FDI) flows into the mining industry, and rising coal prices sparked a recovery that began in late 2016. GDP grew by 4.1 and 6.0 percent y/y in the first two quarters of 2017, following annual growth of 1.4 percent in 2016. Although their GDP growth rates remain high, Cambodia and Myanmar are showing signs of slower growth in 2017. *Cambodia's* economy is projected to grow by 6.8 percent in 2017, down slightly from 7.0 percent in 2016, as both textile and construction—the two main drivers of growth—have moderated during the first half of 2017. Investment demand decelerated in *Myanmar*, bringing GDP growth down to 5.9 percent in FY2016/17 from 7.0 percent the previous year, although there are signs of faster growth in FY2017/18, as illustrated in Figure I.A.4.[1] The economy of *the Lao People's Democratic Republic* is projected to continue to grow at 6.7 percent in 2017, supported by strong exports and investment, including additional electricity generation. GDP growth in *Timor-Leste* is forecast to fall to 2.4 percent in 2017 from 5.7 percent in 2016 due to reduced government spending while the government is in caretaker mode during the election period. Owing to lower than expected growth of the non-resource sector and weak commodity prices, *Papua New Guinea's* GDP growth for 2017 is now forecast to be 2.1 percent (versus 2.4 percent expected earlier in the year). Finally, agriculture, fishing, transportation, and the financial sector remain important drivers of 2017 growth in *the Solomon Islands*, which is estimated at 3.0 percent.

Figure I.A.4 Performance is mixed across the region's smaller economies

Annual real GDP growth rates



Sources: National authorities through 2015. World Bank estimates for 2016 and forecasts for 2017.
Note: Myanmar is presented on a fiscal year basis (for example, 2015 = FY2015/16).

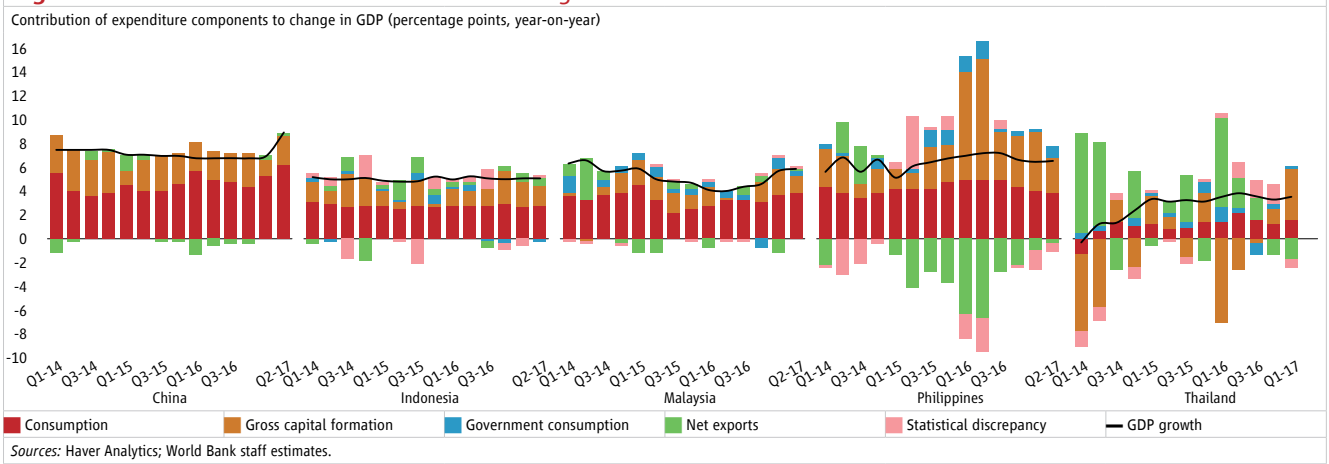
Domestic demand continues to drive economic performance in the region

Growth in consumption spending made the largest contribution to GDP growth in China and most other large economies (Figure I.A.5). Consumption growth accounted for most of China's surge in second quarter GDP, and real consumption spending is on track to grow by almost 8 percent in 2017. Average disposable income has been growing more rapidly than GDP in 2017—in contrast to 2016 in China. Private consumption grew by close to 6 percent y/y during the first two quarters in the Philippines and is expected to accelerate in the second half of the year. Private consumption also grew rapidly in the first half of the year in Indonesia and Malaysia—growing at 5.0 and 5.3 percent y/y, respectively.

1 Myanmar's fiscal year ends on March 31.

Private investment spending has also been important. Implementation of several large-scale manufacturing projects in Malaysia and ongoing investments in the services sector boosted private investment spending to 12.9 percent y/y in the first quarter of 2017. Consequently, the contribution of investment to GDP growth also increased. Indonesian investment spending rose at its fastest pace in the first two quarters of 2017 since late 2015, in large part as a response to falling interest rates. Mongolia's macroeconomic stabilization program restored foreign investor confidence and has been driving a rebound in investment spending that is projected to reach almost 16 percent in 2017. Investment remains high in Lao PDR, driven mainly by FDI in the power sector and public investment projects.

Figure I.A.5. Domestic demand continued to drive growth in 2017

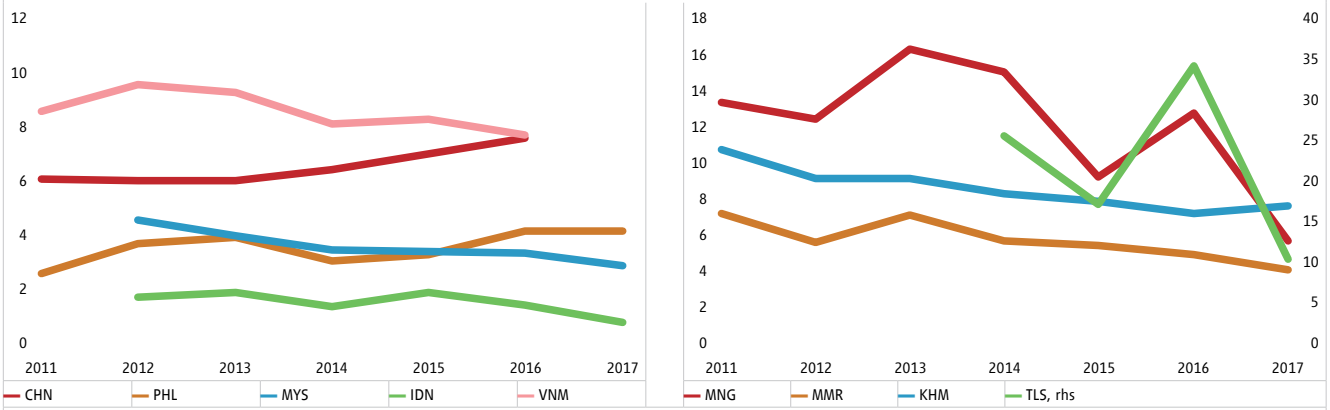


Sources: Haver Analytics; World Bank staff estimates.

Public investment spending is contributing to growth in Thailand and the Philippines, but has been declining in many other countries. Government investment spending in Thailand grew to 9.7 percent of GDP in Q1 2017 from 8.6 percent the previous quarter, and implementation of public infrastructure projects in Thailand has crowded in new private investment, making total investment spending the main driver of growth in the first half of 2017. Government spending on infrastructure supported investment growth in the Philippines in the first half of 2017. Figure I.A.6 shows that public investment spending has not been growing as fast as GDP in many other countries, however. Capital spending dropped sharply in Timor-Leste in 2017 due to lower budget execution during the change in government. It has also been declining gradually for several years in Indonesia, Malaysia, Cambodia and Myanmar. Cambodia's declining trend is particularly worrisome for long-term growth that as it been accompanied by a growing public sector wage bill and rising recurrent spending.

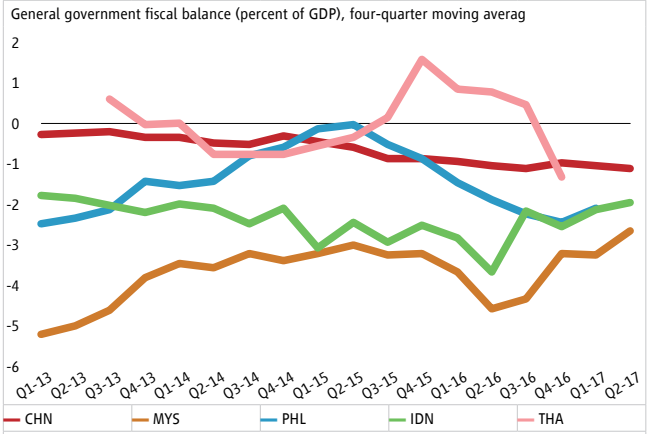
Fiscal deficits narrowed or held steady in 2017 in several of the region's large economies. Deficits narrowed in Indonesia and Malaysia, and have stabilized at around 3.1 percent of GDP in 2017 in China after widening during 2014–16 (Figure I.A.7). Vietnam has also reduced its deficit. Revenue collection surged during the first half of 2017 in Indonesia while the government constrained spending growth. Malaysia recalibrated its budget to lower world oil prices in 2016, which has brought its fiscal consolidation program back on track. In contrast, deficits are widening slightly in Thailand, which has applied fiscal stimulus to promote economic recovery. Like other countries in the region, Vietnam has been introducing measures to increase revenue mobilization and bring down its deficit.

Figure I.A.6. Countries' record on public investment spending is mixed



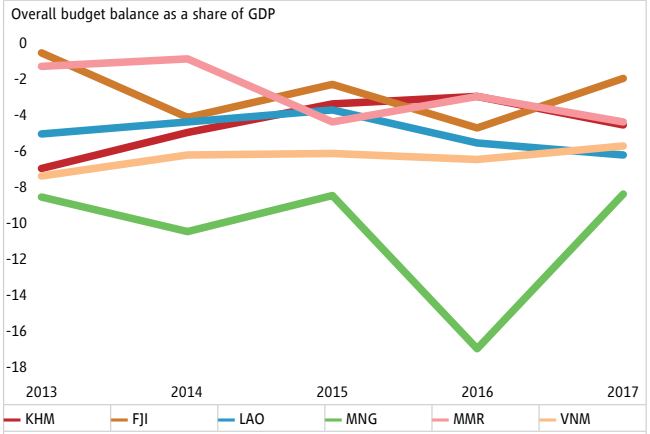
Source: World Bank staff estimates.
Note: Data for Malaysia, Myanmar, and the Philippines refer to central government capital expenditure. Data for Myanmar and the Philippines refer to the fiscal year. Data for Indonesia and Malaysia refer to the four-quarter average. rhs = right-hand side.

Figure I.A.7. After widening in 2016, fiscal deficits in some of the large economies started to stabilize in 2017



Sources: CEIC; World Bank staff estimates.
Note: Data refer to general government fiscal balance, except for Indonesia, where data refer to central government fiscal balance; fiscal deficits do not reflect off-budget spending items.

Figure I.A.8. Budget deficits are large in other countries

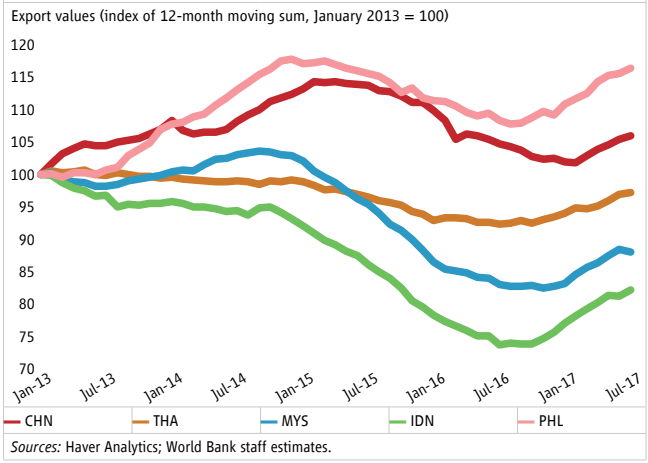


Source: World Bank staff estimates.
Note: The fiscal balance for Mongolia includes commercial spending by the Development Bank of Mongolia.

Budget deficits remain large in most of the smaller economies. Myanmar's deficit is projected to rise to 4.5 percent of GDP in 2017 from 3.0 percent in 2016, although this reflects in part a greater emphasis on capital spending, and Cambodia's deficit is projected to rise to 4.5 percent from 3.0 percent (Figure I.A.8). Low tax receipts in both resource and non-resource sectors of Papua New Guinea and increased costs of debt servicing have led the authorities to revise upward their 2017 deficit forecast in its Mid-Year Economic and Fiscal Outlook to 3.8 percent of GDP from the 2.5 percent target originally presented in the budget. The government expects to pass a supplementary budget that targets deficit reduction. Among countries where deficits are projected to fall, Mongolia has initiated fiscal consolidation as part of its stabilization program, which should bring its deficit down to 8.4 percent of GDP in 2017 from 17.0 percent in 2016. Other countries' deficits fell for less positive reasons. Delays in reconstruction spending in Fiji brought its deficit down to 2 percent of GDP in 2016/17, and Timor-Leste's budget deficit is also on track to fall in 2017 as the government reduces spending while it is in caretaker mode.

Exports continue to grow across much of the region

Figure I.A.9. Export values continued to recover in second half of 2017…

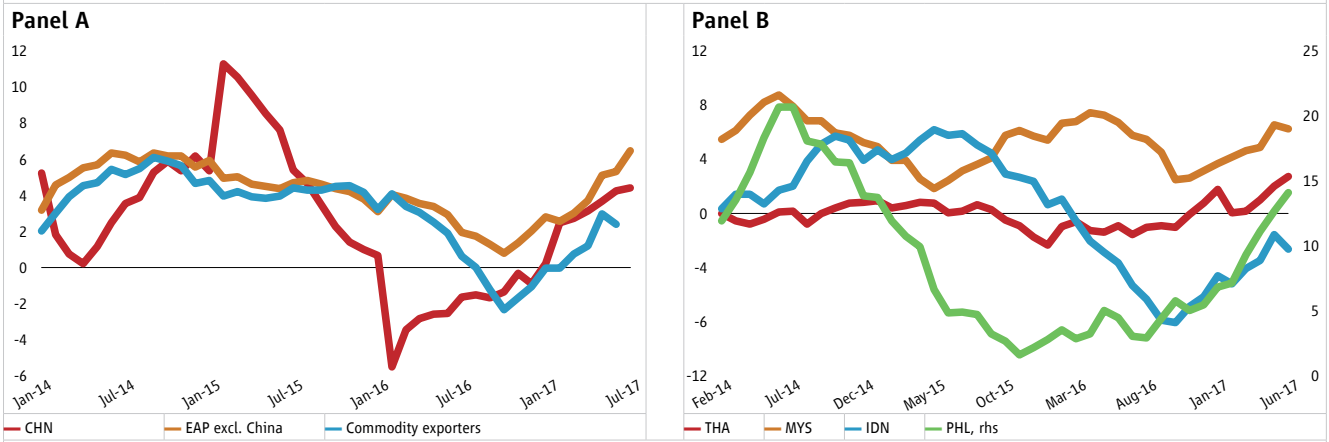


Sources: Haver Analytics; World Bank staff estimates.

Demand for the region's exports increased in 2017 with the recovery in world trade growth and gradual strengthening of global economic activity. Export revenues increased during 2017 in all major economies (Figure I.A.9). Chinese and Thai exports resumed growing in volume terms, after declining during 2016, while volume growth accelerated in Malaysia and the Philippines (Figure I.A.10). Net exports made a positive contribution to China's GDP growth during the first two quarters of 2017 after dragging on growth since mid-2015. Commodity exporters' performance has diverged somewhat from the rest of the region since mid-2016. Figure I.A.10 shows that their recovery has lagged behind the region's more diversified economies.

Stronger growth in advanced economies and in China stimulated demand for the region's manufactured products. Malaysia's electrical and electronics producers enjoyed strong export growth, for example, and the Philippines experienced real export growth of around 20 percent during the first two quarters of the year, led by electronics and semiconductors. Vietnam's export-oriented manufacturing sector grew by 8.4 percent and 12.3 percent y/y during the first two quarters of 2017, and total exports are expected to grow by 14.6 percent in 2017. Among the smaller economies, although Cambodia's exports are expected to grow by 7.0 percent in 2017, its textile and garment producers are facing increased competition from Myanmar and other emerging competitors in the region that have lower wages.

Figure I.A.10. …as have export volumes



Sources: Haver Analytics; World Bank staff estimates.
Note: rhs = right-hand side. EAP commodity exporters include Indonesia, Lao PDR, Malaysia, Mongolia, Myanmar, Papua New Guinea, Timor-Leste, and Tonga.

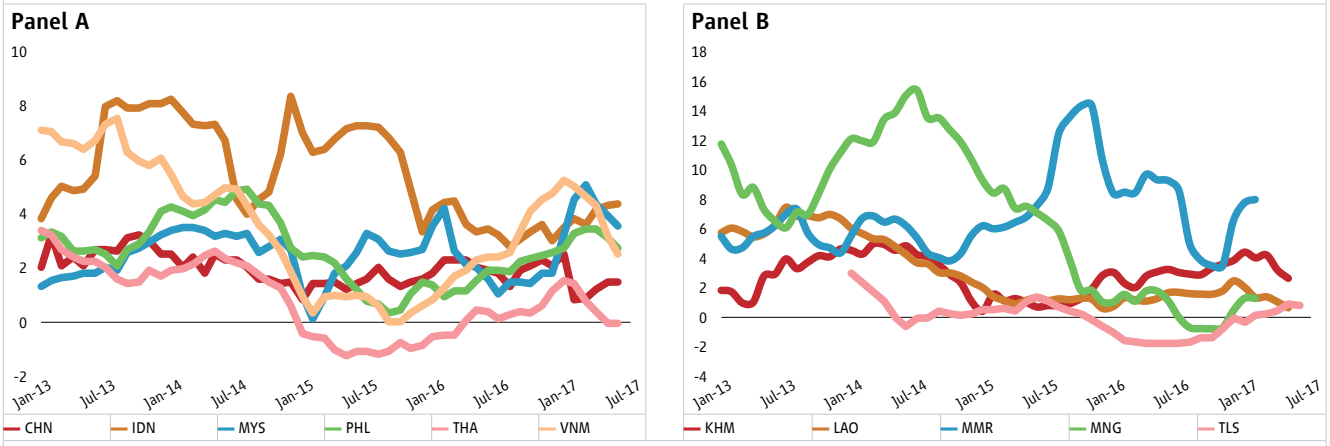
Commodity exporters have also seen an increase in exports, helped by stronger world prices. There has been some variation across countries due to differences in products and specific national conditions. Indonesian and Malaysian natural gas exporters benefited from stronger prices in 2017. Higher world prices also contributed to growing coal exports from Indonesia and a fourfold increase in Mongolia's coal exports during the first seven months of 2017 compared to the same period in 2016.[2] Indonesia's rubber exporters faced declining prices in 2017; Thai production bounced back after flooding at the beginning of the year and Vietnamese producers began harvesting earlier in the year than usual. Indonesian and Malaysian palm oil exports rose during the first half of 2017 as plantations recovered from last year's El Niño conditions, pushing world prices downward since both countries supply most of the palm oil to the world market.

Tourism has become an increasingly important contributor to export revenue for many countries in the region. Tourism generated US$214 billion in export revenue for developing EAP in 2015, accounting for 6.4 percent of the region's total exports.[3] Tourist receipts make up around half of total exports from the small Pacific islands (49 percent in 2015). Tourism is also a major share of exports from Cambodia (29 percent), and contributes between 15 and 20 percent to the exports from Lao PDR, Myanmar, and Thailand. In the larger and more diversified economies, such as China, Indonesia, and Malaysia, tourism is still a notable 5 to 10 percent of exports. International tourist arrivals have grown rapidly in 2017 in many countries. Arrivals to Vietnam during the first five months of 2017 were 31 percent higher than in the same period of 2016, for example. Arrivals grew by around 13 percent y/y during the first part of 2017 in Cambodia, Indonesia, and the Philippines (UNWTO 2015).[4]

Inflation remains low throughout most of the region

Figure I.A.11. Inflation is benign in the region and declined in most countries toward mid-2017

Headline inflation (year-on-year, percent)



Source: Haver Analytics.

In much of the region, inflation is still muted, as in 2016. World commodity prices remain low, despite some growth in late-2016 and in 2017. This has helped to keep inflation levels relatively low, even in countries that have shown some increases in 2016 (Figure I.A.11). Changes in administered prices and monetary policy contributed

2 The United Nations' decision in April 2017 to ban imports of coal from the Democratic People's Republic of Korea also played a role in Mongolia's increased coal exports.

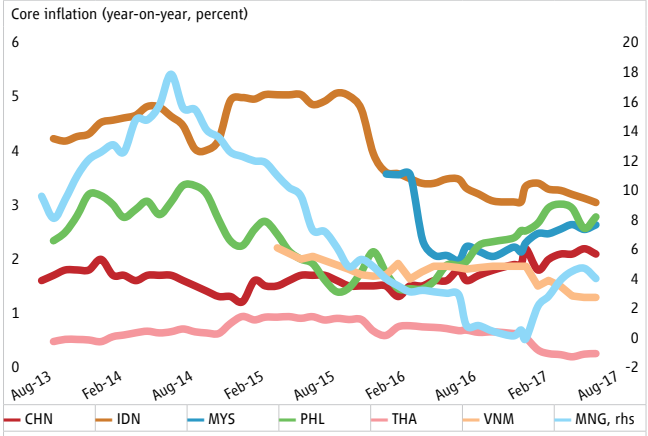
3 Data on Cambodia are for 2014; others are for 2015.

4 Arrivals exclude cruise and other day-only tourists.

to some of the variation across countries. Indonesia's hikes in administered prices pushed its inflation rate up to 4.4 percent by May 2017, whereas tapering of the effects of earlier increases in administered prices pulled Vietnam's inflation rate down after February 2017, reaching 2.5 percent by July. Mongolia's central bank increased its policy rate by 450 basis points (to 15 percent) in August 2016 and then cut the rate by 100 basis points in December; the inflation rate rose to 4.6 percent by April 2017 before moderating slightly. Extreme weather events also influenced inflation rates. As the shortages caused by Cyclone Winston began to ease in 2017, Fiji's inflation rate fell to 2.0 percent y/y in June 2017 from 6.8 percent in January 2017. Consumer prices declined in Timor-Leste in 2015 and 2016 as world oil prices fell, but have since begun to rise slowly.

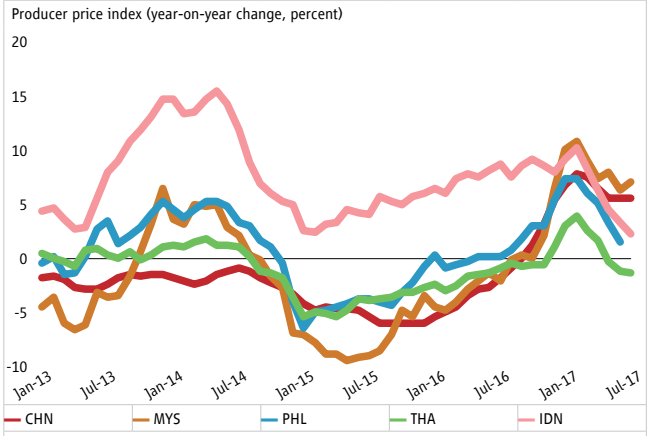
Core inflation remains low in the large economies. It has been trending downward in Indonesia, Thailand, and Vietnam (Figure I.A.12). Core inflation in China rose during 2016 and edged above 2 percent y/y in the middle of 2017. It has also been rising in Malaysia and the Philippines since mid-2016.

Figure I.A.12. Core inflation remains muted



Source: Haver Analytics.

Figure I.A.13. Producer prices increased rapidly in late 2016, but decelerated in 2017

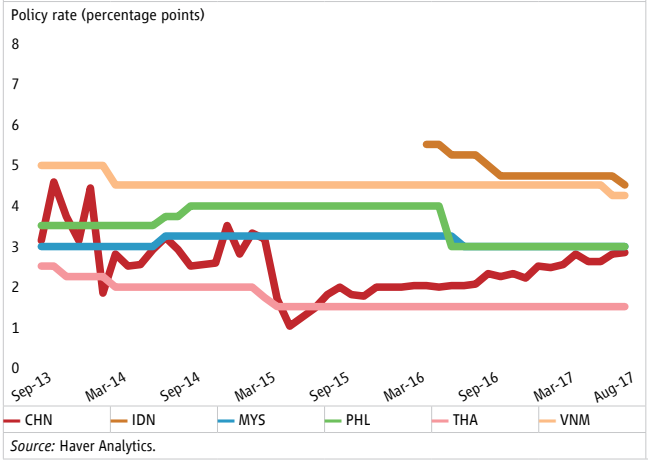


Source: Haver Analytics.
Note: The official PPI of the Philippines only covers the manufacturing sector.

Producer price inflation decelerated in the second quarter of 2017 after rising rapidly during the second half of 2016 in the large economies (Figure I.A.13). Producer prices in Thailand fell in July 2017. The recovery of world energy and metals prices in 2016 and their subsequent decline in Q2 2017 contributed to rising and then declining producer price inflation in China.

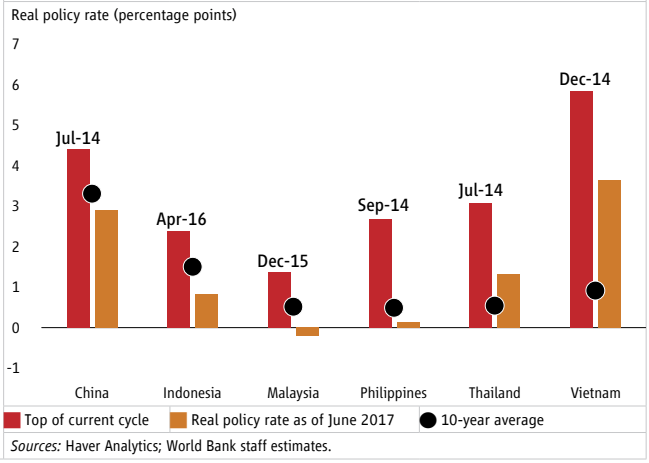
Benign inflation allowed authorities to maintain generally accommodative monetary policies. Most large economies either cut interest rates or held them constant in 2017 (Figure I.A.14). The State Bank of Vietnam, for example, cut its key policy rate by 25 basis points in July 2017 in an effort to stabilize interest rates and boost economic growth. In contrast, China tightened monetary policy through new regulations aimed at cooling the property market and reducing risks in the banking sector. Real policy rates as of mid-2017 had declined well below their peaks in the current cycle and are now negative in Malaysia (Figure I.A.15). Only in Thailand and Vietnam are real policy rates above their long-term average.

Figure I.A.14. Most larger countries have held policy rates constant or reduced them slightly in 2017



Source: Haver Analytics.

Figure I.A.15. Real interest rates in large economies have been declining, and in most cases are significantly below their long-term average



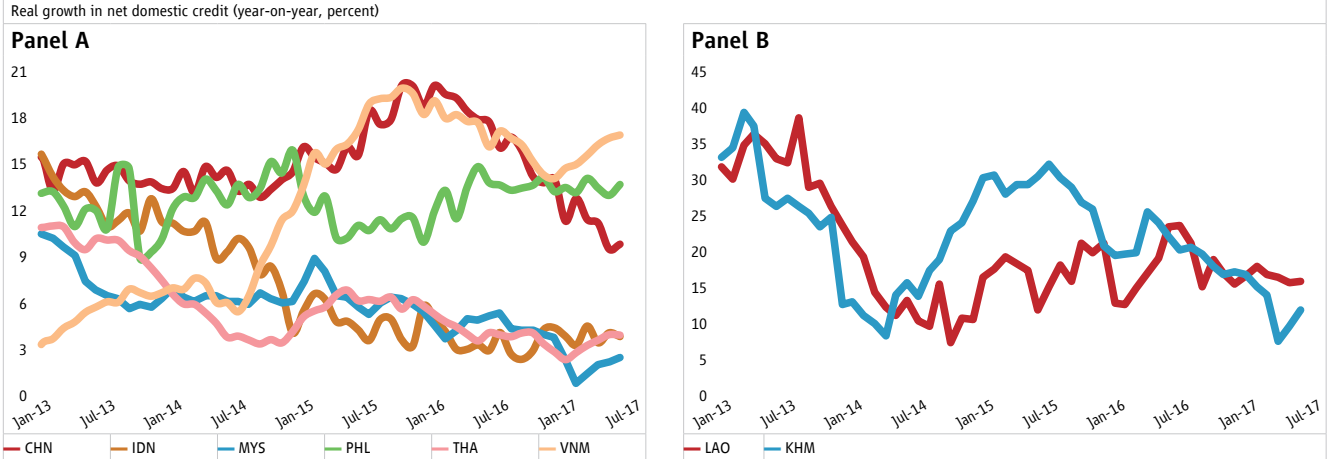
Sources: Haver Analytics; World Bank staff estimates.

Private sector credit continues to expand in the region

Bank lending to the private sector grew somewhat more rapidly in the first half of 2017 in many large economies. After real credit growth moderated during 2016, it accelerated in Thailand, Malaysia, and Vietnam in 2017, and remained stable in the Philippines (Figure I.A.16). As the level of nonperforming loans reached a plateau in the Philippines (hovering at around 2 percent of total loans since Q4 2016), credit growth began to accelerate slightly in early 2017. Credit has been growing at close to 20 percent y/y in nominal terms since the second half of 2015 in Vietnam and has pushed up the credit intensity of GDP, raising concerns over the productivity of new credit and mispricing of risk. Tighter monetary policy and new regulations on shadow financing in China have

Figure I.A.16. Credit growth has slowed over the past year, but remains rapid and showed signs of modest acceleration in some countries in 2017

Real growth in net domestic credit (year-on-year, percent)

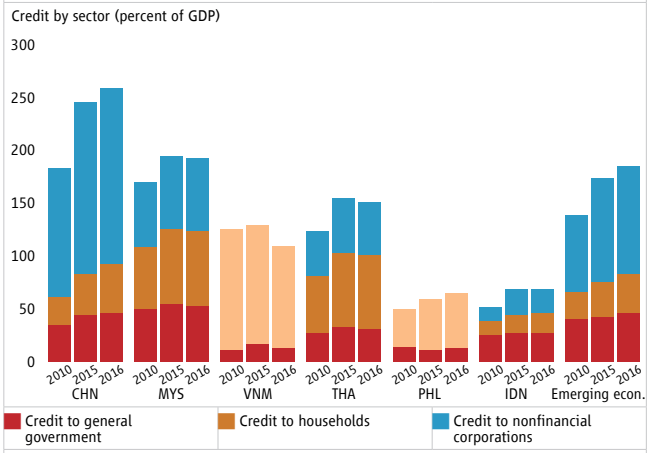


Sources: Haver Analytics; World Bank staff estimates.
Note: Nominal growth in domestic credit is deflated by the CPI.

slowed lending to the nonfinancial sector, thus reducing macroeconomic risks somewhat. Among the smaller economies, credit growth in Cambodia since late 2016 has dropped with the slight easing of economic activity, while it has fluctuated around 15 percent in Lao PDR since 2015.

Private sector debt remains elevated in several economies and has grown more rapidly than government debt. China's total debt stock is well above the emerging market average (Figure I.A.17), and nonfinancial corporate debt has grown to over 160 percent of GDP. A large share of this is concentrated in infrastructure and real estate. Household debt in Malaysia and Thailand exceeds 70 percent of GDP.

Figure I.A.17. The stock of private sector debt remains elevated in several economies

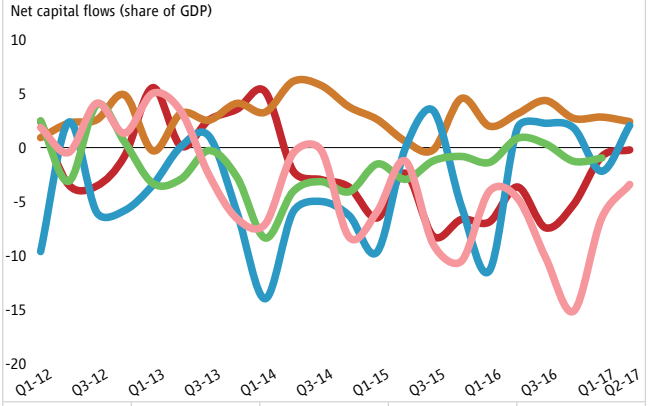


Sources: Bank for International Settlements; Central Bank of the Philippines; *International Financial Statistics*.
Note: For 2016, data refer to end-Q3, except for the Philippines, where they refer to end-2016. For the Philippines and Vietnam, disaggregated data on credit to households and nonfinancial corporations are not available. The group "emerging economies" comprises the following countries, for which data are available: Argentina, Brazil, Chile, India, Mexico, the Russian Federation, South Africa, and Turkey.

Financial conditions and currencies stabilized during the first half of 2017

The large net outflows of capital experienced in many countries in late 2016 subsided or reversed by mid-2017. Appreciation of the U.S. dollar in 2016, intensified at the end of the year by expectations of a fiscal stimulus in the United States and an accelerated return to conventional monetary policy, contributed to net capital outflows from China and other large economies during 2016 (Figure I.A.18). By the middle of 2017, markets came to expect a slower pace of interest rate hikes by the U.S. Federal Reserve. The U.S. dollar lost over 8 percent of its value against major world currencies between the beginning of 2017 and August. These developments dampened the external incentives for capital to flow out of the region. In addition, new policies and other internal developments explain some of the changes in capital flows. The Chinese authorities have introduced stricter capital controls, which helped to reduce outflows to US$42 billion in the first half of 2017 from US$268 billion during the same period of 2016.[5] Net portfolio outflows from Malaysia in Q4 2016 and Q1 2017 were driven mainly by one-off events—the maturing of government securities held by foreign investors and the unwinding of nondeliverable forward positions by nonresident financial institutions—and the balance turned to a net inflow in the second quarter of 2017.

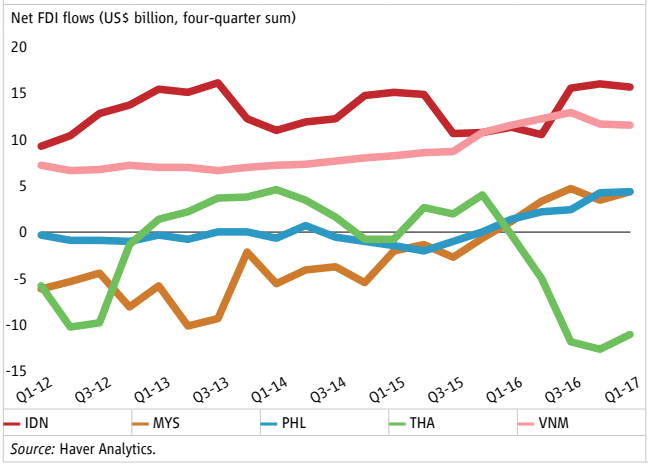
Figure I.A.18. The increase in capital outflows experienced in late 2016 have begun to reverse



Sources: Haver Analytics; IMF *International Financial Statistics*; World Bank staff estimates.

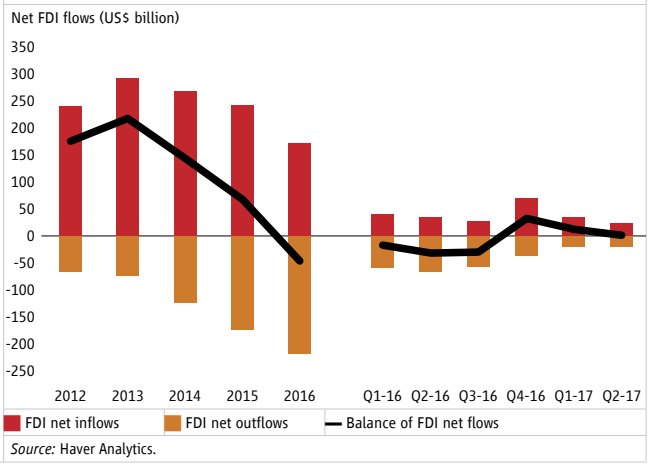
5 This includes errors and omissions.

Figure I.A.19. Net FDI inflows increased in 2016 and 2017 in many of the larger economies



Source: Haver Analytics.

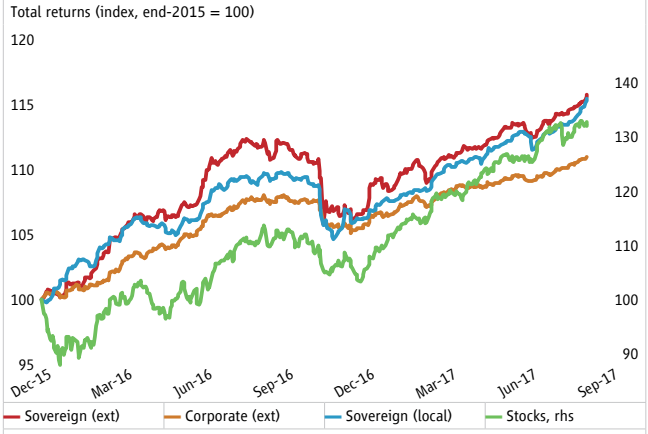
Figure I.A.20. Net FDI outflows from China exceeded net inflows during most of 2016, but the balance may have shifted in 2017



Source: Haver Analytics.

Meanwhile, net FDI inflows have gradually increased in the large ASEAN countries, and net FDI outflows from China have stabilized. Net FDI inflows continued to rebound in Malaysia and the Philippines, reversing the pattern between 2007 and 2015 of small inflows or net outflows between 2007 and 2015, and they remained high in Indonesia and Vietnam (Figure I.A.19). Net FDI inflows into China began to exceed net outflows in Q4 2016, reflecting the new controls on outward FDI (Figure I.A.20). Inflows of Chinese FDI remained large in many of the region's economies, even after taking into account China's tighter restrictions on total capital outflows to the world (Box I.A.2). Thai foreign investment abroad has surged as Thai firms, taking advantage of greater economic integration, expanded their production networks and pursued resources and markets abroad.

Figure I.A.21. Financial markets saw increased volatility in end-2016, but have since recovered



Sources: J.P. Morgan; Thomson Reuters Datastream; IFC Global Macro & Market Research.
Note: Data refer to the following indexes: Datastream Equity Index Asia ex-Japan (stocks), J.P. Morgan Emerging Market Bond Index (EMBI) Global Diversified Asia (external sovereign Bonds), J.P. Morgan Morgan Asia Credit Index (JACI) Corporate (external corporate bonds), and J.P. Morgan Government Bond Index-Emerging Markets (GBI-EM) Asia (local sovereign bonds). rhs = right-hand side.

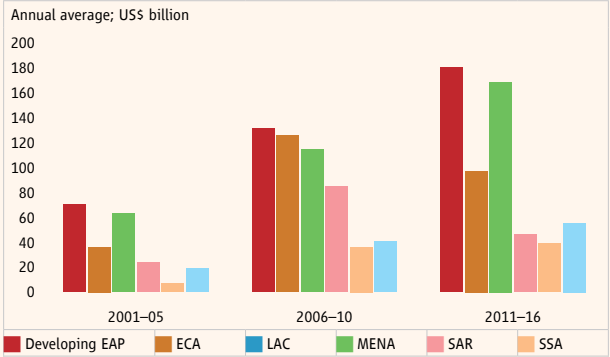
Financial markets recovered from the volatility experienced at the end of 2016. Uncertainty about Chinese growth prospects in Q3 2016 and about the direction of U.S. policies after the November 2016 election had generated volatility in regional financial markets and sparked declines in stock and bond returns. Markets stabilized and then rallied during the first half of 2017. Stock returns rose rapidly compared to corporate bond returns (Figure I.A.21). Regional stock indexes increased during 2017 after declining at the end of 2016 (Figure I.A.22). Stocks in Indonesia, Thailand, and Vietnam registered the largest gains, as indexes exceeded their pre-2016 levels.

Returns on both corporate and sovereign bonds have increased too due to the improving external environment (Figure I.A.21). External bond spreads declined in 2017 (Figure I.A.23). Spreads on Indonesia's bonds fell by 200 basis points between February 2016 and July 2017. Standard and Poor's raised its long-term sovereign credit rating for Indonesia's external bonds

Box I.A.2. FDI Trends in Developing EAP[1]

Developing East Asia and Pacific (EAP) continues to be the largest recipient of foreign direct investment (FDI) inflows among developing regions. FDI inflows into developing EAP have systematically outpaced the levels found in other developing regions since the early 2000s (Figure BI.A.2.1). Moreover, the gap with most of these regions has risen in recent years: during 2011–16, the annual average of FDI inflows to developing EAP reached US$181 billion. Among developing regions, only Latin America and the Caribbean gets close to this value, with an annual average of US$169 billion.

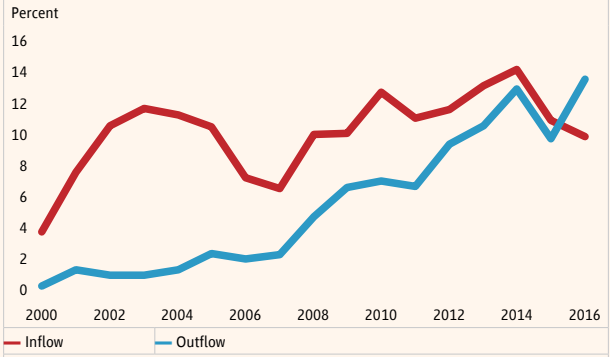
Figure BI.A.2.1. FDI inflows across developing regions



Source: UNCTAD.
Note: All regions include developing countries only.

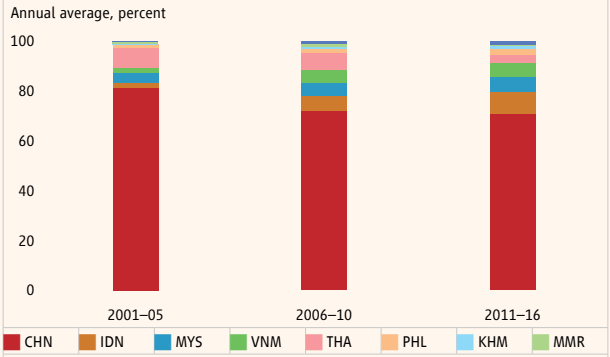
Developing EAP has experienced a strong surge of FDI over the last decade. FDI inflows grew at an annual rate of 9 percent between 2000 and 2016. This dynamism in inward FDI, which is seen also in several other regions, has nevertheless meant that developing EAP has increased its share of global FDI flows, particularly after 2007 (Figure BI.A.2.2). In 2016, the region attracted FDI inflows worth US$170 billion. This value is equivalent to 9 percent of global FDI flows, up from 6 percent in 2007, and after an all-time high of 13 percent in 2014. Outward FDI shows an even more robust

Figure BI.A.2.2. Developing EAP share of global FDI flows



Source: UNCTAD.

Figure BI.A.2.3. Distribution of FDI inflows in developing EAP, by destination



Source: UNCTAD.

pattern: the share of global FDI flows originating in developing EAP moved from a share of 0.3 percent in 2000 to a maximum of 13 percent in 2016. In absolute terms, the outward FDI activity of developing EAP multinationals shifted from an annual average of US$16 billion during 2000–07 to US$125 billion during

(continued)

1 Prepared by Jose Ramon Perea, Zhi (Ken) Gan, with useful inputs from Vera Kehayova.

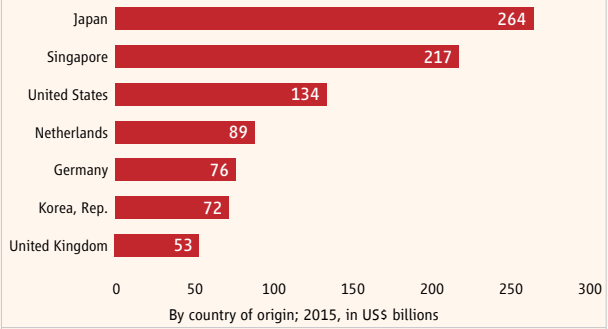
(Box I.A.2 continued)

2008–16. This transition, while largely attributable to the increasing presence of China as a global investor, also points to a more complex set of FDI relationships for developing EAP, with both inward and outward investments growing across a larger number of markets and sectors.

Although China accounts for the lion's share of FDI inflows into developing EAP, other countries have experienced rapid growth. Average annual FDI inflows to China grew from US$57 billion during 2001–05, equivalent to 81 percent of total FDI to developing EAP, to US$128 billion in 2011–16, 71 percent of total FDI (Figure BI.A.2.3). Parallel to the decline in China's share of regional FDI, other economies are playing a bigger role as FDI hosts. This is particularly the case of Indonesia and Vietnam, which went from shares of regional FDI close to 2 percent during 2001–05 to 9 percent and 5 percent, respectively, during 2011–16.

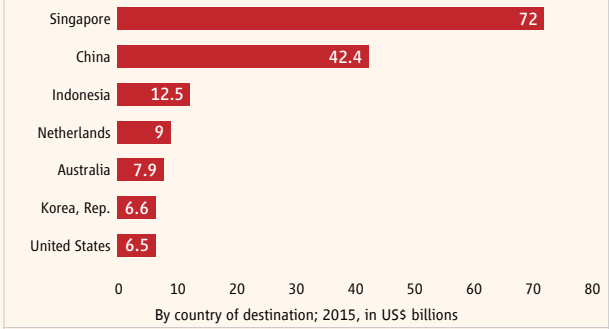
Advanced economies are both the key contributors for inward FDI to developing EAP and the major recipient countries for outward FDI from the region. Advanced economies in Asia took up a major share of the FDI stocks in developing EAP—Japan, Singapore, and Korea accounted for over one-quarter of the 2015 regional FDI stock (27 percent), while the United States, the Netherlands, and Germany are the top FDI investors outside of Asia (Figure BI.A.2.4a). The majority of outward FDI flowed from developing EAP to Singapore, the Netherlands, Australia, Korea, and the United States (Figure BI.A.2.4b). Apart from advanced economies, intraregional FDI across developing EAP countries has become more prominent, with China and Indonesia also taking up a sizable share.

Figure BI.A.2.4a. Developing EAP inward FDI stock



Source: International Monetary Fund, Coordinated Direct Investment Survey.

Figure BI.A.2.4b. Developing EAP outward FDI stock



Source: International Monetary Fund, Coordinated Direct Investment Survey.

FDI in developing EAP is widely distributed across sectors. Statistics on the cumulative value of greenfield and mergers & acquisitions (M&A) FDI projects between 2003 and 2016 illustrate that the sector receiving the most FDI in EAP is coal, oil, and natural gas (14 percent), followed by real estate and financial services (Figure BI.A.2.5).[2] In recent years, the importance of extractive industries has diminished, as Chinese investments have become more diversified across host markets and sectors. Real estate, transportation, and

(continued)

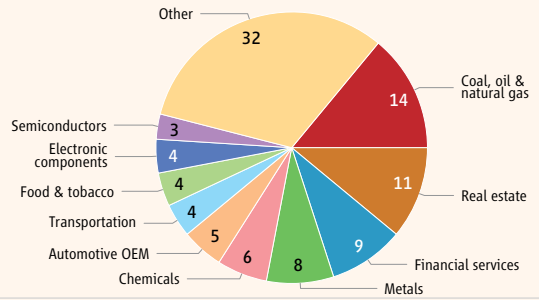
2 This information is extracted from two transaction-level data sources on FDI projects. First, the fDi Markets dataset tracks media announcements of firm-level greenfield FDI projects. Second, the Thomson Reuters dataset provides the value of individual M&A transactions. The matching methodology detailed in Kierkegaard (2013) is used to merge both datasets. The information from these two datasets allows us to create a single FDI dataset covering the years 2003–15 and including both greenfield and M&A.

(Box I.A.2 continued)

automotive original equipment manufacturer are on the rise, while more investments are flowing into new sectors such as hotel and tourism, and leisure and entertainment.

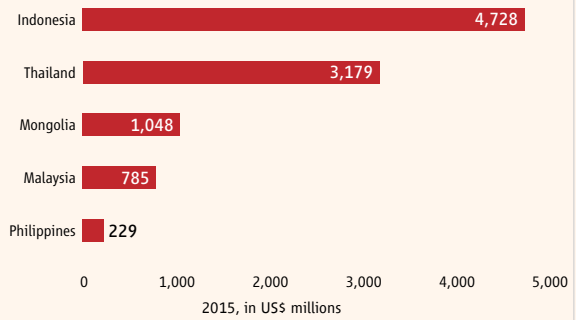
Figure BI.A.2.5. Developing EAP inward FDI by sector

Cumulative value of Greenfield and M&A FDI projects, 2003–16



Sources: fDi Markets and Thomson Reuters.
Note: OEM = original equipment manufacturer.

Figure BI.A.2.6. Chinese FDI stock in developing EAP



Source: International Monetary Fund, Coordinated Direct Investment Survey.

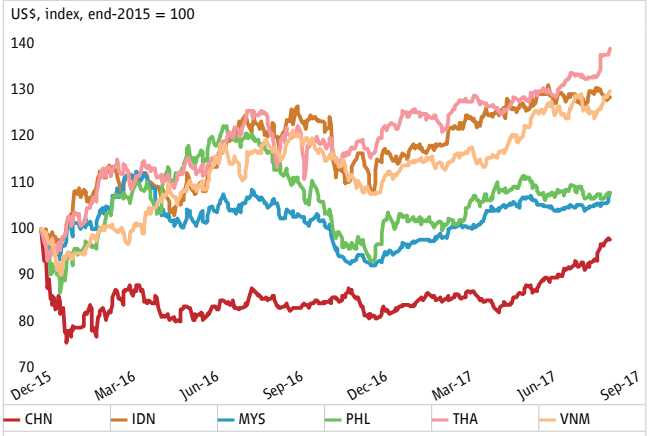
One notable trend is the emergence of China's outward FDI. China has stepped up its global investment activity, reaching US$183 billion by 2016, from less than US$1 billion in 2000. In developing EAP, Chinese investment in the region reached an annual flow of US$5 billion by 2014. The main destination of Chinese outward FDI in developing EAP is Indonesia (Figure BI.A.2.6), with 47 percent of total outward FDI stocks from China, followed by Thailand (32 percent), Mongolia (10 percent), and Malaysia (8 percent). Chinese multinationals are most active in the region in metals, accounting for 30 percent of the cumulative value of the country's outward FDI projects between 2003 and 2016. Real estate and energy extractive industries (coal, oil, and gas) also are significant, with 19 percent and 18 percent of Chinese outward FDI in the region, respectively.

Looking ahead, the development of the Belt and Road Initiative (BRI), a cornerstone of China's development strategy, will likely influence its FDI activity in developing EAP. The BRI aims to create a network of physical connectivity through a network of railways, roads, pipelines, utility grids, ports, and others that would link China with the rest of the world. This initiative involves more than 60 countries and a combined inward FDI stock of around US$6 trillion (UNCTAD 2017). While the BRI is still in its infancy, there is some evidence that it is already contributing to greater Chinese FDI into the rest of developing EAP. Following the announcement of the BRI in 2013, several countries have signed deals with China aimed at addressing infrastructure gaps within the region.[3]

3 These include the construction of a number of high-speed rail lines, including in Malaysia, Thailand, Lao PDR, and Indonesia. One of these would lead to a new high-speed rail line running from southern China through Lao PDR to Thailand and Malaysia. Another would be the first high-speed rail network in Indonesia, linking the cities of Jakarta and Bandung.

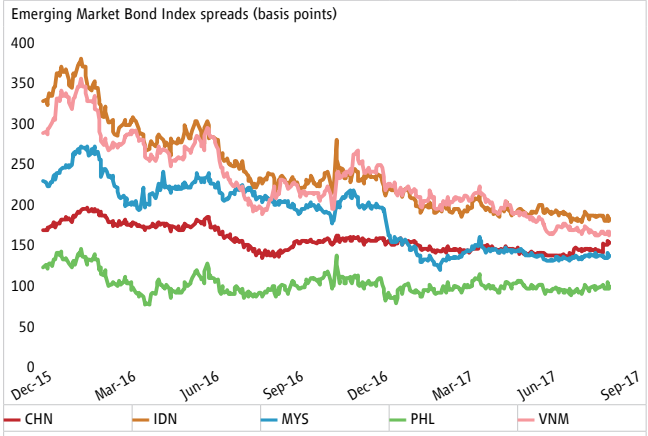
to investment grade for the first time since 1997.[6] Spreads on Malaysian and Vietnamese external bonds fell by similar magnitudes.

Figure I.A.22. Stock prices



Sources: Thomson Reuters; Datastream; IFC Global Macro & Market Research.

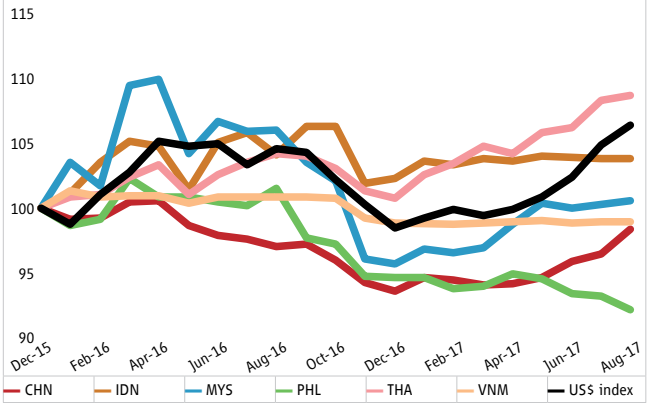
Figure I.A.23. External corporate and sovereign bond spreads have narrowed



Sources: J.P. Morgan; IFC Global Macro & Market Research.

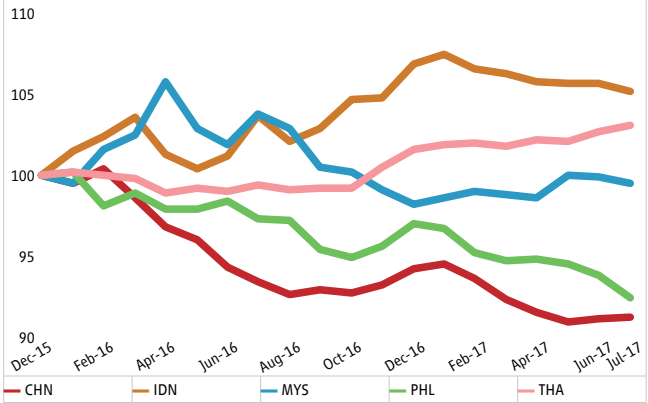
After falling against the U.S. dollar during the second half of 2016, most currencies in the region appreciated against it during 2017. Exchange rates for most major regional currencies reversed course during 2017 as the U.S. dollar depreciated in response to changing expectations about U.S. macroeconomic policies (Figure I.A.24). The Thai baht's value in U.S. dollars increased by 7.5 percent between the end of 2016 and July 2017, for example, and the Malaysian ringgit gained 4.8 percent in value during this period. Only the Philippine peso has depreciated against the dollar during 2017. Nevertheless, in real, trade-weighted terms, only the Chinese renminbi and the Philippine peso have depreciated sharply since the end of 2015 (Figure I.A.25).

Figure I.A.24. Many major currencies have appreciated against the U.S. dollar during 2017



Source: Haver Analytics; U.S. Federal Reserve.
Note: Falling values denote depreciation vis-à-vis the U.S. dollar. US$ index is a weighted average of the values of major world currencies that circulate widely outside their country of issue.

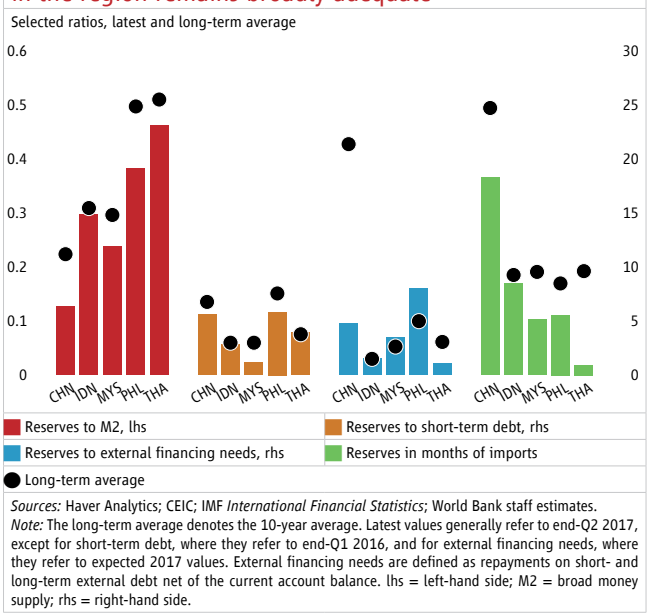
Figure I.A.25. Indonesia and Thailand show appreciation in real, trade-weighted terms



Sources: Bank for International Settlements; CEIC; World Bank staff estimates.
Note: Falling values denote depreciation. The real effective exchange rate (REER) is deflated using the consumer price index.

6 See "Upgraded," *Indonesia Economic Quarterly*, World Bank, Washington DC, June 2017.

Figure I.A.26. Reserve coverage for the major economies in the region remains broadly adequate



Sources: Haver Analytics; CEIC; IMF *International Financial Statistics*; World Bank staff estimates.
Note: The long-term average denotes the 10-year average. Latest values generally refer to end-Q2 2017, except for short-term debt, where they refer to end-Q1 2016, and for external financing needs, where they refer to expected 2017 values. External financing needs are defined as repayments on short- and long-term external debt net of the current account balance. lhs = left-hand side; M2 = broad money supply; rhs = right-hand side.

Reserve coverage across the region is broadly adequate (Figure I.A.26). In 2017, China halted the slide in its foreign reserves, which had declined by around 25 percent between August 2014 and January 2017. The stock of reserves also increased in Indonesia, Malaysia, Thailand, and Vietnam. It stabilized during early 2017 in the Philippines after a sharp drop during 2016. Although these reserve levels are below longer-term averages for these economies, this adjustment is likely appropriate given their high levels in the past.

Recent developments in the Pacific Island Countries

Most small Pacific Island Countries (PICs) experienced moderate GDP growth but remain highly vulnerable to external shocks. GDP growth rates were in the range of 2.5 to 4.0 percent in 2016–17 in most of the PICs, supported by public investment projects, fishing, agriculture, and tourism activities. Due to their small size, remoteness, and dispersion, the PICs remain vulnerable to shocks from extreme weather events, changes in donor financing and terms of trade, and the ebb and flow of construction on infrastructure projects, which can cause large swings in GDP growth. For example, GDP growth in Samoa fell to 3 percent during the first three quarters of FY2017 from 7.1 percent in FY2016, in part due to work on major construction projects winding down.[7] Spending on construction to rebuild from Tropical Cyclone Pam boosted Vanuatu's GDP growth rate to 4.0 percent in 2016, and the recovery of tourism and agriculture, along with continued reconstruction spending, are expected to support acceleration of growth to 4.7 percent in 2017. And Nauru's GDP growth rate jumped to around 10 percent in FY2016 from 2.8 percent in FY2015, partly due to a recovery in exports after seaport repairs, but then is estimated to have slowed to around 4 percent in FY2017 as phosphate exports fell and activity associated with Australia's Regional Processing Centre for asylum seekers moderated.

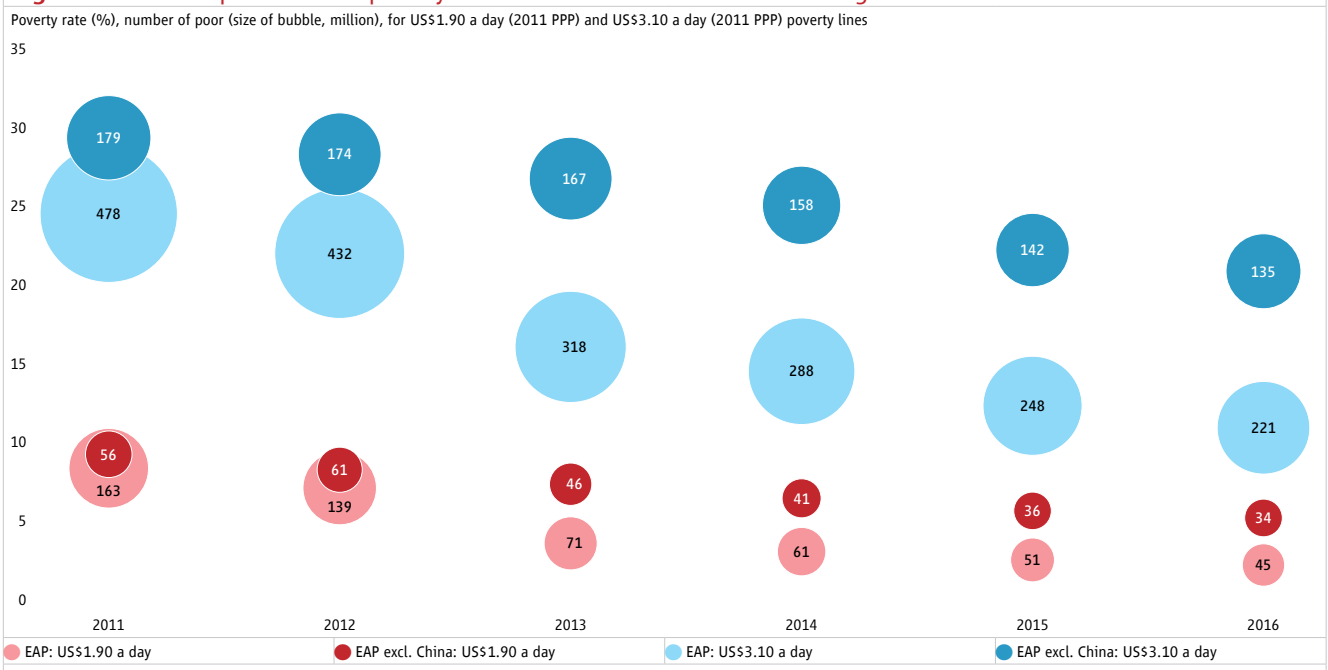
Licensing fees for regional fishing continued to provide large income flows to several PICs. The introduction of the "vessel-day scheme" (a regional agreement that establishes the minimum price of a vessel day and limits the total number of vessel days sold) has substantially increased fisheries incomes for the governments of Kiribati, the Marshall Islands, the Federated States of Micronesia, Nauru, and Tuvalu, and enabled them to boost the value of their savings funds. In 2016, income from this scheme reached 53.2 percent of Tuvalu's GDP, 68.1 percent of Kiribati's GDP, and around 19 percent of the Federated States of Micronesia's GDP. Kiribati's cash reserves exceed its short-term stabilization needs, and the authorities are devoting funds to finance infrastructure investments in the outer islands and to improve connectivity and public service delivery for these populations.

7 The fiscal year in Samoa runs from July 1 through June 30.

Poverty rates have continued to fall across most of the EAP region

Economic growth has contributed to the region's success in reducing poverty. Developing EAP maintains its record of successful poverty reduction. In 2016, the share of EAP region's population living in extreme poverty (below the international poverty line of US$1.90 a day in 2011 purchasing power parity [PPP] terms) fell to an estimated 2.2 percent, or, excluding China, to an estimated 5.2 percent (Figure I.A.27). Projections indicate that some of the region's larger countries (for example, China and Vietnam) have already been successful in eliminating extreme poverty (that is, brought it down to 3 percent or lower), implying a moderation in the pace of poverty reduction (Box I.A.4). The share of the region's population living in moderate poverty (below the US$3.10-a-day line in 2011 PPP terms) also fell, from 14.4 percent in 2014 to an estimated 10.9 percent in 2016. Internationally comparable poverty estimates for Myanmar are now available for the first time; household survey data indicate that poverty has declined over a decade of reforms, though relatively lower growth in agriculture implied that poverty reduction in rural areas has been more sluggish than that in urban areas (Box I.A.3). In Timor-Leste, private consumption growth—a key indicator related to the pace of poverty reduction—is forecast to be lower in 2017 than in previous years. While poverty in the EAP region has declined in the last decade, countries are not completely immune to shocks and risks, as recent household surveys have shown increased poverty rates in Mongolia and urban areas of Fiji. International poverty rates, measured at the US$1.90-a-day (2011 PPP) line, remain over 10 percent in Lao PDR and several Pacific Island Countries.

Figure I.A.27. The prevalence of poverty has continued to decline across the region



Sources: World Bank East Asia and Pacific Team for Statistical Development; PovCalNet.
Note: The most recent household survey used for actual estimates vary from 2006 in Kiribati to 2016 in Indonesia and Mongolia. Estimates prior to 2016 are (a) derived directly from household survey data; (b) China 2013 is a survey break and data are not comparable with previous years; (c) interpolated between existing surveys; or (d) extrapolated based on per capita GDP growth and historical estimates of the growth elasticity of poverty (GEP), but China, Papua New Guinea, and Pacific Island Countries based on neutral growth distribution. For 2016 onward, estimates are projected based on projected per capita GDP growth and the GEP, and are hence preliminary and subject to revision. In China, data through 2012 are not comparable with those for subsequent years, owing to a change in the survey methodology that acted to lower reported poverty, and may account for nearly half of the reported decrease in the poverty headcount between 2012 and 2013. In late 2012, separate urban and rural household surveys were replaced with a single national household survey, which uses stratified, multistage sampling methods. There were significant changes in the collection of information from migrants (now treated as part of the urban population when measuring aggregate disposable income), and the treatment of net taxes and transfers in rural areas; and rents from home ownership are now imputed. This latter factor in particular may have had a substantial effect on reported poverty.

Box I.A.3. Trends in poverty, household welfare and inequality in Myanmar[1]

The Ministry of Planning and Finance of the Government of Myanmar and the World Bank released their first joint assessment of poverty in August 2017. This report fills a pressing information gap on how the people of Myanmar have fared during a period of reform and transition. The last poverty assessment conducted in Myanmar was released in 2011, and showed multiple dimensions of change between 2004–05 and 2009–10.[2] Beginning in 2011, Myanmar launched major political and economic reforms, including the removal of constraints on commerce, trade and private enterprises. Key economic reforms have included the unification of the exchange rate, the removal of a host of import and export restrictions, and new legislation that provides greater autonomy for the central bank, and increased transparency including the publication of the government budget.[3]

Households in Myanmar have seen substantial improvement in their wellbeing over the last decade. Poverty declined over the decade between 2005 and 2015, the latter part of which was a period of substantial reforms. The figures below present estimates of the decline in poverty over time using two methods: the first produced in the Integrated Household Living Conditions Assessment (IHLCA) reports by the Ministry of National Planning and Economic Development and development partners (MNPED et al, 2007) and the second produced by the World Bank (World Bank, 2014).[4] Regardless of the method used, Myanmar has seen substantial poverty reduction over the last decade using nationally benchmarked measures of poverty. Poverty declined from 32.1 percent in 2004–05 to 25.6 percent in 2009/10 and 19.4 percent in 2015 using the method produced in the IHLCA reports. A decline of a similar magnitude was registered using the World Bank's revised estimate: poverty went down from 44.5 percent in 2004 to 37.5 percent in 2009–10 and 26.1 percent in 2015.

These improvements in well-being are also reflected in other measures of welfare. Average household expenditures have increased by 15 percent over the decade, or by 1.4 percent per year, using the IHLCA reports' welfare aggregate. Other indicators of living standards, such as the ownership of motorcycles and televisions, have improved over time. For example, motorcycle ownership increased from just under 10 percent of households to a quarter of households in 2009–10, 39 percent in 2014 and over 42 percent of households in 2015.

Urban areas have seen faster growth in household welfare, and a sharper decline in poverty in percentage point terms. Both rural and urban poverty have declined, with urban poverty falling from

(continued)

1 Prepared by Reena Badiani-Magnusson.

2 Fiscal year ending on March 31.

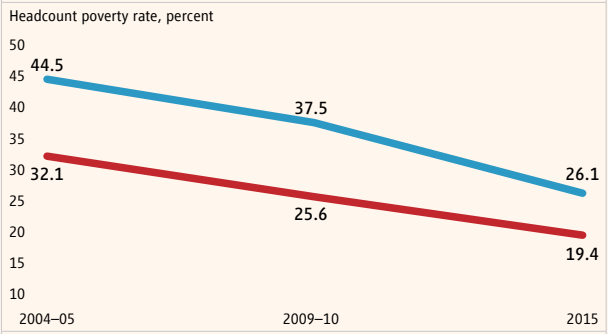
3 For details see, World Bank (2015).

4 Both methods are based on a national definition as opposed to international definitions of poverty, and use a cost of basic minimum needs approach to set their poverty lines. Although a handful of technical choices differentiate the two methods, only a few have substantial explanatory power in explaining the differences in the poverty estimates produced. The first important difference reflects the base year for anchoring the standard of living and definition of poverty. The second difference reflects methodological choices, in particular, how household consumption was translated into individual consumption using adult equivalence scales. Due to the number of people in Myanmar living near the poverty line, small changes in assumptions can lead to large changes in poverty estimates.

(Box I.A.3 continued)

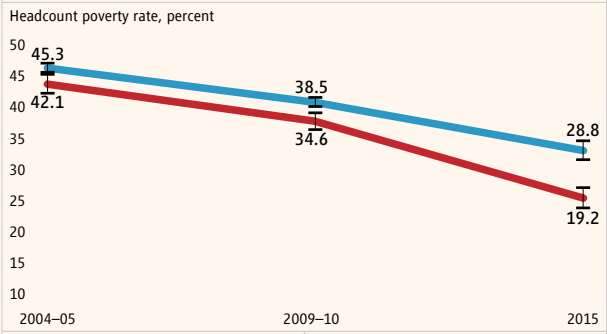
34.6 percent in 2009–10 to 19.2 percent in 2015, and rural poverty falling from 38.5 percent to 28.8 percent over the same period. The same patterns are seen using the IHLCA reports' welfare aggregate. The more rapid decline in urban, relative to rural, poverty is mirrored in sectoral growth figures, which show a more rapid rate of growth in manufacturing and services than in the agricultural sector over the same period (World Bank, 2016). Rising welfare in urban areas has been accompanied by an expansion in asset ownership, which is strongly associated with well-being in Myanmar. Valuable assets are mostly concentrated among richer households in urban areas or in the top expenditure quintile. An increase in asset ownership over this time frame is likely a reflection of both a deepening of markets as well as of rising consumer purchasing power.

Figure BI.A.3.1. Trends in national poverty estimates



Source: World Bank staff estimates. Poverty estimates were produced in collaboration with the Ministry of Planning and Finance.

Figure BI.A.3.2. Trends in poverty in urban and rural areas



Source: World Bank staff estimates. Poverty estimates were produced in collaboration with the Ministry of Planning and Finance.

The faster urban growth has contributed to an increase in inequality in Myanmar. Most measures of inequality have risen over the reform period, albeit from a relatively low base. Households at the top 90th percentile have seen faster consumption growth than the bottom 10th and the median household. The share of total expenditures going to the bottom 20 percent and to the bottom 40 percent has declined since 2009–10. The Gini coefficient of inequality is estimated to be 0.32 in 2015. The rise in inequality is noteworthy but unsurprising, as individuals with better education and more capital to invest benefitted more from the early liberalizations and reforms. While living standards in rural areas have seen substantial improvements, the changes have been more limited than those seen in Myanmar's cities and towns. The rise in inequality replicates the experience of reform periods seen in other countries in the region and elsewhere. While current inequality levels in Myanmar do not stand out from a regional or global perspective, it will be important to monitor reform efforts to ensure that they result in growth that has the potential to reach the entire population. Supporting stronger growth in Myanmar's farms and villages will be especially vital, both for reducing poverty and for keeping inequality in check.

(continued)

(Box I.A.3 continued)

Despite improvements in living conditions, there are many individuals whose consumption patterns place them just above the poverty line. Individuals are considered to be near-poor or vulnerable to poverty if there is a non-negligible chance that they could fall into poverty. This is captured by looking at the population that lies within 20 percent of the poverty line. Although the fraction of poor and near-poor has declined over time, from 61.2 percent in 2004–05 to 54.7 percent in 2009–10 using the World Bank (2014) definition, 40.1 percent of the population continued to live under the near poor line in 2015. Thus, the bottom 40 percent of Myanmar's population continues to be either poor or very vulnerable to falling into poverty. Moreover, beyond facing a substantial risk of absolute poverty, this group has limited access to basic services such as electricity, health care, and improved water and sanitation.

Box I.A.4. Has inequality in China peaked?[1]

China's unprecedented success in reducing poverty since the early 1980s has coincided with possibly the most rapid growth in income inequality in the world. Between 1981 and 2013, China's poverty rate declined from 88.3 percent to a 1.9 percent.[2] At the same time, income inequality rose considerably and at a very fast pace. World Development Indicators (using tabulated income and consumption data from official Chinese sources) show that the Gini coefficient for China went from below 0.30 to 0.43 in 2010, reaching the inequality levels of countries like Russia and Turkey, but lower than in high-inequality developing countries such as Brazil, Mexico, and South Africa. Consequently, it has been claimed that although China is not the most unequal country among large developing countries, it is the one with the largest increase in inequality during this time, and that its inequality has surpassed a threshold based on country peers and income levels (Knight 2014; Xie and Zhou 2014).

Given China's size, its poverty and inequality trends have global implications. The extraordinary economic growth of China since the early 1980s has driven a reduction in worldwide poverty of historic proportions. Given the sheer size of the country, this fast poverty reduction meant that 790 million people moved out of poverty in this period, representing three-quarters of global poverty reduction. Global inequality has also declined thanks to the rise in average incomes of large emerging economies like China. According to Lakner and Milanovic (2013), global inequality, as measured by the Gini coefficient, declined from 0.722 in 1988 to 0.705 in 2008. This trend is mostly the result of narrowing differences in average incomes between countries, particularly China, which had real income growth of 228 percent, well above the world average of 24.3 percent, during 1988–2008. This reduction of between-country inequality has been accompanied by increases in within-country inequality in China, as well as in several other developed and emerging economies. Consequently, lower inequality within China would be good news both for the country and for the world by contributing to lower global inequality.[3]

There is growing consensus that income inequality in China seems to have peaked toward the end of the last decade. A turnaround of income inequality measured by the Gini coefficient was observed toward the turn of the last decade by a number of data sources. Official figures have recorded this decline. Estimates of the Gini coefficient (for income) by China's National Bureau of Statistics show a rise from 0.473 in 2004 to 0.481 in 2008 and then a decline to 0.462 in 2015 (Figure BI.A.4.1). Since official microdata used by China's National Bureau of Statistics are not publicly available, researchers have relied on other sources of data (such as tabulated data, macroeconomic aggregates, and academic surveys) to investigate these trends. For instance, Kanbur, Wang, and Zhang (2017), using six academic surveys from two different

(continued)

1 Prepared by Samuel Freije-Rodriguez.

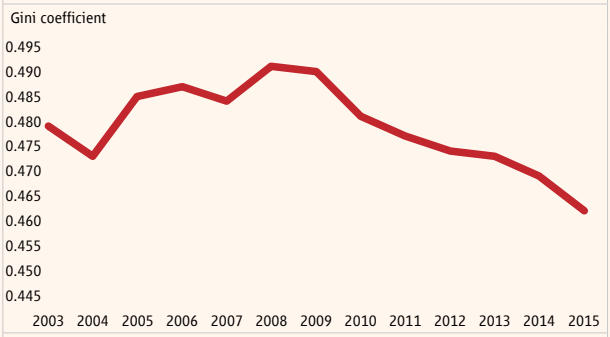
2 These figures are World Bank estimates using tabulated data of income and consumption in China, and adopting the global poverty line of US$1.90 at 2011 purchasing power parity (PPP) exchange rates. Qualitatively similar numbers are attained from the official poverty line of 2,300 yuan (at 2010 prices).

3 The net effect on global inequality of between- and within-country inequality is an empirical matter. For the period 1980 to 2010, there is consensus among economists (see, for example, Lakner and Milanovic [2013]) and noneconomists (see, for example, Hung and Kucinskas [2011]), that the between-country effect has predominated and driven global inequality down, despite growing within-country inequality.

(Box I.A.4 continued)

institutions spanning 1995 to 2015, report that the Gini coefficient (for income) rose from 0.435 in 1995 to 0.533 in 2010, before declining to 0.495 in 2014.[4] World Bank staff, using 10 surveys from four academic institutions spanning 2002–13 find that all surveys show a declining Gini coefficient after 2010, whereas surveys before 2010 show a rising trend in the Gini.[5]

Figure BI.A.4.1. Recent evolution of income inequality in China



Source: China National Bureau of Statistics.

This reversal in inequality is confirmed by other measures of inequality. Other indicators of inequality, such as the generalized entropy family, are more sensitive to trends in the extremes of the income distribution (that is, the very rich or the very poor).[6] Kanbur, Wang, and Zhang (2017), using provincial average consumption data, find that generalized entropy rose from 0.16 in 1978 to 0.229 in 2005, and then declined to 0.172 in 2014. The shares of total income ascribed to specific population groups, such as the top 1 percent of the population or the bottom 50 percent, are easier to understand and have also been analyzed. Piketty, Yang, and Zucman (2017) tabulate income, tax records, and national accounts data, and document that the income share of the top 1 percent in China went from 6.3 percent of national income in 1978, to a peak of 15.6 percent in 2009, and has declined since to 14.0 percent in 2015. The income share of the bottom 50 percent, in contrast, declined from 27 percent in 1978 to14 percent in 2010 and has since remained slightly below the 15 percent mark.[7]

Most sources identify a closing of the income gap between rural and urban areas as the main reason behind the inequality turnaround. Again, official data report a narrowing of the rural-urban income gap. The rural-urban ratio of per capita annual income decreased from 0.50 in 2000 to 0.38 in 2008, and then increased to 0.42 in 2012. Similarly, Kanbur, Wang and Zhang (2017) indicate that the share of inequality ascribed to urban-rural differentials goes from 6.81 percent in 1984 to 14.6 percent in 2004, and declines to 8.4 percent in 2014. Piketty, Yang, and Zucman (2017) find that the ratio of urban-to-rural income per adult goes from 2.0 in 1982 to 3.70 in 2009 and stabilizes at around 3.5 between 2011 and 2015. World Bank staff decompose changes in an index of generalized entropy and find that the urban-rural

(continued)

4 Data from Kanbur, Yang, and Zhang (2017).

5 Data from Freije et al. (2017).

6 The generalized entropy family is a set of indexes of inequality that rely on analogies between income distribution and information theory. The lower the probability of an event, the higher the information it conveys, and the information of a series of events is the summation of their respective probabilities. If all events have the same probability—which is akin to all individuals having the same share of income—then their information content, that is entropy, is maximal—which is akin to maximal equality. Hence, transformations of measures of entropy can be interpreted as measures of inequality. There are several indexes based on this principle, the most common of which is the mean logarithmic deviation: $\sum_i^n 1/n \ln y/y_i$. The generalized entropy family of indexes is often used by researchers due to its decomposability property (not shared by the Gini coefficient), which allows making total inequality the exact sum of inequality between groups plus inequality within groups.

7 Data from Piketty, Yang, and Zucman (2017).

(Box I.A.4 continued)

average income differential—rather than within urban or rural inequality—explains most of the upturn and downturn of income inequality.[8]

Table BI.A.4.1. Components of per capita household income in China

	Old separate surveys								*New integrated surveys*		
	2005	*2006*	*2007*	*2008*	*2009*	*2010*	*2011*	*2012*	*2013*	*2014*	*2015*
Urban per capita annual income									**Urban percapita disposable income**		
Total	11,320.8	12,719.2	14,908.6	17,067.8	18,858.1	21,033.4	23,979.2	26,959.0	26,467.0	28,843.9	31,194.8
wages and salaries	7,797.5	8,767.0	10,234.8	11,299.0	12,382.1	13,707.7	15,411.9	17,335.6	16,617.4	17,936.8	19,337.0
household operations	679.6	809.6	940.7	1,453.6	1,528.7	1,713.5	2,209.7	2,548.3	2,975.3	3,279.0	3,476.1
properties	192.9	244.0	348.5	387.0	431.8	520.3	649.0	707.0	2,551.5	2,812.1	3,041.9
transfers	2,650.7	2,898.7	3,384.6	3,928.2	4,515.5	5,091.9	5,708.6	6,368.1	4,322.8	4,815.9	5,339.7
Rural per capita annual income									**Rural per capita disposable income**		
Total	4,631.2	5,028.1	5,791.1	6,700.7	7,115.6	8,119.5	9,833.1	10,990.7	9,429.6	10,488.9	11,421.7
wages and salaries	1,174.5	1,374.8	1,596.2	1,853.7	2,061.3	2,431.1	2,963.4	3,447.5	3,625.5	4,152.2	4,600.3
household operations	3,164.4	3,310.0	3,776.7	4,302.1	4,404.0	4,937.5	5,939.8	6,461.0	3,934.9	4,237.4	4,503.6
properties	88.5	100.5	128.2	148.1	167.2	202.3	228.6	249.5	194.7	222.1	251.5
transfers	203.8	239.8	290.0	396.8	483.1	548.7	701.4	833.2	1,647.5	1,877.2	2,066.3
rural-to-urban ratios:											
income (total or disposable)	0.41	0.40	0.39	0.39	0.38	0.39	0.41	0.41	0.36	0.36	0.37
wages	0.15	0.16	0.16	0.16	0.17	0.18	0.19	0.20	0.22	0.23	0.24
operations	4.66	4.09	4.01	2.96	2.88	2.88	2.69	2.54	1.32	1.29	1.30

Source: China Statistical Yearbook, several years.

When looking at sources of income, wages and incomes from businesses and farms have played an important role in explaining changes in inequality over the last decade. Wages usually represent the largest income component for most people and, consequently, they also represent a large component of income inequality. Over time, however, their impact on total inequality depends on how wage inequality evolves vis-à-vis inequality in other sources of income. According to Kanbur, Wang, and Zhang (2017), the evolution of wage income represents the largest component of *changes* in inequality between 1995 and 2010. Since 2010, however, wages have contributed to the decline in inequality but incomes from businesses and farms ("operational incomes") have become relatively more important in explaining this decline. This implies that not only wages, but also operational incomes, have become less unequal over time. Official data about components of income in urban and rural households seem to corroborate these

(continued)

8 Freije et al. (2017) using a decomposition of income inequality changes into changes due to inequality within groups, and inequality between groups and for data using the China Household Income Project (CHIP) data for years 2002, 2007, and 2013.

(Box I.A.4 continued)

trends. The rural-urban wage ratio increased from 0.15 to 0.20 between 2005 and 2012, while the rural-urban ratio of operational income declined from 4.66 to 2.54 during the same period (Table BI.A.4.1).[9] Rural wages have narrowed their gap with urban wages (although they still remain much lower), while more urban households now have business returns (which was a predominant source, in terms of farm incomes, among rural households).

The deeper causes of this turnaround in inequality, however, are still unclear and need further study. Some hypotheses have been advanced. It has been argued that China has reached the "Lewis turning point," namely the situation in which, due to rural-urban migration and modernization of agriculture, rural earnings—either wages or farm incomes —start to grow and converge toward earnings in urban areas. Others indicate minimum wage regulations, which have been in place since 2004 but have risen and are now better enforced, may be playing a role in reducing wage inequality. Yet others believe that, despite rapid expansion of the private sector in recent decades, there remains a large presence of the public sector in the Chinese economy. This aspect may put a cap on the growth of certain private sector activities, involve some forms of wage restraint in some economic activities, and result in large capital returns still going to the state rather than to the private sector.

Income inequality is also connected to the distribution of productive assets and wealth, but these have been less studied due to limited data. Background work for a forthcoming World Bank report on inclusive growth in East Asia Pacific (Ruggeri Laderchi et al. 2017) collected and analyzed data from sources such as investment banking reports and stock exchanges. It shows that, as is the case in most countries, wealth inequality in China is likely to be more extreme than income inequality, but that it is comparable to, and may in fact be less extreme than, in other similar East Asian countries (Cunningham 2017; Cunningham, Huertas, and Buhler 2016; Ruggeri Laderchi et al. 2017).

There are several unanswered questions about the recent decline in inequality in China. Three questions seem particularly important. First, there is a need to collect and analyze more updated data to identify whether income inequality continues to fall, levels off at current levels, or regains its previous upward trend. Second, analyses are needed of the factors that have played a role in this decline of income inequality and of the extent to which these can be expected to continue in the future. Finally, there is the question of what public policy in China should do about income inequality. There are few studies about the redistributive impact of the tax-and-transfer system in China, and the ones that exist tend to show that it has limited distributive impact, so that income inequality remains more or less the same before and after fiscal redistribution.[10] This policy issue is of central importance as China advances toward its goal of becoming a modern and more prosperous society.

9 Data for 2013–15, although not strictly comparable because of use of different surveys and reference to different income concepts (that is, disposable income rather than annual income), show the same trend.

10 One study about the redistributive impact of the fiscal system in China is Solt (2016), which uses a global database of pre- and post-taxes income inequality indicators. Another study, which uses different methods but finds similar results, is by Cevic and Correa-Caro (2015).

I.B. Outlook and Risks

The economic outlook for the region remains positive and will benefit from an improved external environment as well as strong domestic demand. The growth of regional GDP excluding China is projected to accelerate to 5.2 percent in 2018. China's GDP growth is expected to decline in 2018 and 2019, although it will remain higher than most countries in the region. Poverty is projected to continue its long-term decline. Rising incomes and improved social protection programs will continue to contribute to poverty reduction. Despite the improved near-term outlook, risks arise from long-term challenges, including financial sector vulnerabilities and large fiscal imbalances that affect many countries in the region. The possible escalation of geopolitical tensions in the region could have serious economic consequences.

Growth is expected to remain robust in the region

Global growth and commodity prices are projected to recover, albeit slowly, while global financial conditions tighten gradually (Box I.B.1). Global growth is projected to increase to 2.9 percent in 2017 and 2018, supported by improved performance in major commodity exporters and modest, investment-led recovery in advanced economies. World trade flows are also expected to accelerate—at a projected pace of 4.2 percent in 2017, which would be the fastest rate since 2010. Global financing conditions are expected to tighten gradually. The likely pace of tightening by monetary authorities in the advanced countries over the near term now appears to be more gradual than was anticipated in the April 2017 *East Asia and Pacific Economic Update*, reflecting the sluggish rise in inflation and the lower likelihood of fiscal stimulus in the near term in the United States.

These conditions mean the outlook for developing EAP remains positive. With China's growth stronger than previously expected, developing EAP as a whole is expected to grow at 6.4 percent in 2017, a modest improvement over 2016 as well as relative to projections in the April 2017 *East Asia and Pacific Economic Update* (Table I.B.1). Excluding China, the region is forecast to grow at around 5 percent during 2017–19, accelerating slightly over the period. The growth outlook remains more favorable than for other regions, except for South Asia. While the largest contribution to growth is expected to continue to come from private consumption, the contribution of investment—public and private—is expected to increase during 2017–19.

China's growth moderation and gradual rebalancing are expected to continue despite the uptick in 2017. With more rapid growth in the first half of the year, the Chinese economy is expected to grow at 6.7 percent in 2017. Growth is projected to moderate to around 6.4 percent in 2018–19 as the economy rebalances away from investment and external demand toward domestic consumption. This expectation also assumes that the authorities continue to implement measures aimed at bringing the growth of debt under control to reduce macroeconomic risks and imbalances.

In most of the large ASEAN economies in the region, growth is projected to increase in 2017 and 2018. Malaysia is expected to grow more rapidly, reflecting improved confidence, higher investment, and the recovery in world trade. Thailand's forecast has also been revised upward due to stronger recovery in merchandise exports

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

Percent change from a year earlier, unless otherwise noted

			forecast			*Change from April 2017[a] (percentage points)*		
	2015	*2016*	*2017*	*2018*	*2019*	*2016*	*2017*	*2018*
Developing EAP	**6.5**	**6.3**	**6.4**	**6.2**	**6.1**	**-0.1**	**0.2**	**0.1**
China	6.9	6.7	6.7	6.4	6.3	0.0	0.2	0.1
Developing EAP excl. China	**4.9**	**4.9**	**5.1**	**5.2**	**5.2**	**0.0**	**0.1**	**0.1**
Developing ASEAN (ASEAN-5)	4.8	4.9	5.1	5.2	5.2	0.0	0.1	0.1
Indonesia	4.9	5.0	5.1	5.3	5.3	0.0	-0.1	0.0
Malaysia	5.0	4.2	5.2	5.0	4.8	0.0	0.9	0.5
Philippines	6.1	6.9	6.6	6.7	6.7	0.1	-0.3	-0.2
Thailand	2.9	3.2	3.5	3.6	3.5	0.0	0.3	0.3
Vietnam	6.7	6.2	6.3	6.4	6.4	0.0	0.0	0.0
Cambodia	7.0	7.0	6.8	6.9	6.7	0.1	-0.1	0.0
Lao PDR	7.4	7.0	6.7	6.6	6.9	0.0	-0.3	-0.2
Myanmar	7.0	5.9	6.4	6.7	6.9	-0.6	-0.5	-0.5
Mongolia	2.2	1.4	2.8	3.1	7.3	0.4	3.0	1.2
Fiji	3.6	0.4	3.8	3.5	3.3	-1.6	0.1	0.0
Papua New Guinea	8.0	2.4	2.1	2.5	2.4	0.0	-0.9	-0.7
Solomon Islands	2.5	3.3	3.0	3.0	2.8	0.3	-0.3	0.0
Timor-Leste[b]	4.0	5.7	2.4	4.2	5.0	0.6	-1.6	-0.8
Assumptions about the external environment:[c]								
World	2.7	2.4	2.9	2.9	2.9	0.1	0.2	0.0
Advanced economies	2.2	1.6	2.1	1.9	1.7	-0.1	0.3	0.1
Emerging and developing economies	3.6	3.7	4.1	4.5	4.6	0.3	-0.1	-0.1
Crude oil (spot, US$/barrel)	51	43	53	56	59	0.0	-2.0	-4.0
Nonenergy commodities (index, 2010 = 100)	82	80	84	85	85	0.0	1.0	1.0
Food (index, 2010 = 100)	91	92	92	93	94	0.0	-1.0	-1.0

Sources: World Bank data and staff estimates.
Note: a. World Bank *East Asia and Pacific Economic Update*, April 2017 (World Bank 2017a). b. Nonoil GDP. c. Global growth forecasts represent preliminary working assumptions. Commodity price forecast drawn from the World Bank *Commodity Markets Outlook*, January 2017 (World Bank 2017). Myanmar data are fiscal year growth rates (2017 = FY2017/18). Changes from April 2017 are calculated with one decimal points precision and rounded to one decimal point.

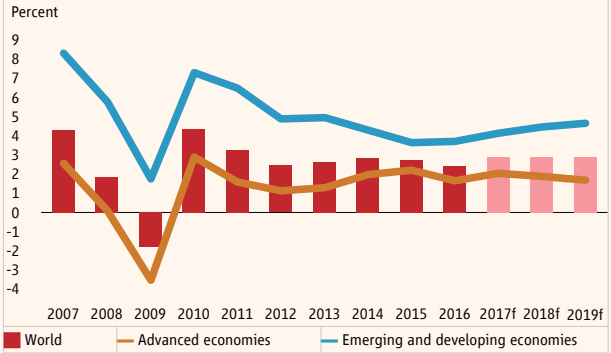
and tourism. Gradual increases in growth are foreseen for Indonesia and Vietnam in 2017 and 2018. In Indonesia, private consumption is projected to strengthen in line with gains in real wages. And, in Vietnam, rebounding agricultural production and strong export-oriented manufacturing will contribute to higher growth. Although the Philippines continues to grow most rapidly among these countries (6.6 percent in 2017 compared to an average of 5.1 percent for this group), it is expected that growth in 2017 and 2018 will be lower than projected in April. The delay in the planned government infrastructure program has contributed to slower growth in investment spending, thus softening the growth prospect for the year.

The outlook for the smaller regional economies is more mixed. Several, including Mongolia, Fiji, and Myanmar, are projected to grow more rapidly in 2017–18. With the introduction of a macroeconomic stabilization program and higher coal exports, Mongolia's economy is now forecast to grow by 2.8 percent in 2017—revised upward from the April forecast of a 0.2 percent contraction—and grow even faster in 2018. The forecast for Fiji is also revised upward, albeit less dramatically, and GDP is now projected to grow by 3.8 percent in 2017, supported by

Box I.B.1. Global outlook and risks

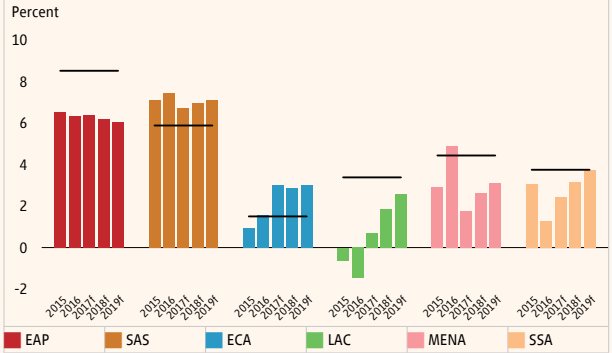
Global growth is projected to strengthen to 2.9 percent in 2017 from a postcrisis low of 2.4 percent in 2016 and remain around that rate in 2018–19 (Figure BI.B.1.1). In advanced economies, a modest investment-led recovery is underway, with growth picking up to 2.1 percent in 2017, from 1.6 percent in 2016, before moderating to 1.8 percent on average in 2018–19.

Figure BI.B.1.1. Global GDP growth



Source: World Bank.
Note: Forecasts for 2017–19 reflect preliminary working assumptions to be finalized and published in the January 2018 issue of the World Bank *Global Economic Prospects* report.

Figure BI.B.1.2. Regional GDP growth



Source: World Bank staff estimates.
Notes: Lines denote long-run precrisis (1990–2008) average growth. Forecasts for 2017–19 reflect preliminary working assumptions to be finalized and published in the January 2018 issue of the World Bank *Global Economic Prospects* report.

In emerging market and developing economies (EMDEs), growth is anticipated to recover to 4.1 percent in 2017, from a postcrisis low of 3.6 percent on average in 2016–17 (Figure BI.B.1.2). Growth in EMDEs is projected to further strengthen to 4.6 percent on average in 2018–19, as obstacles to growth in commodity exporters diminish, while activity in commodity importers remains robust. Following near-stagnation over the last two years, growth in commodity exporters is projected to rise to 1.7 percent in 2017 and 2.6 percent in 2018 in a broad-based recovery.

However, lingering fiscal and external adjustment needs continue to dampen growth prospects in a number of countries. Longer-than-expected adjustment to low commodity prices and, to a lesser degree, lower oil price projections, have resulted in forecast downgrades for a number of exporters. Growth continues to be robust among commodity importers. Windfalls from the recent decline in commodity prices are waning, but accommodative policies are supporting domestic demand, and a recovery in global trade is fueling export growth. The forecast for growth in commodity importers remains stable, at an average of 5.7 percent during 2017–19.

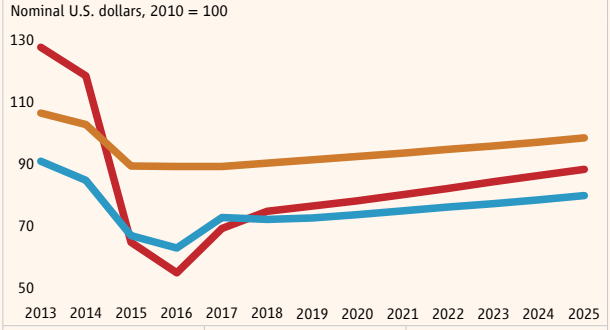
Global trends are supportive. Global trade is expected to grow by 4.2 percent in 2017, its fastest pace since 2010. This represents a significant upgrade from previous projections. Nevertheless, slower trade liberalization, flagging value chain integration, and elevated trade policy uncertainty continue to weigh on the medium-term outlook. Commodity prices are expected to recover at a moderate pace, reflecting

(continued)

(Box I.B.1 continued)

the prospect of increased U.S. shale oil supplies and evidence of sharply falling production costs (Figure BI.B.1.3). Global financing conditions are expected to tighten gradually, benefiting from improving market expectations about growth prospects.

Figure BI.B.1.3. World commodity prices forecast



Source: World Bank.

Although there are risks to the near-term global economic outlook, prospects are more positive than in the recent past. On the one hand, stronger-than-expected growth in the largest advanced economies and the EMDEs—reflecting, for instance, fiscal stimulus in the United States, a more prolonged rebound in the Euro Area, or a sharper recovery in large commodity exporters—could have substantial positive spillovers, including on developing EAP. On the other hand, an abrupt tightening of global financing conditions—triggered, for example, by faster-than-expected balance sheet normalization in major central banks—or an escalation of trade restrictions or geopolitical tensions could derail the recovery. Additional downward pressure on oil prices could set back growth in oil exporters.

reconstruction from Cyclone Winston, although this pace will likely slow during 2018–19. The projected 2017 and 2018 growth rates for Myanmar are revised downward by 0.5 percentage points from earlier forecasts. Businesses in Myanmar appear to have delayed investments as they wait for the government's economic agenda to become clearer. These projections do not factor in any longer-term impact of the ongoing insecurity in Rakhine State, which if it persists could have significant adverse effects by slowing foreign investment. Forecasts for Cambodia and Lao PDR have also been revised downward, although both, along with Myanmar, will still be among the fastest growing countries in the region. The 2017 forecast for Timor-Leste has been revised downward by 1.6 percentage points (to 2.4 percent) in response to volatility in the pace of government spending caused by elections and the change of government. Growth is expected to accelerate to 4.2 percent in 2018—somewhat lower than the April projection due to uncertainty about the economic program that the incoming government will present. The 2017 forecast for the Solomon Islands has been reduced to 3.0 percent due to lower-than-expected log production and to public financial management problems that have resulted in domestic arrears and are impeding private sector activity.

Most of the small Pacific Island Countries (PICs) continue to have a positive outlook. Expanding tourism, low world commodity prices, high levels of revenue from fishing fees, and rising construction activity support moderate GDP growth rates in most countries. GDP growth in Tonga is projected to pick up to around 3.4 percent in FY2018, driven by construction, a rebound in agriculture, and expanding remittances, as well as growth in the tourism sector. In Kiribati, economic growth is expected to gradually moderate toward its potential, around 2 percent per year. Vanuatu's GDP is expected to grow by 4.5 percent in 2017, up from an estimated 4.0 percent in 2016, supported by implementation of public investment projects. Construction activity should also boost GDP growth rates in Palau and Tuvalu. In contrast, the exit of a major manufacturer of automotive wire harnesses from Samoa is forecast to subtract around 1 percentage point from GDP growth in FY2018, which is projected to be between 1 and 2 percent.

Poverty is projected to continue to fall—the pace of reduction across countries will depend on successful implementation of policies to make growth more inclusive

Poverty in EAP, already at low levels compared to other regions, is expected to continue falling (Table I.B.2). Poverty rates in the region overall and in most EAP countries are expected to continue falling. Recent evidence on the pace of poverty reduction across countries has been mixed. For example, in the Philippines, the latest Family Income and Expenditure Survey shows that poverty fell appreciably faster between 2012 and 2015 than during 2009–12; by contrast, in Indonesia, while poverty has continued to fall, the pace of reduction during the last year was slower than the rapid progress achieved during 2006–10. As most of the extreme poor in EAP continue to live in the larger countries—Indonesia, China, the Philippines, and Vietnam—the pace of poverty reduction in future years will depend crucially on their degree of success in tackling the "last mile" challenge of eliminating extreme poverty. Poverty is concentrated among ethnic minorities in some countries—in Vietnam, for example, ethnic minorities account for 15 percent of the total population but a majority of the extreme poor. These groups should be a key focus of future poverty reduction efforts. China has set the ambitious goal of eliminating extreme poverty during the 13th five-year plan period (2016–20), for which closing the rural-urban income gap by reducing barriers to internal labor mobility and strengthening agriculture will be important. In Indonesia and the Philippines, where income inequality has hampered the pace of poverty reduction, accelerating the pace of poverty reduction will require more attention to tackling its root causes, including inequalities of opportunity (for example, by tackling high child malnutrition rates) and wealth (for example, through making the overall tax system more progressive).

Table I.B.2. Poverty will continue to decline in the EAP region

For US$1.90-a-day (2011 PPP): estimates and projections

Developing EAP				
Year	*2016*	*2017*	*2018*	*2019*
Poverty rate (%)	2.2	1.9	1.6	1.5
Number of poor (millions)	45	39	34	30
Developing EAP excl. China				
Year	*2016*	*2017*	*2018*	*2019*
Poverty rate (%)	5.2	4.6	4.2	3.7
Number of poor (millions)	34	30	28	25

For US$3.10-a-day (2011 PPP): estimates and projections

Developing EAP				
Year	*2016*	*2017*	*2018*	*2019*
Poverty rate (%)	10.9	9.7	8.7	7.8
Number of poor (millions)	221	198	179	162
Developing EAP excl. CHINA				
Year	*2016*	*2017*	*2018*	*2019*
Poverty rate (%)	20.9	19.8	18.7	17.7
Number of poor (millions)	135	129	124	119

Source: World Bank East Asia and Pacific Poverty Portal.
Note: The most recent household income and expenditure surveys vary from 2006 in Kiribati to 2016 in Indonesia and Mongolia. Estimates are extrapolated based on per capita GDP growth and historical estimates of the growth elasticity of poverty. PPP = purchasing power parity.

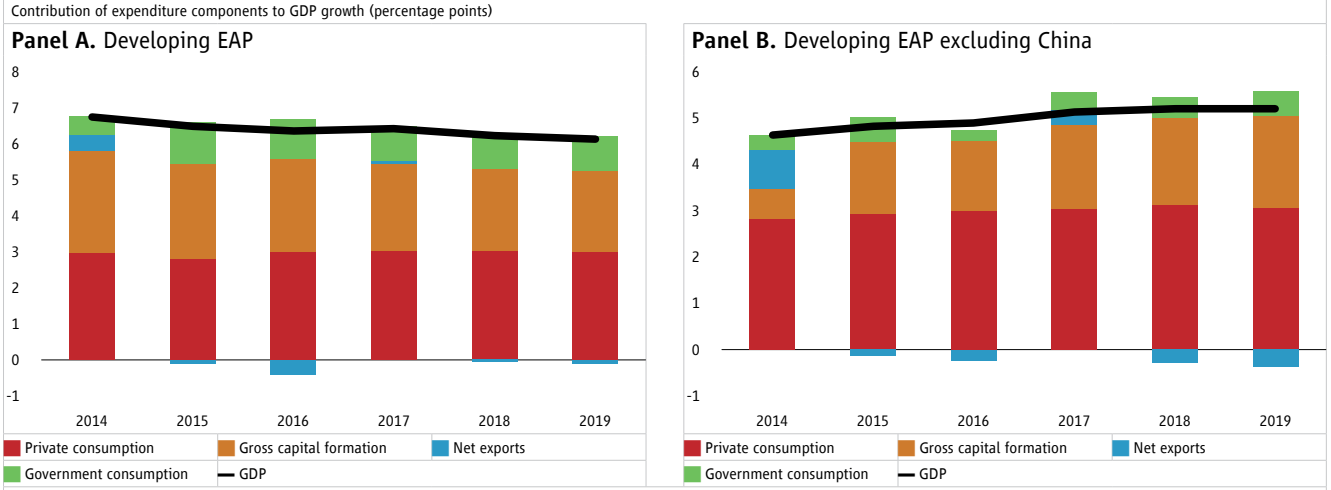
Social protection programs remain important to safeguard poverty reduction against future shocks and slower growth. They will play a key role in Cambodia, where recent floods have devastated homes and the construction industry is moderating, and in Mongolia, whose economy was hit hard by the commodity price plunge and has yet to fully recover. Sustained progress in poverty reduction in China will rely on sustaining reforms in pensions and the hukou (household registration) system to provide equal access to services.

Domestic demand is expected to continue driving growth in the region

Private consumption is projected to remain the primary contributor to GDP growth. Its growth accounts for just under half of developing EAP's growth in 2017 and 2018 (Figure I.B.1). For developing EAP excluding China, private consumption accounts for the majority of regional GDP growth. Private consumption is projected to grow by just under 8 percent per year in real terms in China, and between 5 and 7 percent in the larger ASEAN countries except for Thailand. Among the smaller economies, private consumption growth in Myanmar is expected to exceed 10 percent per year, as rising purchasing power and greater access to markets contribute to rising household wealth. Also notable is Mongolia, where a turnaround in consumption is expected—from a contraction of over 8 percent in 2016 to growth of about the same magnitude by 2019—as the macroeconomic stabilization program proceeds and growth resumes.

Figure I.B.1. Domestic demand is projected to remain the primary contributor to growth of regional GDP…

Contribution of expenditure components to GDP growth (percentage points)



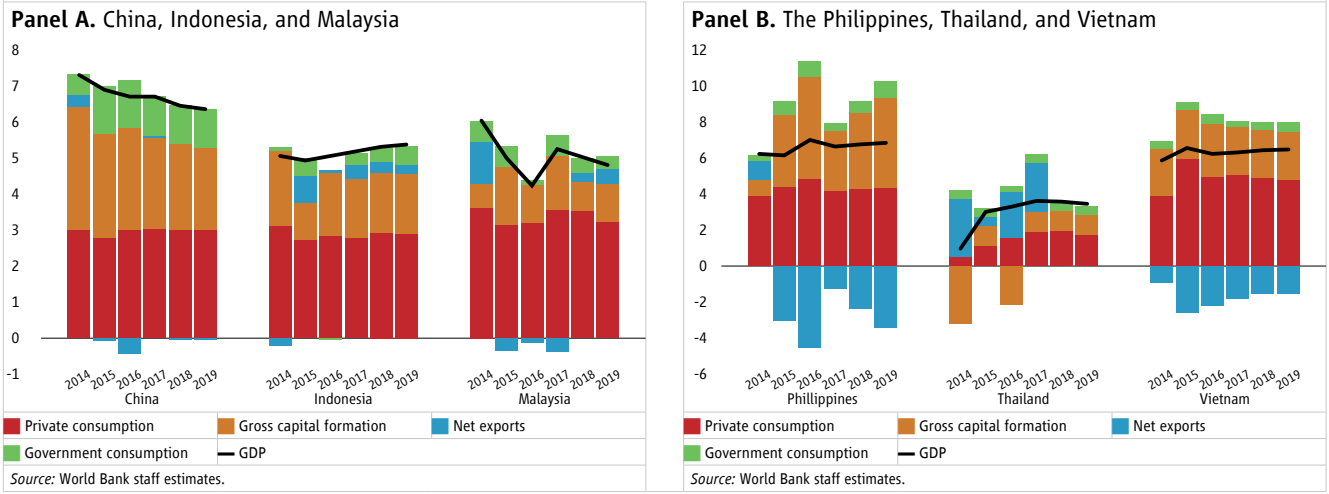
Source: World Bank staff estimates.

Investment spending will also make a significant contribution to the region's GDP growth. In the Philippines, investment (led by public investment) is projected to grow rapidly in 2017–19 and become the largest contributor to GDP growth in 2018–19 (Figure I.B.2 and Figure I.B.3). Real investment spending is also accelerating in Thailand, albeit more modestly (to 4.1 to 4.2 percent in 2017–18 from 2.8 percent in 2016) as the government implements large infrastructure projects. In contrast, investment growth is slowing in China and Vietnam. Among the smaller economies, Mongolia stands out, with increased FDI into the mining sector contributing to the recovery of investment spending in 2017 and beyond, contrasting with its contraction by 20 to 30 percent per year in

2014–15. Work has begun on some transport projects associated with China's One Belt One Road Initiative, such as the high-speed railway connecting Kunming with Vientiane, which is also contributing to investment spending growth in Southeast Asia.

Figure I.B.2. …in most large economies

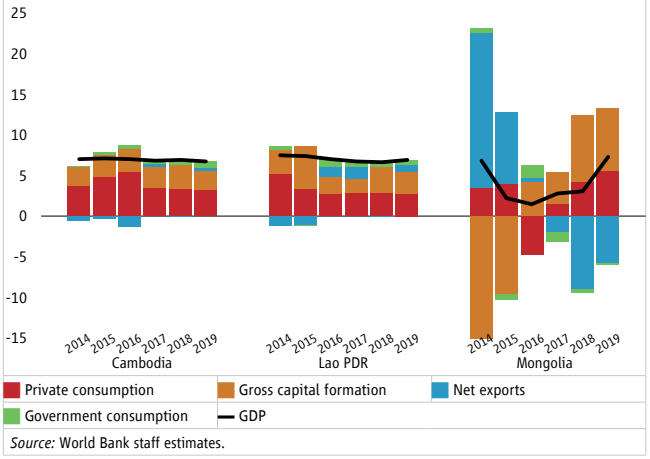
Contribution of expenditure components to GDP growth (percentage points)



Source: World Bank staff estimates.

Figure I.B.3. …and in the smaller economies

Contribution of expenditure components to GDP growth (percentage points)



Source: World Bank staff estimates.

Exports are expected to continue recovering in the region along with the recovery of world trade. Real spending on exports of goods and services is projected to grow rapidly in many countries in the region—by double digits each year in the Philippines and Vietnam, where export-oriented manufacturing is expected to benefit from continued strong growth in China and the economic recovery in advanced countries. Chinese exports are on track to grow by 5.8 percent in 2017, up from 2.7 percent in 2016 and a small decline in 2015. Exports from Cambodia and Lao PDR are forecast to grow by 7.0 and 8.0 percent, respectively, in 2017, and accelerate in 2018 and 2019. New electricity generating capacity is coming on stream in Lao PDR. Net exports are expected to make a stronger contribution to Lao GDP growth as imports fall with the completion of those investment projects (Figure I.B.3). Reflecting their industries' integration into international supply chains and consequently the high import content of many of their exports, real spending on imports of goods and services is also expected to continue growing rapidly in most EAP countries. This effect is pronounced in the Philippines, Vietnam, and Mongolia.

Continued uncertainty about global economic policies and the escalation of geopolitical tensions could jeopardize growth prospects

Rising protectionism and economic nationalism in particular could have a chilling effect on world trade. Recent pronouncements by political leaders in some advanced economies have stoked fears of a retreat from an open, rules-based world economy. Proposals have been floated to introduce discriminatory and restrictive rules of origin into the North American Free Trade Agreement, impose new restrictions on steel and aluminum imports, taxing remittances, and revise business taxation to discourage imports. The likely terms of future access to the U.K. market are becoming cloudier as Brexit negotiations proceed. Some proposed protectionist measures are aimed squarely at EAP countries. More generally, there is a risk that rising economic nationalism will have a chilling effect on world trade, to which EAP countries—especially those specializing in manufactured exports—are disproportionately vulnerable. Effects of new protectionist measures would spread from one country to another through their links in global supply chains.

Geopolitical tensions in the region are rising and could escalate into armed conflict. In September, the United Nations passed additional sanctions on the Democratic People's Republic of Korea in response to its testing of nuclear and missile technologies. Some major powers urge taking tougher measures to stop the country from developing additional nuclear capacity, including potentially military actions.

Escalation of these disputes could have serious economic consequences. Because of the region's central role in global shipping and manufacturing supply chains, escalation of these tensions could disrupt global trade flows and economic activity. The ensuing volatility in global markets would likely hamper EAP countries' growth prospects. The "flight to safety" in financial markets that often accompanies political crises could cause capital to flow out of EAP countries, put pressure on exchange rates, and raise world interest rates. An increase in insurance costs for ships moving cargo in and out of the region would not be unexpected. Concerns about supply disruptions could lead to a spike in world commodity prices.

Financial sector vulnerabilities in many countries could be exacerbated by tightening in global financial markets

Private sector indebtedness has grown across much of the region since the global financial crisis. The nonfinancial sector's borrowing from commercial banks grew to 65 percent of the region's GDP in 2016 from an average of 52 percent during 2010–15. Both the level of private debt and the increase in debt over time in developing EAP exceed those of other regions (Box I.B.2).

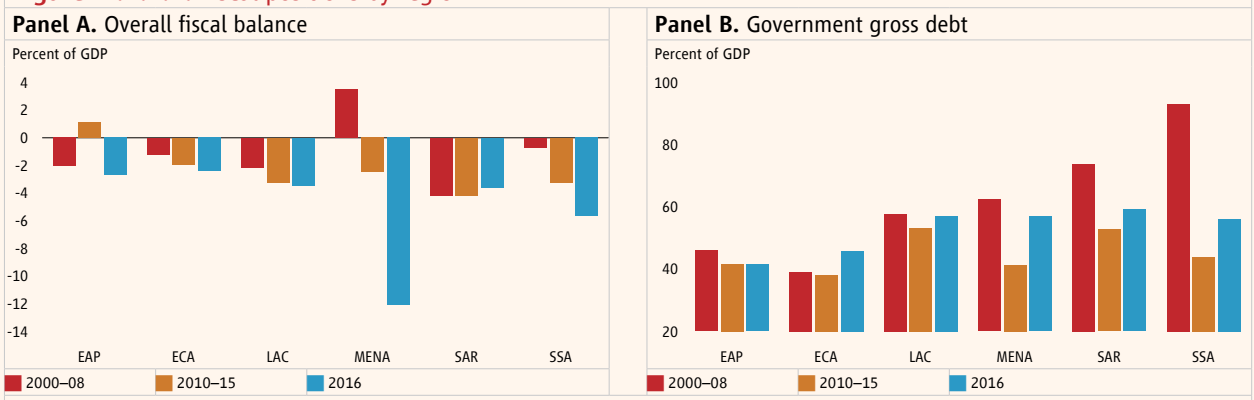
Many banking systems in the region face high leverage and deteriorating asset quality. Nonperforming loans have been rising steadily since 2013 in China, Indonesia, and Thailand, among the larger economies. Rapid credit growth together with a sizable stock of problem loans in Vietnam (broadly defined as reported nonperforming loans [NPLs], bad debts of banks sold to the Vietnam Asset Management Company, and other problem loans) heightens concerns about asset quality and related capital impairment risks in the banking sector. Cambodia also saw an increase in the share of nonperforming loans in 2016, although this has declined somewhat in 2017 (Figure

Box I.B.2. Debt dynamics in developing East Asia and Pacific[1]

Since the global financial crisis, fiscal positions in emerging market and developing economies (EMDEs) have generally deteriorated while private sector debt levels have risen. During 2007–16, government debt in EMDEs, on average, increased from 47 percent of GDP to 53 percent. The deterioration was broad-based as government debt in 2016 exceeded its 2007 level in 71 percent of EMDEs. Over the same period, fiscal balances in EMDEs worsened, on average, by 6.3 percentage points of GDP. Likewise, private sector debt—including households, nonfinancial corporates, and financial corporates—rose to 112 percent of GDP at the end of 2016 from 84 percent of GDP in 2007.

Fiscal positions in developing East Asia and Pacific (EAP) have also worsened, but less than in other regions. On average, developing EAP saw a reversal of fiscal balances from 1.1 percent of GDP in surplus during 2010–15 to a fiscal deficit of 2.7 percent of GDP in 2016 (Figure BI.B.2.1, panel A). The deterioration in fiscal balance was sizable compared to other regions—the second-largest decline after Middle East and North Africa (9.6 percentage points of GDP). Despite this weakening in fiscal stance, deficits in developing EAP remained relatively low, with only the Europe and Central Asia region (2.4 percent of GDP) being lower. By the end of 2016, government debt was 42 percent of GDP in developing EAP, the only region with a decline in debt-to-GDP ratio from the 2010–15 average (Figure BI.B.2.1, panel B). Government debt in other EMDEs was, on average, 55 percent of GDP in 2016. Rapid growth in the region has helped contain the debt level, despite a deterioration of fiscal balances (World Bank 2017a).

Figure BI.B.2.1. Fiscal positions by region



Source: Kose et al. 2017.
Note: Simple averages. EAP refers to developing EAP.

However, indebtedness of the private sector in developing EAP is now much higher than in other regions. In developing EAP, borrowing of the nonfinancial private sector from domestic commercial banks increased, on average, from 52 percent of GDP over 2010–15 to 65 percent of GDP in 2016 (Figure BI.B.2.2, panel A). This ratio varies by country, ranging from around 20 percent of GDP in Myanmar and Papua New

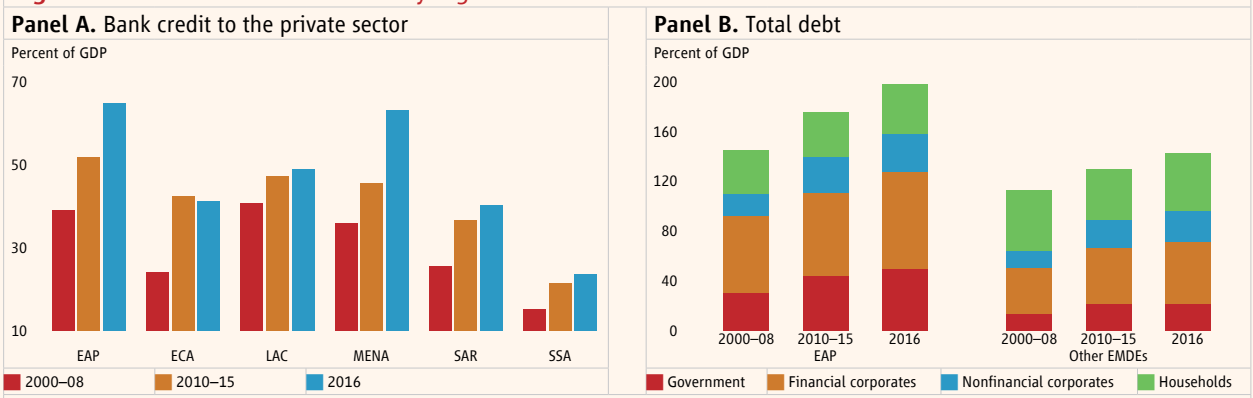
(continued)

1 Prepared by Naotaka Sugawara with the guidance from Ekaterine Vashakmadze.

(Box I.B.2 continued)

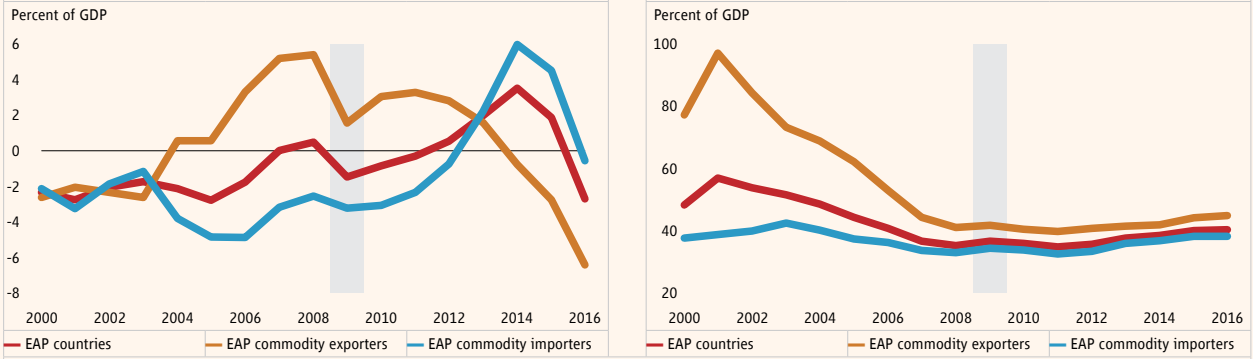
Guinea to more than 150 percent of GDP in China. Total private sector debt in developing EAP was, on average, 158 percent of GDP at the end of 2016, which was higher than in other regions by 62 percentage points of GDP (Figure BI.B.2.2, panel B).

Figure BI.B.2.2. Private sector debt by region



Sources: Institute of International Finance; Kose et al. 2017.
Note: Simple averages. EAP refers to developing EAP.

Figure BI.B.2.3. Debt dynamics in developing EAP



Source: Kose et al. 2017.
Note: Simple averages. EAP refers to developing EAP. The year of global recession (2009) is shaded in gray. Commodity exporters in developing EAP are Indonesia, Lao PDR, Malaysia, Mongolia, Myanmar, Papua New Guinea, Timor-Leste, and Tonga (based on the criteria used in World Bank [2017b]).

The deterioration of debt dynamics has been more pronounced in commodity-exporting developing EAP countries. In commodity exporters, government debt peaked in 2001 as some countries, such as Myanmar, took on sizable debt. However, their debt-to-GDP ratios declined sharply until the eve of the global financial crisis, in part because of strong growth performance, shrinking fiscal deficits, and debt restructuring efforts in the late 2000s. Since the onset of the crisis, debt levels have increased once again, reaching 45 percent of GDP in 2016 (Figure BI.B.2.3, panel A). The postcrisis difference between commodity exporters and importers is highlighted in the evolution of fiscal balances. Fiscal deficits of more than 3 percent of GDP in 2009 in commodity importers turned into surpluses in 2013 and then reached around

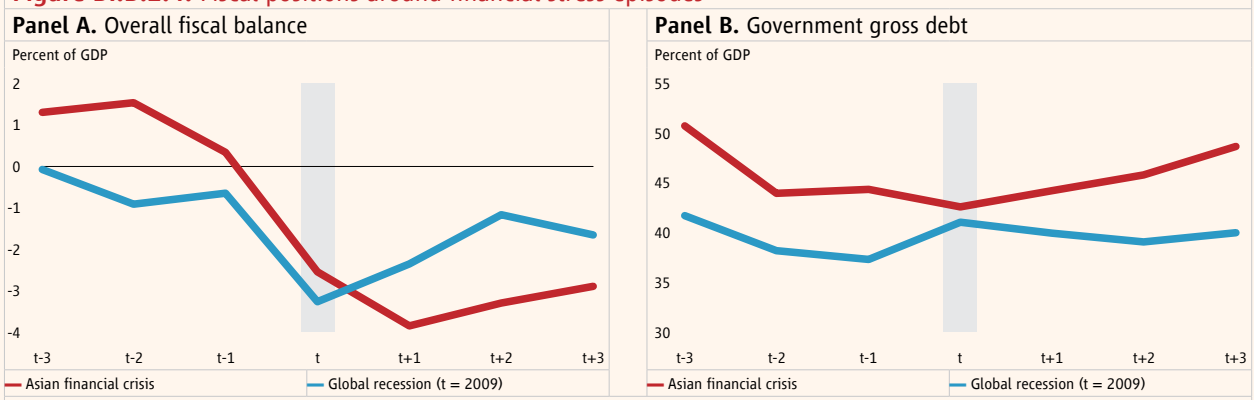
(continued)

(Box I.B.2 continued)

6 percent of GDP in 2014 (Figure BI.B.2.3, panel B). On the contrary, fiscal balances in commodity exporters have worsened year by year since 2010, especially after 2012, partly reflecting the growth slowdown in the aftermath of the commodity price plunge. In 2016, fiscal balances became negative even for commodity importers in the region as a whole.

An analysis of past episodes of financial stress suggests that the postcrisis deterioration in fiscal positions during the Asian Financial Crisis was worse and more prolonged than for the global financial crisis in 2009 (Figure BI.B.2.4, panels A and B).[2] In the runup to the Asian Financial Crisis, fiscal surplus declined to close to zero on the eve of crisis. Since the onset of the Asian Financial Crisis, fiscal deficits kept worsening and reached around 4 percent of GDP in a year and then remained high over the following two years. However, after the global recession in 2009, deficits shrank from 3 percent of GDP to 1 percent of GDP in two years. Government debt increased by more than 6 percentage points of GDP over three years since the Asian Financial Crisis, while debt levels stabilized over the same period after the global financial crisis in 2009.

Figure BI.B.2.4. Fiscal positions around financial stress episodes



Source: Kose et al. 2017.
Note: Samples include Indonesia, Malaysia, the Philippines, and Thailand, where crisis episodes are identified in 1997–98 by Laeven and Valencia (2013). Simple averages. Year *t* refers to the year of onset of financial stress episodes.

During past episodes of natural resource price declines, fiscal positions deteriorated significantly in resource-rich EAP but rebounded quickly as prices and resource revenues recovered. Prior to the past episodes of natural resource price drops, fiscal balances improved in most major resource-rich—energy- and metal-exporting—economies in developing EAP (Figure BI.B.2.5, panel A). In a year following these declines, fiscal balances were weakened in all countries except Indonesia. For example, a fiscal surplus in Timor-Leste was slashed by 10 percentage points of GDP from the year of natural resource price plunges. In Papua New Guinea, a surplus turned into a deficit of 3 percent of GDP. Fiscal deficits also increased in Malaysia and Mongolia. However, within three years after the price declines, fiscal balances were restored

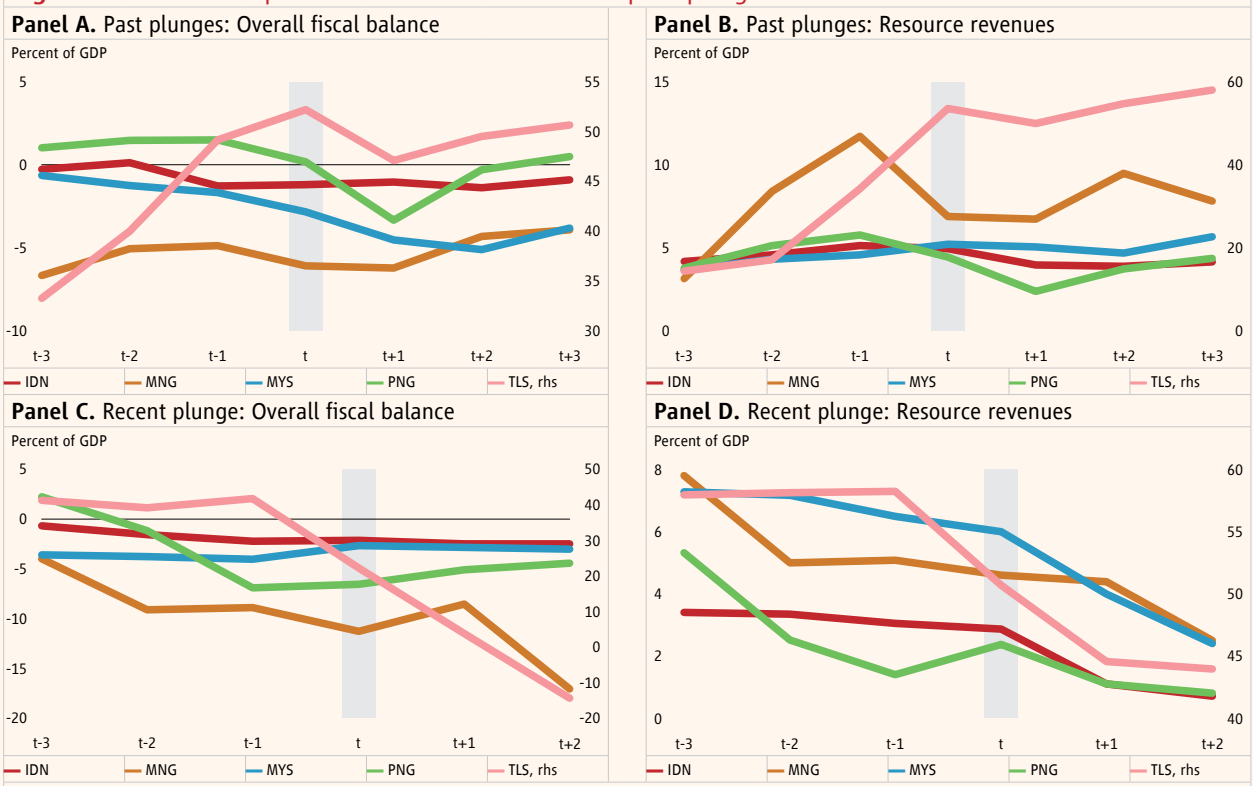
(continued)

2 Recoveries in investment, credit, and house prices were also weaker after the Asian financial crisis than those after other global recessions (Kose 2017).

(Box I.B.2 continued)

to or went above their pre-plunge levels. The improvement of fiscal balances was partly driven by a recovery in resource revenues (Figure BI.B.2.5, panel B). Following a decline immediately after the plunges, resource revenues rebounded to the levels prior to past plunges within three years after the decline.

Figure BI.B.2.5. Fiscal positions around natural resource price plunges



Sources: ICTD/UNU-WIDER Government Revenue Dataset (July 2017); International Monetary Fund; Kose et al. 2017.
Note: Year *t* refers to the year of natural resource price plunges. For resource revenues, data are for central government in all countries except Mongolia (general government).

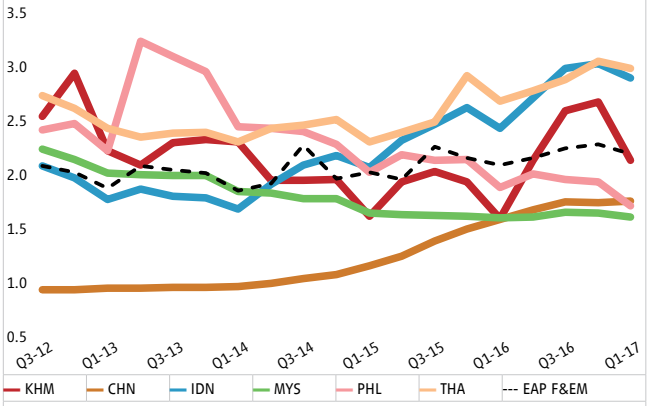
The worsening of fiscal positions has been substantial and persistent during the 2014 sharp decline in natural resource prices. Unlike past price declines, the most recent natural resource price plunge has been associated with a persistent deterioration in fiscal balances. In most cases, resource-rich developing EAP saw fiscal deficits rising even two years into the plunge, while resource revenues became lower than the pre-plunge levels in all countries (Figure BI.B.2.5, panels C and D). In addition, compared to the earlier price declines, these economies entered the most recent one with weaker fiscal positions.

I.B.4). IMF data reveal that the share of nonperforming loans has reached even higher levels in many of the island economies (Table I.B.3).

Lending to the nonfinancial sector has grown in China. Fiscal stimulus after the global financial crisis and again in 2015 sparked rapid growth in credit, and the stock reached 236 percent of GDP by July 2017 (Box I.C.1), an exceptionally high for a midlle-income country. Credit has become more diversified, in addition to growing

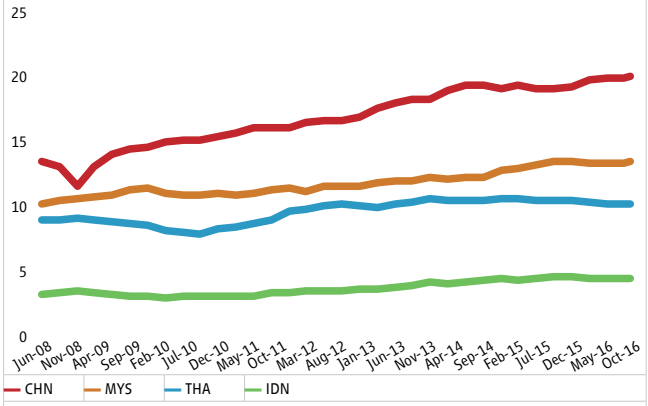
in size, as new financial products are introduced outside the formal banking sector—and outside the scope of traditional prudential regulations (Box I.B.3).

Figure I.B.4. Nonperforming loans are steadily increasing across the region



Source: IMF *Financial Soundness Indicators*.
Note: "EAP F&EM" is an average across frontier and emerging markets EAP economies, including China, Indonesia, Malaysia, the Philippines, Thailand and Vietnam.

Figure I.B.5. Debt service ratio of private nonfinancial sector



Source: Bank for International Settlements.

Table I.B.3. Nonperforming loans are elevated in Timor-Leste and many of the island economies

Bank nonperforming loans as a percentage of total gross loans (percent)

	2012	2013	2014	2015	2016
Fiji	4.2	2.7	2.2	1.4	2.3
Micronesia, Fed. Sts.		2.9	2.6	2.0	
Papua New Guinea	2.2	1.8	2.1	3.1	
Solomon Islands	3.6	7.0	4.7	4.1	3.8
Timor-Leste	30.8	28.0	26.8	32.0	15.3
Tonga	14.4	10.6	10.5	7.6	
Vanuatu	7.8	14.1	10.7	12.3	

Sources: IMF, Global Financial Stability Report; Central Bank of Timor-Leste.

Household indebtedness is growing in several of the large regional economies. It reached 70 percent of GDP in Malaysia and Thailand at the end of 2016, and rose to 44 percent in China from 28 percent in 2011 (Figure I.A.17). Debt service continues to grow as a share of income in the nonfinancial private sectors of China and Malaysia (Figure I.B.5).

Rising world interest rates would aggravate these vulnerabilities. If world interest rates were to rise rapidly, loan defaults and capital outflows from the region could be triggered, undermining the stability of banking systems. Although the pace of interest hikes now appears likely to be more measured, particularly in the United States, than was expected at the time of the last Update, the gradual normalization of monetary policy in advanced economies will ultimately tighten conditions for EAP countries.

Box I.B.3. An overview of shadow banking in China[1]

The People's Bank of China (PBOC) defines shadow banking as "credit intermediation involving entities and activities outside the regular banking system, with the functions of liquidity and credit transformation, which could potentially cause systemic risks or regulatory arbitrage" (PBOC 2013, p.203). This definition is very much along the lines of the description of shadow banking by the Financial Stability Board (FSB), which also points out that "Such intermediation, appropriately conducted, provides a valuable alternative to bank funding that supports real economic activity" (FSB 2013, p.ii). Some have argued that shadow banking in China has contributed to growth by making financial services available to customers who cannot access the formal banking system. At the same time, however, a leveraged shadow banking system can also be vulnerable to bank-like risks to financial stability.

There is no consensus on how to determine the extent of shadow banking activities in China. There have been attempts to quantify these intricate financial constructions from as early as 2011/12. A range of estimates regarding the size and composition of the shadow banking system in China varies widely between 8 and 80 percent of GDP, depending on how shadow banking is defined. This broad spectrum indicates the complexity of how shadow banking activities in China are defined or accounted for (see Table BI.B.3.1).

Table BI.B.3.1. Selected estimates of the size of the Chinese shadow banking system

Source	*Date*	*Percent of GDP*
International Monetary Fund	March 2014	35% of 2014 GDP
UBS	Year end-2013	50–70% of 2013 GDP
Financial Stability Board	Year end-2013	31% of 2013 GDP
Standard Chartered	Year end-2013	8–22% of 2013 GDP
J.P. Morgan	Year end-2013	81% of 2013 GDP
Standard &Poor's	Year end-2012	44% of 2012 GDP

Source: Elliott, Kroeber, and Qiao 2015.

Since the Global Financial Crisis, a large share of the new debt created in China has been bank lending converted into investment assets through innovative financial engineering or has come from nontraditional lenders, both of which have supported the recent rapid growth of shadow banking.[2] Therefore, shadow banking activities in China can be executed by banks and nonbank financial institutions. The activities by banks can be classified into off and on balance sheet. On the one hand, the off-balance-sheet activities of banks include credit provided through bank-intermediated entrusted lending, off-balance-sheet bank wealth management products (WMPs), undiscounted bankers' acceptances, and other credit guarantees. On the other hand, activities on the banks' balance sheets include credit loans disguised under bank investment/interbank repo assets (that is, investment receivables, trust beneficiary rights, and AMPs by insurance/securities companies). In terms of the activities by nonbank financial institutions, these include

(continued)

1 Written by Radu Tatucu and Ana Maria Avilés, with inputs from Nan Zhou, and comments from Haocong Ren, Luan Zhao, and Changyi Shao.

2 For more details, see Griffin and Walsh (2017).

(Box I.B.3 continued)

the credit business of trust companies (trust loans); securities and fund management companies (investment products); insurance companies (nonstandard credit assets); and, to a lesser extent, leasing company/pawnshop businesses. A typical flow involves credit assets being packaged by nonbank financial institutions into special purpose vehicles, which in turn provide financing to end borrowers, including local government financing vehicles, real estate developers, public-private partnership projects, and certain companies in unfavored/overcapacity sectors. By modifying the financing structure, these credit assets are not recognized in banks' loan books, but are accounted as investment assets on the balance sheet or completely moved off the balance sheet.

Since shadow banking activities are outside the formal banking sector, they are under less regulatory scrutiny. Indeed, shadow banking in China is generally viewed as an instrument of regulatory arbitrage that uses nonbank channels to circumvent regulatory and lending restrictions for banks (Elliott, Kroeber, and Qiao 2015). Some of these restrictions include (a) PBOC caps on bank lending volumes, (b) a 75 percent limit on the ratio of bank loans to deposits (removed in 2015), (c) concentration of lending in certain industries or sectors, and (d) costly reserve requirements imposed by PBOC on banks while capital and liquidity requirements are lower for nonbanks.[3] Since the formal banking sector is required to maintain significantly higher capital and liquidity than what shadow banking chooses to carry, activities in the formal banking sector are safer though more expensive. Therefore, shadow banking can offer lower cost and higher returns to a segment of customers willing to try riskier products, for instance, by foregoing collateral protection typically required by a traditional bank. In this context, shadow banking falls outside the scope of public safety nets of deposit guarantees and lender of last resort facilities that protect banks.

China's shadow banking system has been growing rapidly in recent years. As illustrated in Figure BI.B.3.1, the three most representative shadow banking activities, entrusted loans, trust loans, and bankers' acceptances, soared from under 7 percent of GDP in 2005 to over 31 percent of GDP in 2016. WMPs also rose significantly from 11 percent of GDP in 2013 to 31 percent of GDP in 2016, as has their importance in bank resource mobilization, as illustrated in Figure BI.B.3.2. Indeed, the ratio of WMPs to bank deposits increased from 3 to 5 percent in 2008–09, to 17 percent in 2015, confirming that WMPs are increasingly used by banks as a source of off-balance-sheet shadow credit.

While China's shadow banking sector is still small relative to the shadow banking sector in developed economies, it has been expanding much faster than in other emerging markets and differs in its composition. According to the broadest definition of shadow banking adopted by the FSB and the IMF, at the end of 2015, global assets held by other financial intermediaries (OFIs) reached a record US$92 trillion. This represents 28.8 percent of total financial assets and 150 percent of GDP. Moreover, China's OFI assets represent 8.3 percent of global OFI assets or US$7.36 trillion (67 percent of GDP in 2015) and almost

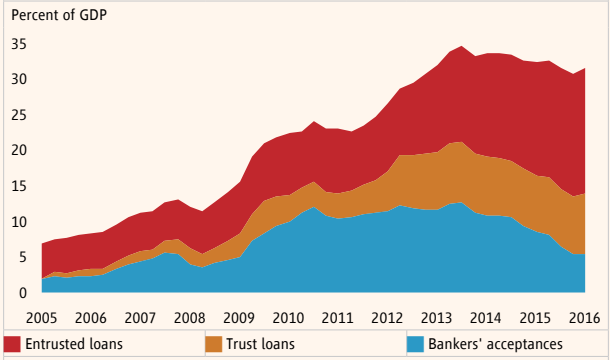
(continued)

3 Amendment to the Law of the People's Republic of China on Commercial Banks, effective October 1, 2015, and approved by the Standing Committee of the National People's Congress.

(Box I.B.3 continued)

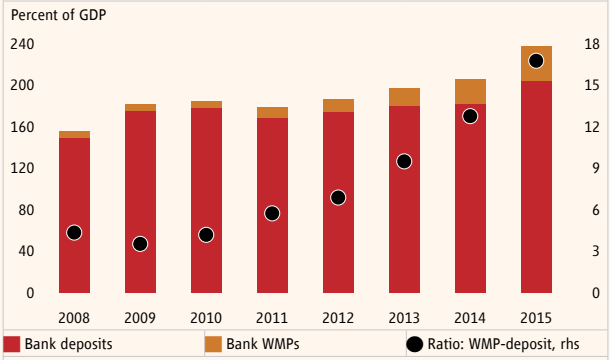
quadrupled between 2011 and 2015—the fastest growth rate among the selected jurisdictions (Figure BI.B.3.3 and Figure BI.B.3.4). Deeper and more mature financial systems, such as the ones in the United States, the United Kingdom, and the Eurozone, have large shadow banking activities in terms of GDP. However, the diverse activities included under OFIs, such as standard collective investment funds, which provide market-based financing, are very different in nature from asset management plans in China, which mainly serve to channel bank credit.

Figure BI.B.3.1. Alternative total social financing instruments, 2005–16



Source: PBC and CBRC.

Figure BI.B.3.2. Bank resource mobilization



Source: PBC and CBRC.
Note: rhs = right-hand side.

Figure BI.B.3.3. Share of global OFI assets for selected jurisdictions

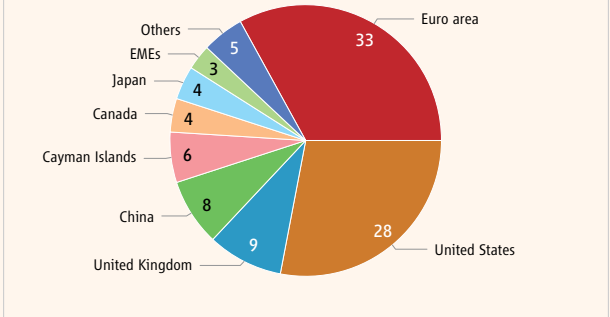
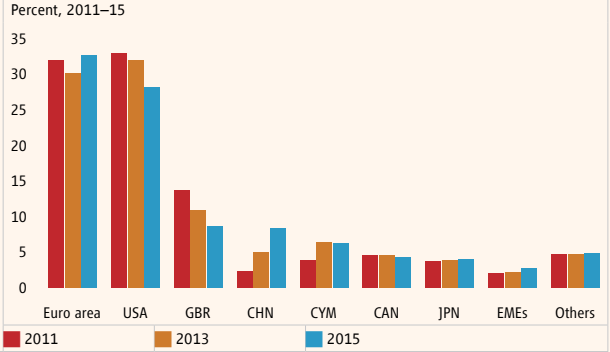


Figure BI.B.3.4. Evolution of OFI shares by jurisdiction over time



Source: FSB 2017.
Note: (a) Also includes captive financial institutions and money lenders. Exchange rate effects have been netted out by using a constant exchange rate (from 2015). Based on time series data included in jurisdictions' 2016 submissions. The evolution of OFI shares may also reflect improvements in the availability of data for some OFI subsectors over time at the jurisdiction level. (b) EMEs include Argentina, Brazil, Chile, India, Indonesia, Mexico, Russia, Saudi Arabia, South Africa, and Turkey. (c) Others include Australia; Hong Kong SAR, China; Korea; Singapore; and Switzerland.

The increased complexity of the shadow banking system has made supervision and risk assessment more difficult, but Chinese authorities have taken steps to contain the risks stemming from these activities. The authorities have adopted several regulatory measures to try to mitigate the major risks associated with shadow banking. In recent months, there has been some indication that the enhanced regulation of shadow banking has somewhat contained the recent rapid growth of WMPs. During the latest

(continued)

(Box I.B.3 continued)

National Financial Work Conference (July 14–15, 2017), the authorities emphasized the need to strengthen supervision as financial services "go back to the origin" of serving the real economy.[4] Thus, there is an expectation that efforts will continue in developing a cohesive regulatory framework for financial services and asset management businesses, as a way of managing the risks associated with shadow banking. A comprehensive list of the recent supervisory measures adopted by the authorities to reduce various shadow-banking-related risks is presented the Table BI.B.3.2.

Table BI.B.3.2. Select regulatory measures aimed to reduce shadow banking risks[5]

July 2014	The China Banking Regulatory Commission (CBRC) sets tighter rules on wealth management products (WMPs); establishment of department for supervising WMPs; new rules on trading.
January 2015	CBRC tightens rules on entrusted loans by disallowing firms' lending of bank loans and prohibiting borrowers from investing in financial assets such as WMPs, bonds, and equity.
September 2015	CSRC intensifies crackdown on less-regulated margin financing activities such as umbrella trusts and private financing.
May 2016	CBRC issues guidance on banks' loan-beneficiary rights transfers, to curb banks' transferring loans off balance sheet without full risk transfer, and to enhance transparency of nonperforming loans on their books. CSRC proposes limits to fund companies in setting up subsidiaries
December 2016	PBOC confirms to include banks' off-balance sheet WMP business into the Macro Prudential Assessment (MPA) framework since 2017.
January 2017	PBOC steps up regulatory oversight on the country's fast growing third-party payment industry, effective from April 17, 2017.
February 2017	PBOC circulates draft rules on taking coordinated approach to tighten supervision on broad asset business in the financial system, which aims to contain spillover risks from rising interconnectedness between formal and shadow banking system. CBRC improves its supervisory information system (namely the Project 1104) with more disclosure requirements for interbank business (e.g. issuance of negotiable certificates of deposit, issuance of WMPs).
March 2017	PBOC launches a centralized clearing platform to separate the payment and clearing operations in the e-payment industry.
April 2017	CBRC issues eight guidelines/opinions and vows to improve regulatory effectiveness and enhance risk control on the banking industry. Banks are required to conduct self-inspections of compliance with laws and regulations, and practices of regulatory arbitrage/improper operations.
May 2017	Banking Wealth Management Product Registration & Depository Center tightens the disclosure rules on banks' WMP asset composition and structure.
June 2017	PBOC, together with other 16 Chinese government ministries and commissions, extend the expected completion day of rectification on e-finance to June 2018.
July 2017	Chinese authorities deliver their refreshed commitment to remain vigilant to financial risks and facilitate reforms to curb leverage after the National Financial Work Conference. A new committee under the State Council will be established to better supervise financial stability and development.

Sources: Moody's Investors Service; Griffin and Walsh (2017).

4 The National Financial Work Conference is a major conference that has taken place every five years in China since 1997. At this flagship event, China's top finance officials discuss ways to improve the country's complex financial system and set future priorities for the development of the financial sector in China.

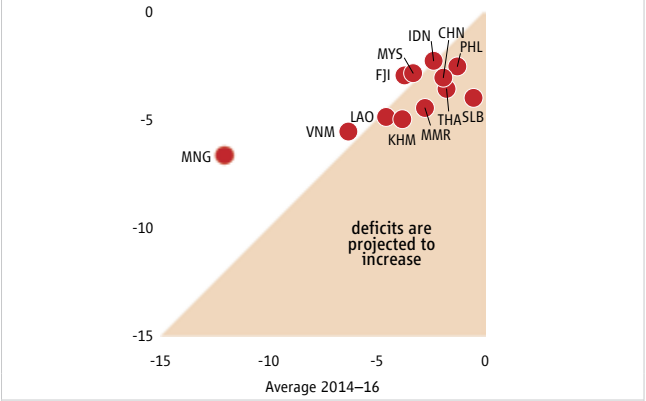
5 This is not a comprehensive list of all measures adopted by regulators to prevent and mitigate the various risks associated with shadow banking.

High budget deficits and rising public debt pose risks for many countries in the region

Fiscal positions deteriorated in many EAP countries during the last decade. As in other regions, many governments in EAP ran large budget deficits to support growth in the face of collapsing world trade during the global financial crisis, reversing a trend of steady debt reduction. Box I.B.2 illustrates that the deterioration of debt dynamics was especially pronounced among commodity exporters that borrowed while world prices were rising, depleting the fiscal buffers they needed after prices plunged.

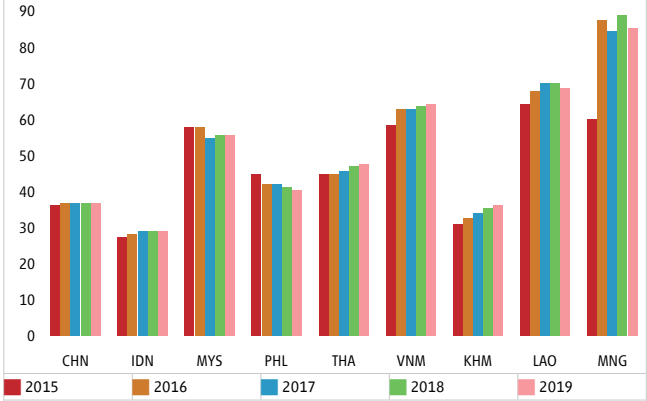
Budget deficits are expected to remain high or grow larger in most countries over 2017–19. Other than in Indonesia and Malaysia, the average budget deficits of large countries during 2017–19 are forecast either to be higher than the average of the previous three years or to remain above 5 percent of GDP (Figure I.B.6). Increases are pronounced in Cambodia and the Philippines and, among the smaller economies, in the Solomon Islands. Vietnam is working to improve fiscal balances, but budget deficits are projected to average 5.5 percent over the medium term, and the composition of spending has become more tilted toward recurrent expenditure (see World Bank 2017c).

Figure I.B.6. Fiscal deficits are high or rising in many countries



Source: World Bank staff estimates.
Note: Data refer to general government fiscal deficit, except for Indonesia, where they refer to central government fiscal deficit, and Cambodia, where they refer to general government fiscal deficit before grants.

Figure I.B.7. Government debt is also high or rising in many countries



Source: World Bank staff estimates.
Note: Data refer to general government fiscal balance, except for Indonesia, where data refer to central government debt. Data for China exclude significant off-budget debts for public investment accumulated since 2015.

These deficits are especially worrying in cases where public debt is also high or rising. It is the combination of the two that poses risks to fiscal sustainability, as this combination narrows governments' policy space for responding to shocks. Mongolia's debt approaches 90 percent of GDP (Figure I.B.7). Lao PDR's debt is projected to exceed 70 percent of GDP in 2018. Only in the Philippines is the debt-to-GDP ratio moving along a steadily declining trajectory. In Vietnam, concerns about debt are amplified by the banking sector's unresolved impaired assets, which could eventually translate into significant public sector liabilities.

The prospect of tighter global financing conditions heightens the need for fiscal discipline. Although monetary authorities in advanced countries have signaled a gradual pace for reducing their balance sheets in the

near term, they remain committed to eventually returning to conventional monetary policy. This implies higher interest rates, which will raise the cost of new borrowing and refinancing debt for countries that have not succeeded in trimming their deficits, leaving them with little fiscal space to undertake countercyclical policies in the event of shocks or to make public investments needed for long-term economic growth and poverty reduction. Some countries are already taking steps toward fiscal consolidation. Malaysia is focusing on achieving efficiency in spending. Vietnam has succeeded in mobilizing more nontax revenue while working to enhance discipline on spending. More dramatically, because more drastic action was needed, Mongolia is implementing a macroeconomic stabilization program that aims to bring the deficit down to 5 percent by 2019 from 17 percent in 2015 through a wage and hiring freeze, reprioritization of capital projects, and additional revenue measures.

The Pacific Island Countries remain vulnerable to shocks, highlighting the importance of savings and stabilization mechanisms

The PICs remain especially vulnerable to external shocks from extreme weather, volatile international markets, or policy changes in larger neighboring countries. Poor households in Tuvalu, Vanuatu, and other countries that depend heavily on home production of foodstuffs are particularly susceptible to weather shocks, for example. Households in countries that rely more on imported food (for example, Vanuatu and the outer islands of Tuvalu) are exposed to volatility in world commodity and currency markets. An unexpectedly rapid rise in world oil prices would undermine current account balances and increase consumer prices, given these countries' total dependence on fuel imports and their remote locations that translate into high transport costs. Nauru's growth outlook is particularly threatened given the uncertain future of operations at Australia's Regional Processing Centre for asylum seekers.

The long-term outlook for several PICs will be influenced by the extent to which elevated revenues from fishing license fees persist, and as importantly by how well these revenues are used. In some PICs, pressing development needs mean that there may be an argument to use part of these revenues to finance current spending on public services, or for public investments that yield a positive social return. However, excessive use of the increased revenues to finance current consumption could undermine long-term fiscal sustainability, especially in countries with already high public debt burdens.

I.C. Policy Considerations

The improved outlook for global growth provides a window of opportunity for developing EAP to continue to reduce key vulnerabilities and strengthen the foundations for sustained and inclusive growth in the medium term. China should continue its policies aimed at deleveraging and strengthening fiscal discipline, including through reforms of state-owned enterprises (SOEs). In several developing EAP countries that are experiencing rapid credit growth or facing a high level of debt, improvements in supervision and prudential regulation can help safeguard economic stability. Global policy uncertainty remains high, strengthening the case for maintaining fiscal buffers sufficient for future maneuver. This need is particularly acute for commodity exporters affected by the fall in commodity prices. Meanwhile advancing tax reforms continues to be a priority to build fiscal buffers. Despite moderate inflation in many countries, most monetary authorities may need to start considering adjusting their accommodative monetary policies, as external financing tightens and inflationary pressures pick up. The improving short-term prospects for most of the region could also prove opportune for governments to accelerate structural reforms to reap the long-term economic benefits of higher productivity and improved competitiveness. Developing EAP countries could benefit significantly from further developing tourism sectors and deepening regional integration to offset the emerging global protectionism. Policies to ensure inclusive growth should involve ensuring economic mobility and security for all, going beyond an exclusive focus on reducing poverty.

Improving prospects for global growth provide an opportunity to address vulnerabilities

The favorable environment for developing EAP countries offers the space to move away from policies aimed at stimulating short-term growth towards measures that address underlying vulnerabilities. Over the last few years, facing weak global growth, many countries in developing EAP had strived to boost growth by loose monetary and fiscal policies, which in some cases has already led to accelerated credit expansion, diminished fiscal space, and overly accommodative monetary policies. Fortunately, firming global economic recovery and a pickup in trade activities in 2017 are likely to keep growth buoyant for developing EAP over the short to medium term. This, absent large shocks (from the realization of the risks discussed in Part I.B), can potentially alleviate the pressures to secure short-term growth, and provide a window of opportunity to tackle the economic vulnerabilities that have built up, which will pave the way for more sustained growth.

Addressing the risks posed by rapid credit growth

China needs to continue its deleveraging effort to tackle rapid credit expansion and the rise of shadow banking. Fiscal stimulus and financial innovation after the global financial crisis helped offset the adverse impact of the crisis. These developments, however, led to increased indebtedness (Box I.C.1), and contributed to the expansion of a sophisticated shadow banking sector (Box I.B.3). The Chinese authorities have highlighted the importance of containing financial sector risks: the State Council Financial Stability and Development Commission was established

to coordinate financial regulatory and monetary authorities, and since late 2016, the authorities have tightened financial regulation and monetary policy to contain the growth of banking sector assets. Strengthening supervision over shadow banking activities should remain a policy priority. The authorities also need to maintain deleveraging policies, although in a measured way to avoid causing an abrupt blow to the financial sector.

Improvements in supervision and prudential regulation can help contain risks in other economies that have experienced rapid credit growth and debt accumulation. Credit growth remains elevated across much of the region, as discussed in Parts I.A and I.B. Myanmar, the Philippines, and Vietnam registered rapid real credit growth and quick accumulation of debt during the last several years. Real credit growth in Cambodia has decelerated since mid-2015, when it was growing by over 30 percent y/y, but remains high. Lao PDR and Malaysia still face high levels of debt. Meanwhile, asset quality has deteriorated—the ratio of nonperforming loans to total loans have been rising steadily in China, Indonesia, Thailand, and Cambodia (Figure I.B.4).[1] A sharp tightening of global financing conditions could heighten these risks. The authorities should strengthen regulation and supervision, and make use of macroprudential regulations to reduce risks to financial stability associated with leveraging (World Bank 2016).[2] Several countries, including Thailand, the Philippines, Vietnam, Cambodia, and Myanmar, have strengthened such measures.[3]

Persistent global uncertainty calls for continued fiscal prudence

Governments in the region need to build fiscal buffers and take measures to control fiscal risks. Even though GDP growth is strong in most countries and the global environment has become more favorable during 2017, conditions could deteriorate rapidly. Public debt levels are high in many countries, and governments face considerable contingent liabilities, including corporate and financial vulnerabilities.[4] Although current conditions make it possible to rebuild fiscal space, most governments are projected to increase their budget deficits. Low energy prices open a window of opportunity to reform energy pricing, including by cutting energy and fertilizer subsidies, increasing fuel taxes, and in some cases moving toward greater cost recovery in electricity (World Bank 2015). SOE reforms, including measures to enhance transparency and governance, would help reduce public financial liabilities. In particular, China needs to continue strengthening fiscal discipline. Financing investments through public-private partnerships and strengthening measures to improve fiscal sustainability for subnational governments and public-benefit SOEs would yield significant gains.[5] Revenue constraints are particularly binding for commodity producers. Low commodity prices have already had a significant impact on public revenue and public finances in Indonesia, Malaysia, Mongolia, Myanmar, Papua New Guinea, and Timor-Leste. Policy makers need to streamline expenditures in line with the countries' development priorities and undertake reforms to improve

1 For instance, Vietnam has a legacy of nonperforming assets in its banking system.

2 A list of measures includes risk-informed pricing, rigorous borrower affordability assessments, supervisory vigilance over underwriting practices and capital adequacy, elevated reserve requirements, higher liquidity ratios or loan-loss provisions, and appropriate loan-to-value and debt-to-income limits.

3 In Cambodia, minimum capital requirements for financial institutions were recently increased, and the required liquidity coverage ratio was raised to 60 percent in September 2016. In Thailand, the authorities have established a Financial Stability Committee to monitor and mitigate systemic risk, and publish financial stability reports. In Myanmar, the recent adoption of the prudential regulations is expected to help manage risks to financial sector stability. In the Philippines, the authorities have enhanced monitoring of real estate and credit conditions, and are addressing data and regulatory gaps related to the real estate sector and rising corporate leverage. In Vietnam, macroprudential regulation of credit markets was strengthened in April, with a focus on real estate.

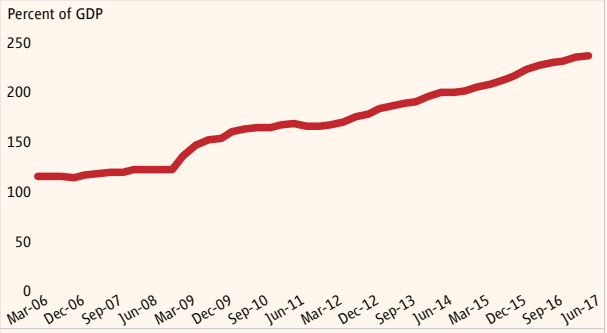
4 Including recapitalization of banks and payout of deposit insurance funds.

5 In this regard, the adoption by the State Council of a new framework to address the current imbalance in revenues and expenditure responsibilities at different levels of government is a positive step in that direction.

Box I.C.1. Deleveraging in China[1]

There is increasing concern about the pace of debt accumulation in the nonfinancial sector since the global financial crisis. Credit growth to the nonfinancial sector averaged more than twice GDP growth during 2008–16, reaching 236 percent of GDP by mid-2017.[2] This increase in debt began with a massive fiscal stimulus carried out in response to the global financial crisis. While some measures were adopted earlier in the decade to phase out this stimulus and better regulate credit growth, the pace of leveraging nevertheless accelerated in 2015–16. However, 2017 could potentially mark a turning point with moderating credit growth and improved financial regulation in China.

Figure B1.C.1.1. Credit to the nonfinancial sector in China



Sources: CEIC; World Bank staff calculations.

The acceleration of credit growth in 2015–16 can partly be associated with a renewed fiscal stimulus aimed at sustaining strong GDP growth during a time of weak global growth. During 2015–16, public benefit SOEs (local government financing vehicles) involved in public investment projects and real estate accelerated their borrowing at a particularly high rate (over 20 percent).[3] Credit growth to the nonfinancial sector surged to 14.9 and 15.9 percent in 2015 and 2016 (up from 14.2 percent in 2014), respectively. Even these numbers underestimate the actual credit growth during these two years. A significant part of the recent expansion in credit to the nonfinancial sector can be associated with shadow finance that is not fully reflected in Total Social Financing data, most notably in the form of wealth management products (WMPs) (see Box I.B.3).

Much of the rapid expansion in credit, commercial bank assets, and wealth management products has been concentrated in the small- and medium-sized city and joint stock banks. These banks grew their asset and credit portfolios at over 20 percent in most years since the global financial crisis, and, since 2010, have been expanding at more than twice the pace of the Big Four national commercial banks. City and joint-stock banks are also responsible for the majority of recent shadow banking activities. Their primary exposure is to the corporate sector, including to public benefit SOEs. As deposit growth in these banks has been modest, small banks have been increasingly reliant on the Peoples' Bank of China (PBOC) and the interbank market for liquidity to support the expansion in their credit. The volume of short-term interbank placements as negotiated certificates of deposit (NCD) mushroomed to RMB 6.3 trillion by end-2016 from

(continued)

1 Prepared by John Litwack and Luan Zhao.

2 This is commonly measured in China as Total Social Financing-Equity+Government Bonds. Total Social Financing includes commercial bank credit to the nonfinancial sector, corporate bonds, and several forms of nonbank credit to the nonfinancial sector.

3 Since the Budget Reform of 2014, the government prefers to refer to former "local government finance vehicles" still involved in public investment as "public benefit SOEs."

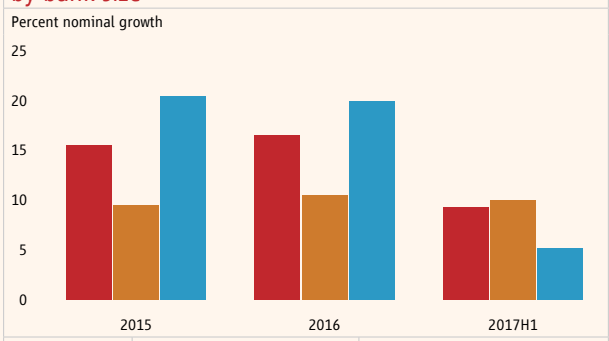
(Box I.C.1 continued)

negligible levels in 2014.[4] At the same time, PBOC claims on banks increased from around RMB 2 trillion in 2014–15 to RMB 8.5 trillion in 2016.

Since late 2016, the authorities have taken several measures aimed at reducing the pace of credit growth. One aspect of this is a significant tightening of monetary policy. Net liquidity injections by the PBOC in the first half of 2017 amounted to RMB 1.7 trillion, compared to RMB 2.9 trillion in the first half of 2016. Interest rates have increased, as well. After the rapid increase in PBOC net claims on banks in 2016 described above, this increase became negligible in the first half of 2017. This policy tightening has been complemented by regulatory measures aimed at alleviating risks in the commercial banking sector. Commercial banks are now obliged by new regulations to limit the amounts of WMPs associated with so-called nonstandard products (that is, other than stocks and bonds) to below 4 percent of assets and 35 percent of outstanding WMPs. An official reclassification of NCDs as interbank liabilities should also limit commercial bank reliance on this and other interbank sources of financing, which will need to be below 33 percent of total liabilities. Other important measures include more comprehensive and frequent monitoring of risks in the banking sector, including those off balance sheet, a strengthening of bankruptcy provisions, the creation of "mutual assistance funds" to mitigate liquidity risks, and the promotion of an active role for creditor committees in restructuring existing problem debts.[5]

While credit to the nonfinancial sector has continued to expand at a rapid pace in 2017, there is evidence that the new monetary and regulatory measures are having an impact on the composition of credit. Total credit to the nonfinancial sector increased at a 15.1 percent annualized pace in the first seven months of 2017, only slightly slower than 15.9 percent in 2016. However, this aggregate measure masks the real progress because it does not include a good part of shadow finance, including much of that associated with WMPs. More importantly, the stock of WMPs associated with commercial banks was 2 percent lower in mid-2017 relative to the end of 2016. This can be compared with an explosive growth of 56.5 and 23.6 percent in the stock of such WMPs in 2015 and 2016, respectively. Mirroring this change, assets in commercial banks in the first half of 2017 have been expanding only half as fast as in 2015–16. The slowdown was particularly sharp for smaller city and joint-

Figure B1.C.1.2. Commercial bank asset growth by bank size



Source: China Banking Regulatory Commission.

(continued)

4 In many countries, negotiated certificates of deposit are longer-term instruments similar to bonds. Since their introduction in China in 2013, however, they have been used by banks largely for short-term (one to three month) interbank placements tied to short-term interest rates. For this reason, financial regulators in China decided in 2017 to reclassify these short-term NCDs from "bonds" to "interbank borrowing."

5 These are funds set up at the local level that allow banks to pool funds for covering potential liquidity shortfalls in individual banks.

(Box I.C.1 continued)

stock banks, whose assets increased at a 5.3 percent annualized rate in the first half of 2017. By comparison, asset growth in large commercial banks moderated modestly from 10.5 percent in 2016 to 10.0 percent annualized in the first half of 2017.

Sustaining the measures aimed at bringing credit growth under control remains challenging. Under the current circumstances, tightening both monetary policy and financial regulations simultaneously, as China did in the first half of 2017, could be associated with potential liquidity risks in the small- and medium-sized banks. As a result, the PBOC has moved to provide a bit more liquidity in the beginning of the second half of the year. Going forward, serious progress in deleveraging will likely need to involve effective resolution measures for individual cases of smaller banks that are now overextended. This is also linked to needed timely and effective restructuring, as well as to addressing insolvency and resolution in the corporate sector. The longer-term impact of the current crackdown on shadow banking and its link to commercial banking remains to be assessed. Past crackdowns on certain specific shadow banking instruments (trust loans and entrusted payments) eventually led to their substitution with new instruments, including various forms of WMPs. Despite the tighter regulatory and monetary policy environment, the incentives in commercial banks to circumvent regulations through shadow banking activities may remain strong, thereby blunting efforts to contain the pace of credit growth.

spending efficiency.[6] Vietnam, facing elevated levels of debt and contingent liabilities from the banking sector, also needs to implement fiscal reforms to build fiscal space.[7] Similarly, Lao PDR should consolidate its spending and strengthen public debt management to address elevated debt and speed up the restructuring of state-owned banks.

Advancing tax reforms will create more fiscal buffers. Growth in tax collection has been moderating in developing EAP, while revenue leakage and collection compliance costs remain high (Box I.C.2). Despite the uneven progress in tax reforms across the region, the broad thrust should continue to focus on broadening the base and reducing the rates of tax collection. Priorities for Malaysia should include broadening the base of the personal income tax, and reducing exemptions from the general sales tax. In the Philippines, the proposed tax policy reforms, with their focus on broadening the tax base, lowering tax rates, and raising excises, represent a step in the right direction.[8] The government of Lao PDR has removed the fuel imports tax and is taking steps to reduce tax leakage. In addition, as e-commerce has become more prominent in a number of countries, one challenge is for the countries to design their major taxes (VAT, income taxes) to capture this potentially large but elusive base. China has put emphasis on equal treatment in taxation of electronic and traditional services. Another area of tax reforms is to consider introducing new taxes. Notably, a VAT was recently introduced in Malaysia and is being

6 In Malaysia, the civil service pension and cutting income-support measures should yield additional fiscal space. Mongolia, with large fiscal imbalances, needs to strengthen fiscal discipline to contain the imminent fiscal risks. Myanmar needs to reallocate spending across and within sectors away from low-priority to high-priority areas to accelerate the delivery of much needed public services. In Timor-Leste, the emergence of large structural deficits demands efforts to prioritize essential investments that raise domestic supply potential and support diversification efforts.

7 The costs associated with the recapitalization of state-owned commercial banks in Vietnam are estimated to be 2.5 percent of GDP.

8 Measures to expand the VAT base, increase fuel excises, tax sugary products, and reduce the elevated personal income tax rates, with an expected net positive impact on revenue, have already been submitted to the legislature. Future measures are expected to include a rationalization of fiscal incentives, a reduction in corporate income tax rates, a simplification of property taxes, and a harmonization of capital income tax rates.

planned in Timor-Leste. A number of new taxes are under discussion across the region.[9] New taxes on capital gains, property, and interest income could be introduced in Vietnam. Vanuatu would benefit from introducing an income tax. Moreover, countries could establish a regional coordination mechanism to avoid harmful tax competition and to address profit shifting and erosion of the tax base. This should be accompanied by tax administration reforms focusing on enhancing efficiency, integrity, and effectiveness, and on reducing administration and compliance costs.

Tightening external financing and rising inflation may accelerate monetary policy adjustment

Developing EAP economies may need to tighten monetary policies as external financing conditions adjust. Despite the appreciation of major currencies against the U.S. dollar during 2017, future tightening of global financial conditions could spark capital outflows and put pressure on exchange rates in the region. In that case, the monetary authorities need to be prepared to tighten their policy stance in response. The financially integrated economies of Malaysia, and to a lesser degree Indonesia, Thailand, and the Philippines, remain relatively more exposed to exchange rate risk with sizable external debt in corporates and banks, although foreign exchange reserves currently appear adequate. In case of another wave of depreciation pressures in China, the Chinese authorities should allow greater adjustment through relative prices, and closely monitor financial sector vulnerabilities as monetary policy further tightens. Some of the smaller economies are already facing significant exchange rate pressures. In Lao PDR, Papua New Guinea, and Myanmar, the monetary authorities need to ensure exchange rate flexibility and tighten monetary policies. Macroeconomic stabilization in Mongolia requires continued tight monetary policy and exchange rate flexibility.

Rising inflation may also require an adjustment in monetary policy. Although inflation remains largely muted across developing EAP, there are signs of a pickup in a few large economies in the region. In China, core inflation has been rising and edged above 2 percent y/y in the middle of 2017. Malaysia and the Philippines also saw gradual acceleration in core consumer prices since mid-2016. Monetary policy should stand ready to respond if and when inflation pressures become more pronounced.

Monetary policy institutions in several smaller economies need to be strengthened (Box I.C.3). Given the increasing short-term stabilization needs that underscore the importance of effective monetary policy going forward, countries need to improve monetary policy transmission by advancing the development of financial markets and relevant institutions. These measures may need to be supported by greater fiscal adjustment.

Accelerating reforms for sustained and inclusive growth

As short-term economic prospects improve, countries in the region should continue to pursue structural reforms that can yield long-term economic benefits. China needs to continue to advance market reforms to unlock its growth potential. The authorities have initiated measures to reduce overcapacity in their state-owned enterprise sectors, which will need to be sustained. Recent measures to regulate shadow banking activities need to

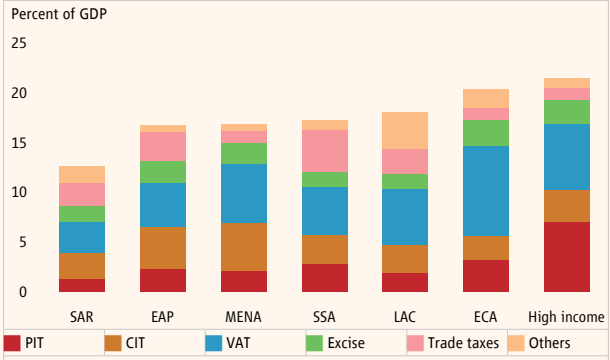
9 These new taxes include an environmental tax in Vietnam, taxation on passive or capital income in Mongolia, an excise on sugar beverages in the Philippines, a wealth and asset-transaction tax in Thailand, new mechanism design for an alternative minimum tax, and a tax on inheritance and gifts in Indonesia.

Box I.C.2. Taxation in developing EAP: Trends, reforms, and policy implications[1]

Trends and main drivers of tax performance in EAP

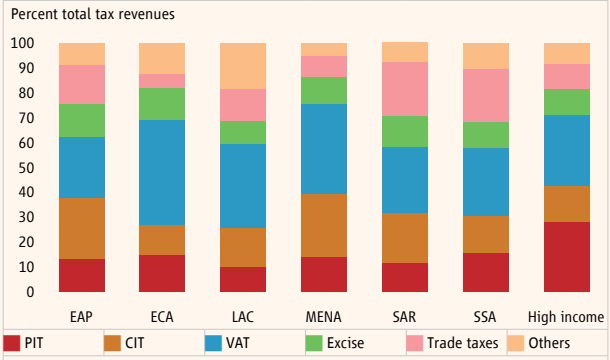
Tax collection in developing EAP has been trailing other developing regions. In aggregate, the region ranks fifth in total tax collection as a share of GDP (16.8 percent) out of six developing regions, only ahead of the South Asia region (12.7 percent) (Figure BI.C.2.1). The revenue intake from the value-added tax (VAT), at 25 percent of total tax revenues, is the lowest level in the region (Figure BI.C.2.2). On average, collection from trade taxes remains high, at approximately 3 percent of GDP or 16 percent of total tax intake.

Figure BI.C.2.1. Tax collection in percent of GDP, by region, 2010–15



Source: IMF revenue database.
Note: CIT = corporate income tax; PIT = personal income tax; VAT = value-added tax.

Figure BI.C.2.2. Tax collection in percent of total tax revenues, by region, 2010–15



Source: IMF revenue database.
Note: CIT = corporate income tax; PIT = personal income tax; VAT = value-added tax.

EAP is a region where tax efforts and the drivers of tax collection are highly diverse across countries. The regional averages as presented mask the vast country-specific differences in terms of total tax intake and the collection by tax type. Figures BI.C.2.3 and Figure BI.C.2.4 show the average tax effort and collection by different types of taxes in select EAP countries during 2010–15. Some contrasts are worth noting. For example, even though Cambodia's total tax intake is low, the country manages to mobilize sizable revenues from the VAT (4.2 percent of GDP, about 35 percent of total tax revenues). The collection of the VAT in total tax intake in Cambodia is comparable to the VAT attained by the small island states of Fiji and Samoa, with the highest overall tax efforts (23.5 and 21.5 percent of GDP, respectively). Taxes on income and profits, in contrast, have been the major drivers that shape the collection pattern in the Philippines and Malaysia.[2] China, Indonesia, Malaysia, and Thailand have managed to shift away from trade taxes, whereas others still rely heavily on that revenue source.

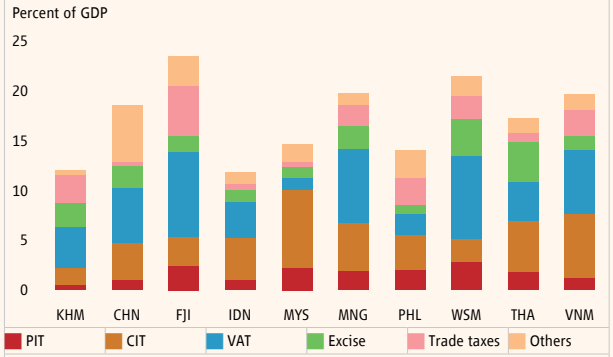
(continued)

1 Prepared by Tuan Minh Le, with valuable inputs from the Bank's country economists in EAP.

2 The analysis of the long-term revenue trend in selected Asian countries during 1990–2015 by the OECD (2017) shows similar results. The study also attributes significant improvement in tax administration to the higher tax revenues in Malaysia. (Notable improvements in tax administration include the transformation in 1996 that makes the tax administration agency a statutory authority, and the shift from administrative to self-assessment, with increased focus on performance and compliance.)

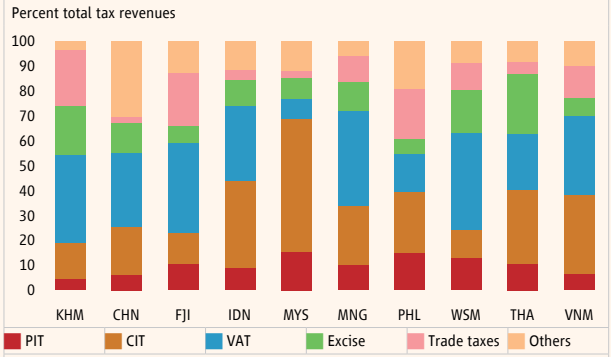
(Box I.C.2 continued)

Figure BI.C.2.3. Tax collection in percent of GDP, select EAP countries, 2010–15



Source: IMF revenue database.
Note: CIT = corporate income tax; PIT = personal income tax; VAT = value-added tax.

Figure BI.C.2.4. Tax collection in percent of total tax revenues, select EAP countries, 2010–15



Source: IMF revenue database.
Note: CIT = corporate income tax; PIT = personal income tax; VAT = value-added tax.

Uneven compliance costs across EAP countries

Average tax compliance cost is relatively high in EAP but with much heterogeneity—both the top performers and low achievers are in the region. Data from the World Bank's *Doing Business* (2017) indicate the contrast in cross-country performance. While Vietnam and Lao PDR are not the countries with the highest total tax burden (as percentage of total profits), they are ranked unfavorably in terms of ease of paying taxes: the number of hours required annually for tax compliance are 362 in Vietnam and 540 in Lao PDR. Such transaction costs are far higher than any regional average and are in sharp contrast to the best performers in the region, including Singapore, where the time required for complying with all taxes is only 67 hours.[3] The distance to frontier—an aggregate indicator of the overall doing business performance—also reflects this intraregion contrast: Hong Kong SAR (China) and Singapore are the closest to the efficiency frontier (99 and 92, respectively), whereas Vietnam performs poorly (49).[4]

Intense tax competition and implications for tax policy and administration

EAP is known as a region of aggressive tax incentives and benefits with multiple objectives. Intraregional tax competition and complex, incoherent tax policies combined make the tax system prone to abuse and lead to depletion of the tax base. In addition, EAP countries increasingly rely on tax holidays, which are regarded as the most inefficient form of tax incentives, plus an extensive list of generous fiscal benefits (for example, reduced tax rates, investment allowance, super-deduction).[5]

(continued)

3 The indicator for EAP is 198 hours (the regional best), while, for comparison, the regional averages are approximately 222 for Eastern Europe and Central Asia, 304 for Africa, and 343 for Latin America and the Caribbean, the highest.

4 The distance to frontier score measures the distance of each economy to the "frontier," which represents the best performance observed on each of the indicators across all economies in the *Doing Business* sample since 2005. An economy's distance to frontier is reflected on a scale from zero to 100, where zero represents the lowest performance and 100 represents the frontier (World Bank *Doing Business* Database 2017.)

5 In the survey of the incentive regimes in 12 countries, 92 percent of the sample have tax holidays, the most prevalent type of incentives in EAP (see World Bank 2015b).

(Box I.C.2 continued)

Globalization and regional integration have a significant impact on taxation, and the EAP region is no exception. Tax policy in other countries and international business transactions have become ever more important for policy makers in EAP in the design and implementation of country-specific tax reforms. On one side, multinational corporations increasingly engage in profit shifting through aggressive tax planning. On the other side, tax authorities in most EAP countries are generally bound by outdated tax laws and treaties, and face numerous challenges, including asymmetric information and limited data access, poor knowledge of the multinational corporations' structure and their complex web of international transactions, and constrained administrative capacity. The fiscal cost from transfer pricing can be substantial, with the estimated revenue lost from developing countries averaging US$100 billion per year during 2002–06 (Hollingshead 2010).

Trends in tax reforms and policy implications

Ongoing and planned tax reforms across EAP countries aim to address the common dual objectives of raising revenues and reducing tax-induced investment hurdles. These dual objectives contain some inherent conflicts from the perspective of policy design. Vietnam and Indonesia, for example, have continued to struggle with setting straight their major objectives, recognizing the need to attain a balance of trade-offs. They are considering a substantial reduction in statutory corporate income tax (CIT) rates, yet are unsure how to design an appropriate approach to streamline the existing complex incentive system that achieves a broader tax base. In addition, policy makers face the long-standing tradeoff between efficiency and equity, and strive to enhance the efficiency of major taxes (CIT, VAT, excise), in a way that does not excessively impact the poor.[6] The political reality separating tax policy and propoor expenditure consideration, commonly observed in EAP, tends to add further complexity and incoherence to the setting of individual tax regimes.

Several common trends in revenue reforms can be observed in the region. Despite the differences in the breadth, depth, rationale, and timetables in country-specific tax reforms, policy makers do seem to agree on certain goals and ways to achieve them, which are reflected in the following policy trends in the region:

- **Balancing between pro-growth and revenue adequacy objectives in tax policy design.** The clear path to achieve the seemingly inherently conflicting objectives is to broaden the base and reduce the rates.[7] Such policy choice has long been part of the overall tax policy reforms in EAP countries, in concurrence with the trend firmly established worldwide since the 1990s. The majority of EAP countries strive to link this strategic reform with the provision of a list of incentives embedded in major taxes

(continued)

6 For example, extending the list of VAT exemptions or nonexport zero ratings to cover certain commodities consumed by the poor would improve the equity but lower the efficiency of the tax and create an additional burden on enforcement and compliance.

7 See, for example, OECD (2010). However the country-specific tax system setting and performance would require a specific policy strategy, as in the case of Indonesia. The country has been cutting CIT rates while at the same time adding more incentives (including extending the scope of tax holidays). As a result, total tax collection has long been stagnant. In such a context, the rate-cutting policy option should only be rationalized if coupled with other revenue-enhancing tax reforms (for example, reforming the VAT and restructuring the special tax regime for micro, small, and medium enterprises).

(Box I.C.2 continued)

(CIT, PIT, VAT).[8] However, this rationalizing of incentives in major taxes is not always easy, politically or economically. In addition, some countries attempt to establish direct and explicit links between fiscal incentives and targeted investments conducive to growth (such incentive regimes include upfront cost reliefs and/or reductions in the operational costs involving R&D investment). Another policy development relates to the emergence of e-commerce; countries have attempted to redesign their major taxes (VAT, income taxes) to capture this potentially large but mostly elusive base. Some countries, like China, in contrast, put emphasis on equal treatment for taxation of electronic and traditional services.

- **Considering introducing new taxes.** A VAT was recently introduced in Malaysia and is being planned in Timor-Leste. Some countries are planning to introduce a new environmental tax (Vietnam), to tax passive or capital income (Mongolia), to design new mechanisms for an alternative minimum tax, and to impose a tax on inheritance and gifts (Indonesia). Such consideration is gaining momentum in countries that face mounting budget pressure and receive donor technical assistance.

- **Embarking on selected actions of the anti-base erosion and profit-shifting (BEPS) agenda.** There is more awareness related to the BEPS-induced revenue risk, and countries in the region have started to engage in selective actions from the BEPS agenda (specifically, transfer pricing, thin capitalization, and controlled foreign company rules). These actions aim to help protect the domestic tax base and alter the behavior of taxpayers in view of increased productivity and fairness in taxation.

- **Establishing regional cooperation to reverse the trend toward harmful tax competition.** Without effective regional cooperation, EAP countries—acting as individual players—would be driven toward continued competition in granting increasingly excessive fiscal incentives. The ASEAN countries have attempted to reverse this trend by initiating a dialogue on improving transparency and exchange of taxation information.

- **Reforming tax administration.** These reforms tends to focus on enhancing efficiency, integrity, and effectiveness in tax administration with the aim of boosting revenues and reducing both administration and compliance costs. As the large tax offices are created to administer large taxpayers, who are more capable of devising and engaging in various BEPS schemes, reforms to strengthen tax offices have increasingly been conducted as an integral part of the overall strategy to address the BEPS mechanisms.

A snapshot survey of 14 EAP countries reveals the most commonly perceived challenges in revenue collection and directions for reforms.[9] The top challenges reflect concerns about stagnation or decline of tax revenues; administrative weaknesses and high compliance costs (both flagged by 86 percent of the survey respondents); and base erosion due to globalization and international tax matters (71 percent of the respondents). Such perception drives the way the reform strategies are being shaped, focusing on revenue

(continued)

8 Some countries (for example, Fiji and Mongolia), however, strive to increase the PIT exemption threshold as an integral part of their overall reform strategy. One immediate impact of such reform is to improve equity by excluding more of the low-income earners (mostly wage earners) from a PIT regime.

9 The survey was conducted with the respective World Bank country economists. The sample consists of the following countries: Cambodia, China, Fiji, Indonesia, Lao PDR, Mongolia, Myanmar, the Philippines, Samoa, Thailand, Timor-Leste, Tonga, and Vietnam. The file is with the author.

(Box I.C.2 continued)

enhancement and improvement in efficiency and equity through restructuring the tax mix and reforming tax administration.[10] Table BI.C.2.1 summarizes the key features of the ongoing and planned tax policy and administration reforms in the 14 countries surveyed.

Table BI.C.2.1. Key challenges, objectives, and strategies for tax reforms in developing EAP[a]

Key challenges	*Objectives of tax reforms*	*Ongoing and strategic direction in tax reforms*	
		Tax policy	*Tax administration*
Insufficient revenue effort or declining tax collection. Increasing risk of base erosion and profit shifting (BEPS) from international business transactions. Weak and inefficient tax administration and high compliance costs.	Enhance or stabilize tax revenue collection. Improve efficiency and equity in taxation by restructure the tax mix and enhance the quality and integrity of tax administration.	• Develop a midterm strategy for tax policy. • Introduce new taxes where justified (e.g., an environmental tax); introduce/revise existing efficient type of taxes (property taxes). **INDIRECT TAXES** *VAT/Excises* • Introduce a VAT to replace the existing sales tax regime. • With the existing VAT regime, unify the rates while extending the scope of excise for selected commodities; broaden the base with rationalizing the exemption list and/or lowering the VAT threshold. **DIRECT TAXES** *Personal Income Tax* • Reduce or rationalize the top marginal rate with consideration to harmonize with corporate income tax regime. • Simplify the rate structure and reduce exemptions. • Rationalize the exemption threshold to serve equity purpose. *Corporate income tax* • Reduce the rate. Simplify the rate structure. • Rationalize special incentives. • Review and reform the micro, small, and medium enterprise special tax regimes toward lowering the cost of compliance and making the regime more in line with the standard income tax regime. • Increase attention to revise the tax policy and regulations to deal with the BEPS (notably, from transfer pricing, controlled foreign company rules, thin capitalization, and extended definition of permanent establishments).	• Strengthen the capacity of tax administration agency (in certain cases, increase the degree of autonomy of the administration). • Enhance transparency, integrity, and efficiency in taxation through an improved legal framework for tax administration. • Reengineer business processes with central focus on voluntary compliance through enhancement of both enforcement and taxpayers service. • Introduce internet banking and use of third-party information sharing and cross-checking. • Design and implement selected actions with regard to BEPs, especially in direct links with establishment, restructuring, or refunctioning of large tax offices.

Note: a. This table only reports the status of tax-related reforms, but does not reflect the institutional view nor the Bank's endorsement for these reforms.

10 While most countries focus on revenue raising, there are a few exceptions in EAP countries. Some focus more on equity and efficiency of the tax system while maintaining revenue neutrality (for example, Fiji, which has retained relatively stable revenue at 32 percent of GDP). (As a side note, in reforming its tax system, Singapore focuses more on growth. Its general sales tax or the VAT was designed to achieve an overall negative tax revenue, and each general sales tax rate increase has been accompanied with a staged reduction in income tax rates.)

Box I.C.3. The effectiveness of monetary policy in developing East Asia and Pacific[1]

The increasing short-term stabilization needs underscore the importance of effective monetary policy in developing EAP countries. Despite the central role it plays for advanced economies in smoothing economic fluctuations, the efficacy of monetary policy in developing economies is perceived to be weaker. The world has entered a period of elevated volatility after the global financial crisis, underpinning the need for short-term stabilization. And in anticipation of the spillovers from the eventual normalization of monetary policy in advanced economies, this need will be even greater going forward. It is therefore important that the countries in developing EAP can use monetary policy effectively to respond to these volatilities.

In recent years, improved policy regimes and operational frameworks, along with greater independence of central banks, have laid the groundwork for monetary policy to play a bigger role in developing EAP. Central banks in developing countries have gained greater political and economic autonomy to conduct independent monetary policy (Arnone, Laurens, and Segalotto 2006). In developing EAP, the results are reflected in improved central bank independence and governance ratings since the 1997–98 Asian financial crisis (Ahsan, Scully, and Wickramanayake 2008). Many EAP economies have transitioned away from foreign exchange pegs allowing for independent monetary policy, and moved toward monetary regimes governed by policy rules (Stone and Bhundia 2004), either toward explicit price targets or implicit price anchors (Morgan 2013). Monetary policy operational frameworks have also improved, as central banks revised the set of instruments and procedures by which they implement, as well as communicate, monetary policy (BIS 2006).

In light of the discussion on monetary policy effectiveness in the region, this box assesses quantitatively a particular channel of monetary policy transmission and identifies its main determinants. Improved policy regimes, operational frameworks, and greater independence of central bank improvements are all factors that could strengthen the monetary policy transmission mechanism.[2] Ultimately, however, the effectiveness of monetary policies and the factors that contribute to it are empirical questions. Based on Mishra et al. (2014), an empirical investigation is carried out by assessing the effectiveness in a major channel of monetary transmission in developing countries—the "bank lending channel" through which monetary shocks transmit to bank lending rates. The analysis is done in two steps. In the first step, a measure for the effectiveness of monetary policy is calculated for each country, which relates to the historical response of bank lending rates to a shock to the monetary base, using a heterogeneous structural panel

(continued)

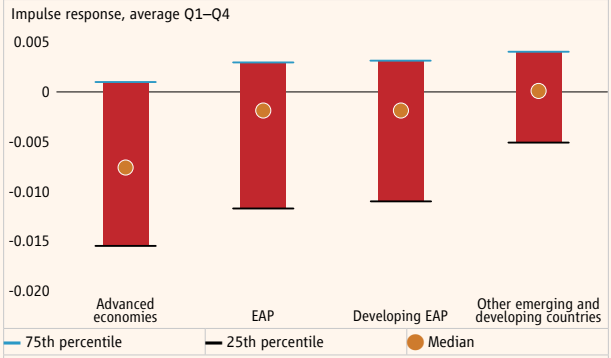
1 Prepared by Antonio M. Ollero, Congyan Tan, and Raju Huidrom. The authors would like to thank Peter Pedroni for the very helpful discussion and the computer codes for the Structural Panel Vector Autoregression model.

2 The monetary policy transmission mechanism is the process by which monetary policy decisions affect the economy in general, acting on intermediate targets and operating through various channels (Mishkin 1995).

(Box I.C.3 continued)

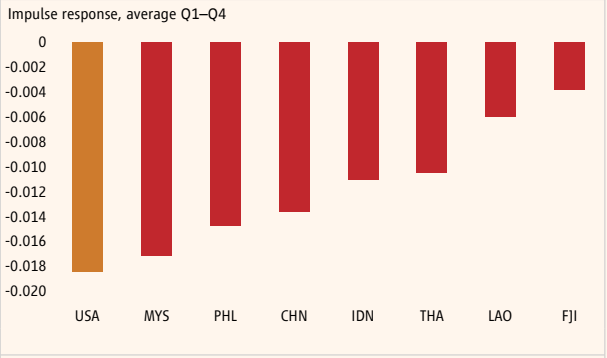
vector autoregression model following Mishra et al. (2014).[3,4] In this framework, the monetary policy is considered more effective if a favorable shock to the monetary base (that is, loosening monetary policy) can elicit a larger reduction in bank lending rates.[5] In the second step, correlations between this measure and a set of contributing factors are established to assess the impact of each factor on the effectiveness of monetary policy transmission.

Figure BI.C.3.1. The median impulse response of the bank lending rate to a monetary expansion is negative, but weaker for developing EAP than for advanced economies



Source: The impulse responses are derived from a Structural Panel Vector Autoregression analysis based on a sample of 132 countries with the time span from Q2 1978 to Q2 2017 (when data are available).
Note: The impulse response reported (vertical axis) is the average of the responses of bank lending rates to a one standard deviation shock to the monetary base, over the first year (four quarters) following the shock.

Figure BI.C.3.2. The impulse responses are negative and strong for Malaysia and the Philippines, and negative but weak for Lao PDR and Fiji



Source: Staff calculations.

Based on this analysis, the overall strength of monetary policy effectiveness in developing EAP lies between the advanced economies and the rest of developing economies, with a predictably wide dispersion across the region. The first-stage analysis shows that a monetary expansion leads to a drop in the banking rate for most economies—a negative impulse response.[6] The median response in developing EAP appears to be stronger (or more negative) than for other emerging and developing countries, but weaker (or less negative) than for the advanced economies (Figure BI.C.3.1). The dispersion across the responses (proxied by the distance between the 25th and 75th quantile) is wide compared to the quantile responses for other emerging and developing countries. The larger economies in developing EAP, many of

(continued)

3 The main innovation in this framework is that it identifies both common and country-specific monetary shocks over a cross-section of countries, and permits heterogeneity in the response of model variables to those shocks. As in Mishra et al. (2014), a Structural Panel Vector Autoregression was applied on the (log) bank lending rates and the (log) monetary base (M0) of 132 countries over 39 years (Q2 1978–Q2 2017). The identification is based on the "long-run restriction" hypothesis that the M0 does not have impact on the equilibrium lending rates over the long run. The monetary policy shocks used in this analysis are the identified shocks to M0. The effectiveness of monetary transmission in an economy is proxied by the impulse response of bank lending rate to a one-standard-deviation increase in the M0 shock (monetary expansionary).

4 The advantage of a structural VAR in panels over a conventional time series structural VAR in a single country analysis is that it "takes into account responses to both idiosyncratic and common structural shocks, while permitting full cross member heterogeneity of the response dynamics" (Pedroni 2013, p180). Specifically, the technique allows for estimating both the responses of individual countries to their own independent monetary policies (in a manner that controls for common global shocks) and their responses to common international shocks that capture global events.

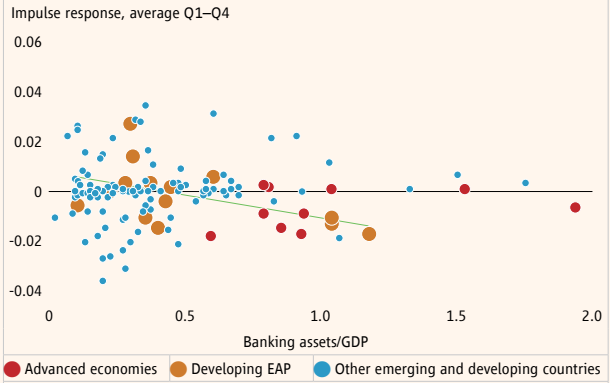
5 The effectiveness of monetary policy is usually assessed in terms of inflation and output outcomes. That said, the long rates determine the cost of credit for households and firms, and eventually affect inflation and output.

6 The developing EAP countries included in this analysis are China, Indonesia, Malaysia, Philippines, Thailand, Lao PDR, Mongolia, Vietnam, Fiji, Papua New Guinea, the Solomon Islands, Tonga, Vanuatu, and Samoa.

(Box I.C.3 continued)

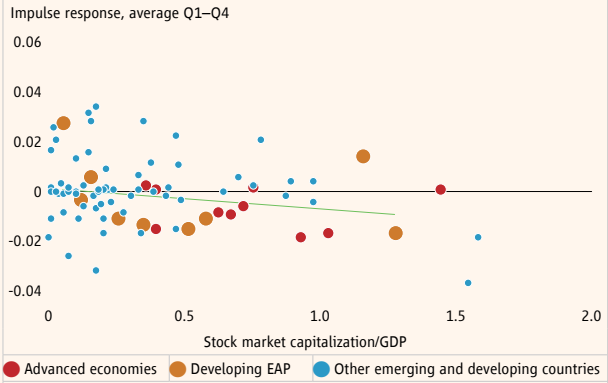
which have improved their policy regimes and operational frameworks, exhibit impulse responses that are negative and reasonably strong compared to that of an advanced economy benchmark such as the United States (Figure BI.C.3.2). Many of the smaller countries show impulse responses that are either negative but weaker or have the reverse sign.

Figure BI.C.3.3. Monetary policy is more effective when the banking system is larger …



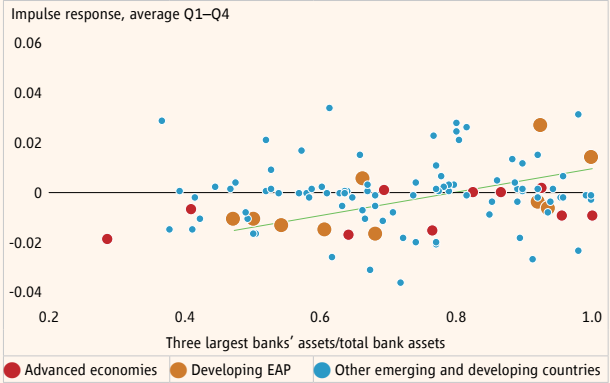
Sources: Cihak et al. 2012; World Bank Global Financial Development Database.
Note: Banking assets data are annual averages, 1980–2015, for 132 countries.

Figure BI.C.3.4. …and deeper with the depth of the stock markets



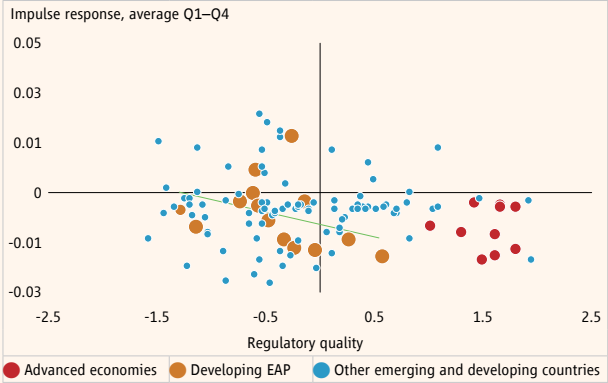
Sources: Cihak et al. 2012; World Bank Global Financial Development Database.
Note: Stock market capitalization data are annual averages, 1980–2015, for 92 countries.

Figure BI.C.3.5. But less effective when concentration in the banking system is higher



Sources: Cihak et al. 2012; World Bank Global Financial Development Database.
Note: Banking concentration data are annual averages, 1996–2015, for 120 countries.

Figure BI.C.3.6. …but strengthens with the quality of the regulatory framework



Source: Kaufmann, Kraay, and Mastruzzi 2009.
Note: Regulatory quality captures perceptions of the ability of the government to formulate and implement sound policies and regulations that permit and promote private sector development. The data give the country's score on the aggregate indicator, in units of a standard normal distribution, that is, ranging from approximately -2.5 to 2.5. Data are annual averages, 1996–2015, for 132 countries.

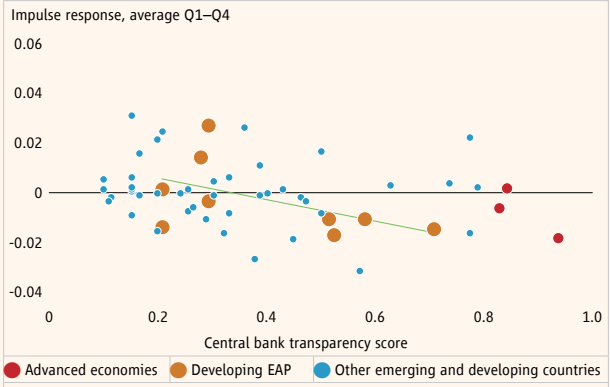
This analysis also identifies a set of contributing factors on the state of financial sectors and the quality of institutions. In countries where banking and capital markets are large and deep, such as China, Malaysia, and Thailand (Figure BI.C.3.3 and Figure BI.C.3.4), the transmission mechanism is strong. Competition in the banking sector also matters, as does the quality of the institutional and regulatory environment within which banks operate. In countries where banking competition is intense and concentration is low, as in Indonesia and Thailand, the lending channel is robust. Banks are incentivized to pass on lower policy rates to borrowers (Figure BI.C.3.5). Moreover, in countries where the operating environment is supportive of private

(continued)

(Box I.C.3 continued)

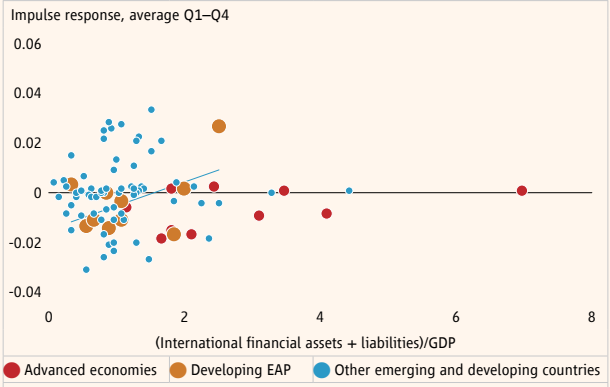
activity, as in Malaysia, banks are more willing to pass on the rate effects of expansive monetary policy to the market (Figure BI.C.3.6). The transparency of the central bank also enhances the monetary transmission mechanism: frequency of communication with the public of key decisions and information, as would be the case in the Philippines and Thailand, allows banks to better interpret the monetary authority's policy intentions and to respond to shocks that signify a change in the policy stance (Figure BI.C.3.7). Meanwhile, high degrees of integration of the economy with international financial markets, as can be observed in Mongolia and Vanuatu, tend to dampen the effect of a monetary policy shock on the lending rate (Figure BI.C.3.8).

Figure BI.C.3.7. The impulse response is enhanced by central bank transparency…



Source: Dincer and Eichengreen 2009.
Note: Central bank transparency scores are annual averages, 1998–2004, for 60 countries.

Figure BI.C.3.8. …but dampened by integration with international financial markets



Sources: Dhungana 2008; IMF, International Financial Statistics; World Bank World Development Indicators; and OECD data.
Note: Financial integration = international investment assets, net of foreign exchange reserves excluding gold, plus international investment liabilities, net of long-term concessional debt (debtors) or net official development assistance (creditors), in percent of GDP. Data are annual averages, 1980–2016, for 100 countries.

The dispersion in the impulse responses reported for developing EAP countries can be explained by the wide variation in the development of the financial systems and the quality of institutions among EAP countries. The 25th and 75th percentiles of the impulse response function for the region are wide apart, which is mirrored by the fact that financial structures and institutional frameworks in developing EAP also vary widely.

These results suggest institutional reforms in several areas for developing EAP to improve the effectiveness of monetary policy. In terms of overall macroeconomic policies, governments need to further strengthen the transparency of their central banks, improve their monetary policy regimes, and refine their policy operational frameworks. More broadly, structural reforms need to be advanced to strengthen their institutional and regulatory structures, improve competitiveness in the banking sector, and deepen their financial markets.

be maintained. Across the region, structural reforms are needed to strengthen competitiveness and productivity. These should focus on building human capital through better education and training, and on improving the institutions and business environment. Specifically, in Indonesia, the government needs to reduce the level of restrictiveness of the negative investment list. In Thailand and the Philippines, where large infrastructure projects are underway, public investment management systems need to be strengthened. Vietnam, facing a similar set of challenges as China, also should address the risks associated with its SOEs and distortions in land and capital markets.

Reform agendas for the smaller economies in the region reflect their diverse development needs. Energy sector reform is an area of reform priority in Cambodia and Myanmar. Public investment management systems need to be developed in countries such as Cambodia and Lao PDR that undertake large infrastructure projects.

Improving trade to address the risks of rising protectionism

Improvements in tourism competitiveness can generate large gains in trade for the region. Tourism has been growing rapidly in developing East Asia over the last two decades and has the potential to provide substantial economic benefits. However, if this growth is not well managed, it could mean challenges for economic, social, and environmental sustainability. For many of the smaller economies in the region, such as Cambodia, Lao PDR, and Myanmar, tourism is one of the main exports and sources of foreign exchange. Based on demographic, economic, and technological trends, and in particular the emergence of China as the fastest-growing tourism source market, growth will likely accelerate in the coming years. To seize this opportunity to develop tourism sustainably and enhance its economic benefits, countries need to address a range of issues, among which ensuring environmental sustainability is the most pressing one. Specifically, in countries with relatively mature tourism sectors, such as Indonesia, Malaysia, and Thailand, safety and sanitation issues are the main challenges; in countries where tourism development is relatively basic, as in the case of Lao PDR, Mongolia, and Myanmar, infrastructure development is the key issue. And for other countries in the region, tourist service infrastructure and the business environment need to be further improved.

Intraregional trade could benefit significantly from deeper regional integration. Opening up markets, harmonizing standards, and streamlining the business environment would significantly boost the productivity of service industries, as well as manufacturing, which relies critically on service inputs (ASEAN Secretariat; World Bank 2015). After the United States withdrew from the proposed Trans-Pacific Partnership, alternative regional platforms have been discussed to advance developing EAP's trade integration. In particular, faster progress on the Regional Comprehensive Economic Partnership (comprising the 10 ASEAN members, China, Japan, the Republic of Korea, Australia, New Zealand, and India) could help sustain the integration agenda, provided it addresses such issues as nontariff barriers.

ASEAN is celebrating its 50-year anniversary in 2017, and, has successfully promoted integration across developing East Asia. ASEAN's on-going integration, including the launch of the ASEAN Economic Community (AEC) in 2015, has significantly reduced tariffs on trade, boosted FDI flows, including with advanced economies in the region, and stimulated intra-regional trade. However, there remains considerable potential for broadening the scope of integration within ASEAN, particularly with regard to liberalizing services trade and reducing nontariff

barriers (World Bank 2015). Recognizing these possibilities, the ASEAN Economic Community (AEC) has developed the *AEC Blueprint 2025* that provides the strategic direction of regional economic integration in ASEAN for the coming decade. Several initiatives have been taken recently including: adoption of an ASEAN Trade Facilitation Framework in 2016, which envisions a 10 percent reduction in trade transaction costs by 2020; the ASEAN Agreement on Movement of Natural Persons (MNP) aimed at boosting labor mobility (World Bank 2017); and the ASEAN Institutional Framework on Access to Finance for the Micro, Small and Medium Enterprises (MSMEs).

Fostering inclusive growth

A new set of policy challenges has emerged in ensuring the continued inclusiveness of growth and development. While the policy mix aimed at achieving broad-based growth was effective in lifting most of those at the very bottom of the income distribution over the past three decades, new concerns are now emerging across the region beyond a focus on reducing poverty. Public perceptions now point to growing concerns among the regions' citizens about high and rising inequality, falling mobility and growing economic insecurity. And some of the long-term trends that supported the region's growth with equity model in the past—such as the demographic transition and rapid urbanization—need to be better managed.

Governments in the region can adapt to these changing needs by raising the bar on policy priorities. Policies aimed at advancing inclusive growth should involve ensuring economic mobility and security for all, going beyond the primary focus on reducing poverty. Such an emphasis will entail tailoring poverty reduction interventions to address the heterogeneity of extreme poverty at the country level, fostering mobility by closing gaps in access to jobs and services and seeking to improve the quality and productivity of those jobs, and increasing economic security by putting in place mechanisms that can help reduce households' exposure to risks while enhancing their ability to cope with the consequences of shocks when they occur.

An agenda for the Pacific Island Countries

In the Pacific Island Countries (PICs), reforms in several areas could provide significant opportunities over the medium term. Tourism, labor mobility, fisheries, and the knowledge economy are all sectors in which policy and institutional reforms over the medium term could allow the PICs to exploit economic opportunities. In turn, these reforms could lead to significantly higher incomes and employment by 2040. The higher government revenues from increases in fishing license fees and the broadening of the tax revenue base, if combined with improvements in the quality of public spending, could help PIC governments finance significant improvements in human development outcomes (Box I.C.4).

Tourism also holds considerable potential to raise incomes and generate employment in the PICs. Comparative advantages of resource endowments and geographical limitations make tourism development a unique opportunity for these countries. To seize this opportunity for long-term development, the PICs need to work on several fronts, including aggressively targeting the Chinese visitor market, engaging more directly in the rapidly-growing Pacific cruising product, expanding the high-end resort market, and capitalizing on the aging

population in key origin markets by developing a long-stay visitor opportunity for retirees. With appropriate reforms and additional investments, estimates from the World Bank's *Pacific Possible* report indicate that the PICs could attract an additional 1 million annual arrivals to the region by 2040 above and beyond a business as usual scenario. This would generate additional annual spending of more than US$1.6 billion, and create more than 110,000 additional jobs.

Box I.C.4. Enhancing human development by spending more and spending better: What's possible in the Pacific?[1]

The World Bank recently launched a report, titled *Pacific Possible*, assessing transformative opportunities to boost economic growth in the Pacific over the next 25 years.[2] *Pacific Possible* (PP) quantitatively assesses the extent to which exploiting available economic opportunities—in tourism, labor mobility, fisheries, and the knowledge economy—could lead to significantly higher incomes, employment, and government revenue in 2040 in each of the Pacific Island Countries (PICs).[3] For each of these opportunities, an "opportunity scenario" is developed in which the PICs and their development partners intervene through policy changes to realize the potential gains. It is then possible to estimate the potential impacts on per capita incomes, employment, and government revenue by comparing the opportunity scenario with the baseline projections that typically reflect historical trends.

This box focuses on how taking advantage of these opportunities could affect long-run spending and human development outcomes. PP interventions would expand PIC revenues, which could help bolster fiscal buffers while also enabling their governments to finance increased spending on public services. If spent well, these increases in public spending have the potential to significantly improve human development outcomes.

***Pacific Possible* opportunities boost government revenues in two ways.** First, PP fisheries interventions are projected to directly increase the fishing license fees accruing to PIC governments. Second, interventions in each of the four areas—tourism, labor mobility, fisheries, and the knowledge economy—are projected to boost GDP and hence the tax base in each of the PICs, which leads to higher revenues (assuming the tax share of GDP remains unchanged). In percentage terms, the largest revenue increases in 2040 are in countries that stand to gain the most from higher fisheries income, namely Kiribati, the Federated States of Micronesia, and Tuvalu (Figure BI.C.4.1). Nevertheless, the potential revenue increases (relative to current baseline projections) are also substantial in other countries—including Fiji, Samoa, Tonga, and Palau—

(continued)

1 Prepared by Kim Alan Edwards.

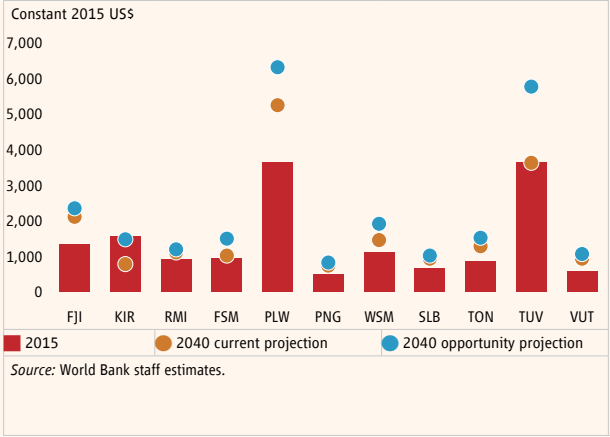
2 The material in this box is drawn substantially from "Financing Pacific Governments for Pacific Development," *Pacific Possible* Background Report No. 7, World Bank, Washington, DC, 2017d.

3 The countries included in this study are the Federated States of Micronesia, Fiji, Kiribati, the Republic of Marshall Islands, Palau, Papua New Guinea, Samoa, the Solomon Islands, Tonga, Tuvalu, and Vanuatu. For more details, see also "Box I.B.4 What is Possible in the Pacific in 2040?" in the *World Bank East Asia and Pacific Economic Update April 2017*, World Bank, Washington, DC, pp. 50–53.

(Box I.C.4 continued)

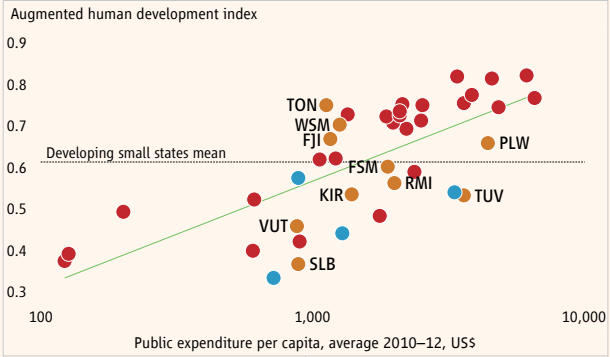
highlighting the role that PP interventions can potentially play as drivers of government revenues as well as economic growth.

Figure BI.C.4.1. Projected revenue per capita



Source: World Bank staff estimates.

Figure BI.C.4.2. Relationship between human development and public spending per capita in developing small states



Source: World Bank staff estimates.

By boosting government revenues, the PP interventions can potentially help PIC governments finance increases in public expenditure. According to the Augmented Human Development Index (AHDI),[4] which incorporates health, education, and infrastructure provision, all the PICs apart from Fiji, Palau, Samoa, and Tonga currently have human development outcomes that are lower than expected given current per capita levels of government spending (Figure BI.C.4.2). However, after controlling for geographic constraints associated with remoteness and internal dispersion, the "efficiency" of public spending in most PICs—as measured by the development outcomes associated with a given level of public spending per capita—appears to be close to, or better than, that in other developing small states (Table BI.C.4.1, column 4).[5] At the same time, human development indicators remain relatively low in several PICs due to low levels of public spending (column 5) and/or geographic constraints (column 3), implying that increasing public expenditure could help improve development outcomes. The PP interventions improve the capacity of PICs to finance such increases in public expenditure.

(continued)

4 The Augmented Human Development Index is based on the United Nations Development Programme's Human Development Index but excludes the income component and adds an infrastructure component.

5 Under this definition, spending "efficiency" will depend on factors that governments can work to improve (for example, improved public financial management or increased allocative efficiency), but also factors that may lie outside government control (for example, geographic characteristics, but also linguistic diversity, history of conflict, and social and cultural factors).

(Box I.C.4 continued)

Table BI.C.4.1. Current human development outcomes in the PICs

			of which		
	Index of human development	*Difference from small states average*	*Explained by geography*	*Explained by other sources of spending inefficiency**	*Explained by shortfall in public spending***
Tonga	0.75	0.137	-0.035	0.205	-0.033
Samoa	0.704	0.091	-0.001	0.112	-0.02
Fiji	0.668	0.055	-0.008	0.091	-0.028
Palau	0.659	0.046	-0.052	-0.022	0.12
Micronesia	0.602	-0.011	-0.059	0.022	0.026
Marshall Islands	0.562	-0.051	-0.074	-0.009	0.032
Kiribati	0.534	-0.079	-0.071	0.001	-0.009
Tuvalu	0.532	-0.081	-0.126	-0.052	0.097
Vanuatu	0.457	-0.156	-0.016	-0.08	-0.06
Solomon Islands	0.368	-0.245	-0.005	-0.18	-0.06
Papua New Guinea	0.332	-0.281	0.004	-0.182	-0.103
Small states average	*0.613*				

Source: World Bank staff estimates.
Notes: * relative to the small states average. ** the deviation from the small states average index of human development that is associated with a shortfall in public spending. A negative (positive) value indicates more (less) spending would be required, assuming small states average geographic constraints and spending efficiency (i.e. assuming the PICs moved to the regression line estimated in Figure B).

For many PICs, the baseline GDP projections imply that governments would find it difficult to finance the levels of public spending necessary to meet aspirational human development targets.[6] These estimates of public expenditure are shown in Figure BI.C.4.3. If *Pacific Possible* opportunities were fully exploited, however, the public spending required in 2040 to meet these targets would fall as a proportion of GDP, due to the associated increases in national income. The direct revenue impacts of fisheries interventions will also provide more fiscal space to finance these expenditure needs in some cases.

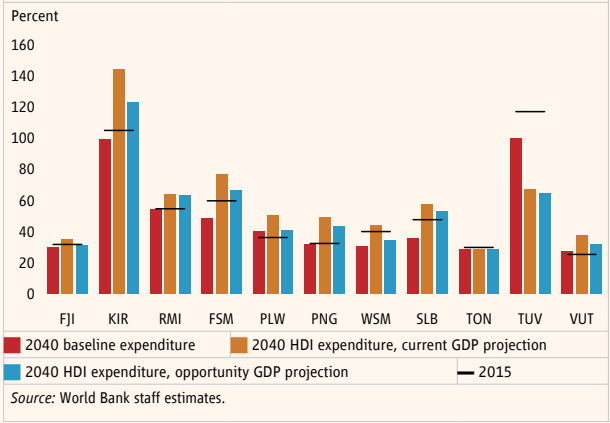
Over the next 25 years the PP interventions could potentially have a significant impact on the PICs' ability to finance the public spending needed to achieve their human development targets. Figure BI.C.4.4 shows fiscal balances in 2040 under the human development expenditures scenario, again under both current GDP and revenue projections and PP projections. While the human development expenditures scenario would give rise to unmanageable fiscal deficits in 2040 for most of the PICs under current (baseline) growth projections, PP interventions could have a pronounced positive impact in some cases, including in Federated States of Micronesia, Vanuatu, Kiribati, and Tuvalu, as well as in Palau and Samoa. Nevertheless, budget deficits are projected to remain unsustainably large in the North Pacific countries and in Papua New Guinea, the Solomon Islands, and Vanuatu, even assuming PP growth dividends. This suggests that additional measures to increase domestic revenues and/or aid may be required to finance development-enhancing public spending in these countries over the next 25 years.

(continued)

6 The target AHDI is set at the developing small states average (0.613). In those PICs where the AHDI is already above the developing small states average (Tonga, Samoa, Fiji, and Palau), the target is set equal to the current AHDI of the highest-performing PIC on this measure (0.75).

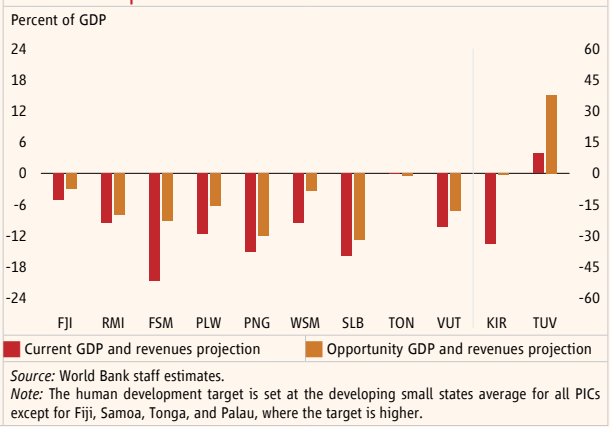
(Box I.C.4 continued)

Figure BI.C.4.3. Projected expenditures as a share of GDP



Source: World Bank staff estimates.

Figure BI.C.4.4. Projected fiscal balances as a share of GDP (2021–40 average) given human development scenario expenditures



Source: World Bank staff estimates.
Note: The human development target is set at the developing small states average for all PICs except for Fiji, Samoa, Tonga, and Palau, where the target is higher.

In addition to increasing the quantity of spending, measures to improve the quality of public spending will be of critical importance in several PICs.[7] Although the estimates suggest that spending is relatively efficient in most PICs, in a number of countries—including Papua New Guinea, the Solomon Islands, and Vanuatu—failure to improve the efficiency of public spending would likely mean that the human development targets would remain well out of reach, even if spending levels were to increase significantly.

7 The above analysis assumes that between 2015 and 2040, countries in which spending is less efficient (controlling for geography), are able to boost the efficiency of their public spending to be in line with the small states average.

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Part II. Medium-Term Development Agenda

II.A. Raising the Bar: From Reducing Poverty to Fostering Inclusive Growth in East Asia And Pacific[1]

Developing East Asia and Pacific is now a region made up entirely of middle-income countries, thanks to rapid growth. As a result, most countries have also seen a dramatic reduction in poverty. While eliminating the remaining pockets of poverty must remain a priority, data on public perceptions point to increasing concerns among the regions' citizens about high and rising inequality, falling mobility, and growing economic insecurity. Some of the long-term trends that had supported the region's successful growth with equity model in the past—such as the demographic transition and rapid urbanization—also now need to be managed so as not to turn into challenges.

Against this backdrop, this section explores a new characterization of inclusive growth—defined as fostering upward economic mobility (improving one's lot in life) and economic security (being able to hold onto gains made) for all, in addition to eliminating extreme poverty—which can form the basis for a new social contract in middle-income countries such as those in East Asia and Pacific. Such a concept of inclusive growth goes beyond a binary view of societies in terms of the poor and the nonpoor, and seeks to address the needs and aspirations of all citizens. Central to this analysis is the identification of different economic classes, which can allow governments to address the concerns of their increasingly diverse populations.

Introduction

Developing East Asia and Pacific (EAP) is now a region of middle-income countries. This transformation has been underpinned by the rapid recovery of most economies in the region from the Asian financial crisis in the late 1990s and their resilience to the global financial crisis a decade later. While middle-income status masks the range of income levels across the region—from over US$12,000 (GDP per capita) in Malaysia to about US$1,100 in Cambodia—it also highlights the tremendous progress that has been made across the region in reducing extreme poverty. In 1990, developing EAP, with almost 1 billion poor people (that is, people living below US$1.90 a day in 2011 purchasing power parity [PPP] terms), accounted for over half of the world's extreme poor. A quarter of a century later, this number had fallen to about 50 million and made up less than 7 percent of the world's extreme poor (Figure II.A.1). While there remain countries such as Lao PDR, Myanmar, Papua New Guinea, and Timor-Leste, where the incidence of extreme poverty remains relatively high, it is now much less significant in much of the region.

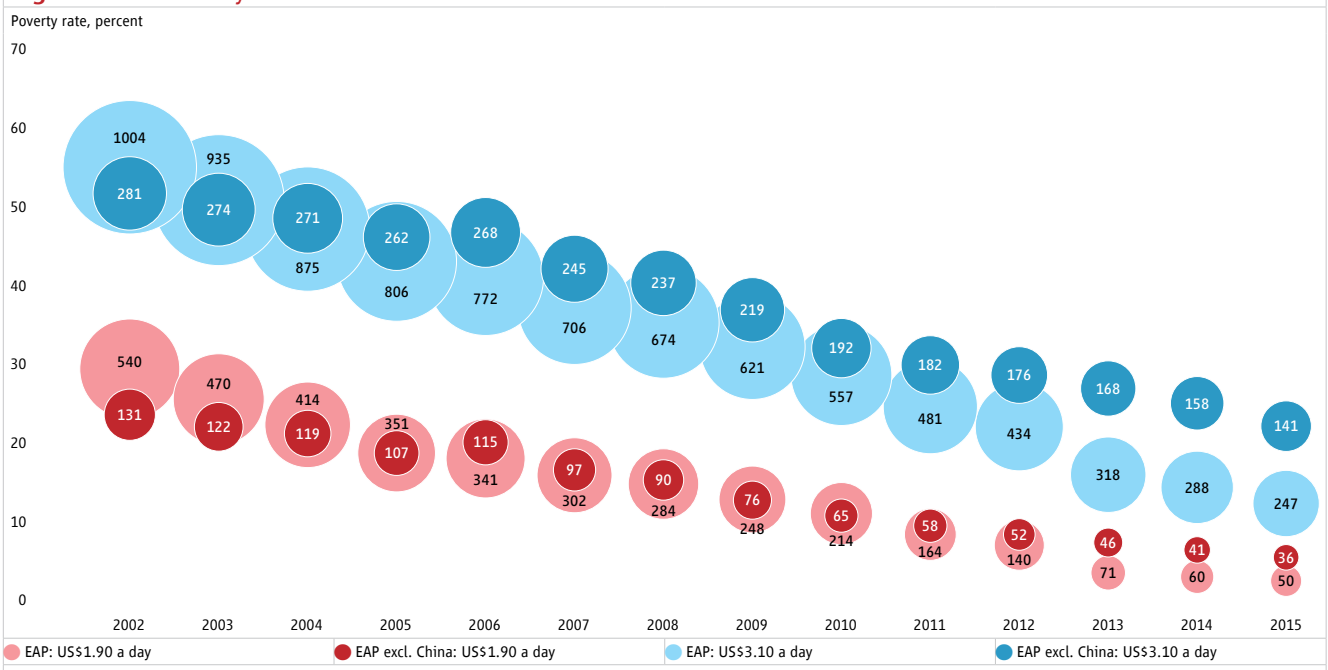
The region's success in reducing poverty and its evolution into a middle-income region have led to the emergence of a new set of policy challenges in ensuring that growth and development remain inclusive. While the past policy mix aimed at achieving broad-based growth—the East Asian "growth with equity" development model—was effective in lifting most of those at the very bottom of the income distribution, new concerns are emerging across the region making it necessary to go beyond a focus only on reducing poverty. Inequality is high[2] or rising in most countries in the region, particularly the large ones. Market-oriented reforms to take advantage of

1 Prepared by Caterina Ruggeri Laderchi, with special thanks to Sudhir Shetty, Salman Zaidi and Nikola Spatafora.

2 In line with much of the literature, inequality is defined as being high if the Gini coefficient exceeds 40 percent.

greater integration, and technological change, have brought prosperity to many, but also rising inequality between workers with high and low skills, between urban and rural areas, and in countries such as China and Vietnam, between coastal areas and remote inland locations (Kanbur, Rhee, and Zhuang 2014). An extreme manifestation of this trend is the sense that wealth at the top end of the distribution is becoming increasingly concentrated in many countries, and at a pace that is faster than in other regions of the developing world.

Figure II.A.1. Poverty trends 2002–15



Source: World Bank EAP Poverty Portal.
Note: The most recent household survey used for actual estimates vary from 2006 in Kiribati to 2015 in the case of Indonesia. Estimates prior to 2015 are: (i) derived directly from household survey data; (ii) China 2013 is a survey break and data are not comparable with previous years (iii) interpolated between existing surveys; or (iv) extrapolated based on per-capita GDP growth and historical estimates of the growth elasticity of poverty (GEP), but China, Papua New Guinea and Pacific Island countries based on neutral growth distribution. For 2015 onwards, estimates are projected based on projected per-capita GDP growth and the GEP, and are hence preliminary and subject to revision.

Looking ahead, some of the same factors that had supported the growth with equity model and the wave of prosperity that it brought with it could be turning into challenges. Aging and rapid urbanization are particularly important factors. An aging population could slow growth and lead to increased vulnerability for some segments of the population. From a policy point of view, the key concern is that much of the region is "getting old before getting rich": social insurance systems have not developed enough and accumulated enough resources to cover the aged population with sufficient incomes to avoid poverty (World Bank 2016). Similarly, urbanization, which underpinned broad-based improvements in living standards for the early developers in the region, such as the Republic of Korea and Taiwan (Province of China), helped support an expansion of basic services, has now turned into a challenge for many countries. As people move to take up the opportunities and services that cities provide, and the poor are increasingly concentrated in urban areas, urbanization needs to be managed through policies and investments that ensure that cities are livable and engines of opportunity (see also World Bank, 2017). Together with an uncertain outlook for export-oriented manufacturing to be able to continue to fuel high and broad-based growth, these trends suggest that rising inequality might be more than a transitory phenomenon in the region.

A range of data on public perceptions point to growing concerns among the regions' citizens about high and rising inequality, falling mobility, and growing economic insecurity. While these trends are not unique to this region, they are especially challenging because they threaten to undermine the region's long-held belief in economic opportunities being available for all. Respondents in EAP are marginally more likely to think that "income differences are too large" than in Latin America and the Caribbean (LAC),[3] another middle-income region but one long synonymous with high inequality.[4] And while there is still a strong belief in EAP that high income inequality provides positive incentives to exert oneself (higher than in LAC, for example), this is much lower than in other regions such as Sub-Saharan Africa, South Asia, or the Middle East[5]. Perceptions of mobility (the belief that hard work will pay off) according to the Gallup poll are no higher in EAP than in LAC, despite much lower levels of inequality. In an interesting twist, while in LAC, all income groups, including the rich, appear to have similar beliefs regarding mobility, higher-income groups in EAP believe less in mobility. That the more affluent in EAP believe less in hard work paying off could reflect both their higher expectations due to the greater visibility of wealth, and a greater awareness that hard work alone might not be enough to get ahead.[6]

There is also a growing sense of insecurity associated with EAP's economic success, which is consistent with the "paradox of unhappy growth" noted by Graham and Lora (2009). They highlight how in "rapidly growing middle income countries … high growth rates are, typically, associated with increasing inequality and with uncertainty as rewards to skills are changing" (Graham 2017, 27).[7] "Major changes in life satisfaction in the context of record levels of economic growth in China in the 1990s [are…] a case in point" (Graham 2017, 29). While this phenomenon is observed in fast-growing economies around the world, most of EAP might be less equipped to deal with this insecurity than other middle-income regions. Indeed, most countries in LAC and in Eastern Europe and Central Asia (ECA) have in place risk management systems that help households cope with a wide variety of shocks. In EAP, despite significant innovations over the last decade, neither social assistance programs to support the most vulnerable or social insurance measures that help households deal with specific risks have sufficient coverage or provide adequate support.

Not surprisingly, policy makers are taking note of these concerns and considering the need for measures that address them. A recent survey of policy makers in the region (Kanbur, Rhee, and Zhuang 2014) found that over half of them believed that high levels of inequality were not acceptable even if poverty was declining, while 95 percent thought that addressing inequality mattered to maintain stability and growth.

The rest of this note discusses how to characterize inclusive growth in a way that lends itself to the concerns of policy makers in EAP countries. In doing so, it synthesizes the main elements of the approach adopted by *Riding the Wave*, an upcoming World Bank report about EAP (Ruggeri Laderchi et al. 2017). That report suggests defining inclusive growth in terms of the three pillars of eliminating extreme poverty, fostering upward mobility, and providing economic security for everyone. Central to the analysis in that report is a focus on economic class, which helps address societal concerns that growth is not delivering for everyone, by emphasizing the needs and aspiration of each specific segment of the population.

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3 According to International Social Survey Programme (ISSP) 2009 data.

4 EAP respondents are less likely to agree with this view than respondents in Western Europe though.

5 According to World Value Survey, various waves between 2000 and 2014.

6 Relatedly, evidence from Eastern Europe and Central Asia, another middle-income region, shows that perceptions of actual mobility (and the gap between such perceptions and objective mobility) are greatly influenced by signs of growing polarization in the economy, as well as distrust of public institutions and concerns about unfair institutions (Cancho et al. 2014).

7 This paradox is apparent controlling for GDP levels (which are positively correlated with happiness), as respondents in high-growth countries are on average less happy.

Using economic classes to characterize inclusive growth

In a middle-income East Asia and Pacific, the policy focus of countries is now less on how growth affects poverty levels and more on how growth affects the welfare of different groups in the income distribution. To capture these concerns, it is useful to look at the different segments of the income distribution. This allows a focus on inclusive growth which includes both the need to eliminate extreme poverty (especially in countries or subregions where it remains high) and concerns for the welfare and aspirations of all groups in the population. Other ways of looking at inclusiveness, such as by focusing on inequality trends (for example, a measure like the Gini index or the relative shares of labor and capital income) have a narrower focus. For example, a similar increase in the Gini index could be affecting different parts of the distribution in different ways in different contexts.

To capture the needs and aspirations of different segments of the income distribution, it is useful to characterize five economic classes defined in terms of per capita daily consumption expenditures (PCE). Those classes are defined as the extreme poor, with a PCE of less than US$1.90 a day; the moderate poor, with a PCE between US$1.90 and US$3.10 a day; the economically vulnerable, with a PCE between US$3.10 and US$5.50 a day; the economically secure, with a PCE between US$5.50 and US$15.00 a day; and the middle class, with a PCE of over US$15.00 a day.

Characterizing economic classes

Partitioning the income distribution into classes has received the most attention from economists in characterizing the poor. There are now well-established extreme and moderate poverty lines that allow for comparisons across countries. After the latest update in the factor used to ensure that the dollar value of different currencies is constant across countries (the purchasing power parity factor, or PPP, last updated with 2011 values), those lines currently stand at US$1.90 and US$3.10 a day in U.S. dollar 2011 PPP terms.[8]

In the context of middle-income regions (and countries), a lot of attention has been given to the heterogeneity of the poor in terms of barriers that reduce their upward mobility. In Latin America, for example, these factors have been examined for particular groups of the poor, such as indigenous populations (Patrinos, Skoufias, and Lunde 2007), and more recently, the chronically poor (Vakis, Rigolini, and Lucchetti 2016). Although their emphases differ, these studies highlight the role of poor endowments (in terms of assets broadly defined, including physical, human, and social capital). The analysis of the chronically poor, defined as those who do not experience upward mobility out of poverty, in particular, adds an emphasis on the lack of economic security (uninsured risks) and the quality of institutions, especially in not delivering key services, together with the role that distress plays in driving decisions, as important factors constraining upward mobility.

Identifying economic classes other than the poor is more challenging as there is no standard methodology. Economists, however, typically refer to a particular income level (Ferreira et al. 2013).[9] Despite methodological differences, the literature identifies at least two features that differentiate the middle class from other segments

8 Going forward, the latter line will be specified as US$3.20 per day in U.S. dollar PPP (Joliffe and Prydz, 2016).

9 In contrast, "Sociologists and political scientists … usually define the middle class in terms of education (for example, above secondary), occupation (typically white collar), or asset ownership (including the ownership of basic consumer durables or a house)" (Ferreira et al. 2013). A similar variety of approaches has characterized economic definitions, with an emphasis on, for example, those in some predetermined section of the income distribution (for example, those between the x and the y income percentile; see, for example, Alesina and Perotti [1996]), or those above some relative consumption threshold (x percent of the median; see, for example, Birdsall et al. 1993) or absolute consumption threshold (for example, a threshold derived with reference to global comparators, or to some multiple of the poverty line; see, for example, Banerjee and Duflo [2008]).

of the income distribution. One is a sense of economic security which—in contrast to what happens to the poor—makes middle-class households more likely to "care about and save for the future and to have aspirations for a better life for themselves as well as their children" (Birdsall 2010, 6). Such behaviors could go a long way in explaining consumption patterns that are more skewed toward durables and investment in human capital than those of poorer groups. The other feature of the middle classes, which separates them from the rich, is being dependent primarily on their labor, rather than wealth accumulated "based on prior or current economic rents associated with monopoly or other privileges" (Birdsall 2010, 7), as would be the case for the wealthy. One can hypothesize that the latter characteristic makes the middle classes more dependent on the provision of public goods (such as good governance, including the rule of law, and high-quality provision of services such as education), which enhance the returns to their labor and human capital. In addition, being more likely to have good jobs in the formal sector, the middle classes are easier to tax than other groups, as their income flows are both easier to record than those of the rich and higher, and are generated more from formal sector activity than those of the poor.

An empirically derived anchor for the definition of the middle class is provided by the concept of economic security, defined as low risk of falling into poverty. From a methodological point of view, economic security is captured by having sufficient income so as to face a very low chance of falling into poverty in a particular period (López-Calva and Ortiz-Juarez 2011). Crucial for this methodology is the identification a priori of a maximum level of risk of falling into poverty that is consistent with being in the middle class. This approach, which has been used in the case of the LAC region (Ferreira et al. 2013), set the probability of falling into poverty at 10 percent over a five-year period, approximating the average risk of falling into poverty in upper-middle-income countries such as Argentina, Colombia, and Chile. In the case of LAC, this methodology identifies as middle class slightly less than the top third of the income distribution. An important by-product of having defined an economic security line is that a new economic class—the *economically vulnerable*—can be characterized as those in the population whose income/consumption places them between those living in poverty and the middle class. This class, which in 2009 composed roughly 38 percent of the LAC population (against 30 percent who were poor), has graduated from poverty, but remained at high risk of falling back into it.

Applying the economic security approach to EAP requires adopting some modifications to better reflect the income distribution in the region. Applying the Lopez-Calva and Ortiz-Juarez (2011) methodology in EAP leads to an economic security line of US$5.50 a day 2011 PPP.[10] Since a large share of the EAP population lives above this line with a low risk of falling into poverty—almost two-thirds of the population in 2015—to add granularity to the analysis this group has been partitioned further into *those who live in economic security* and *those who are part of a more affluent middle class*. The lower bound for the middle class has been identified with reference to previous estimates in the literature, and found to be roughly equivalent to US$15 2011 PPP.[11] This somewhat arbitrary line allows us to focus on the "upper tail" of those living in economic security, a practice also adopted in country work on the middle class in Indonesia.[12]

10 For LAC it was estimated at US$10 PPP (2005).

11 This is roughly equivalent to updating for inflation previous estimates which, with different approaches, seemed to converge to US$10 2005 PPP. For example, Kharas (2010) uses US$10 a day to US$100 a day (2005 PPP); Ferreira et al. (2013) adopt a minimum threshold of US$10 a day (2005 PPP) for LAC. And, likewise, respondents to the LatinoBarometro perception survey become more likely to self-identify as middle class than as poor at an income level of US$10 a day (2005 PPP; quoted in Ferreira et al. 2013). Note that Pritchett (2003) argues the upper bound for the global poverty line should be based on the lowest poverty line in the wealthy Organisation for Economic Co-operation and Development countries; the United States has the lowest poverty line, equivalent to US$15.8 a day (2011 PPP).

12 In Eastern Europe and Central Asia, those living in economic security (identified with the middle class) accounted for 42 percent of the population in 2012. This was based on the US$10 a day (2005 PPP) line calculated with LAC, which analysis of Russian and Moldovan panel data suggested could offer a valid "economic security line" in different contexts in the region (Cancho et al. 2014).

Looking at EAP through the lens of economic class

Introducing class differentiation leads to a more nuanced understanding of past trends in the region. While Figure II.A.2A shows the familiar story of the dramatic reduction of poverty in the region (from 55 to 12 percent between 2002 and 2015), Figure II.A.2B offers additional insights. In addition to the virtual elimination of extreme poverty in the region, these include the almost constant share of vulnerable individuals despite the varied events that have characterized the first 15 years of this century, and the rising wave of economic security that has swept the region.

Figure II.A.2A. The evolution of poverty in EAP, 2002–15

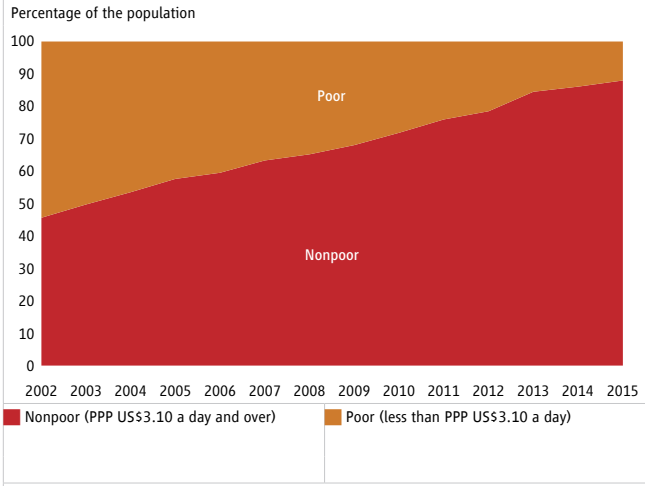
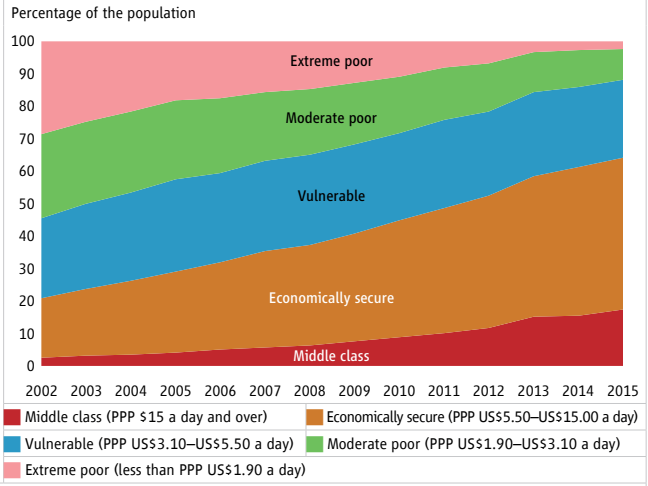


Figure II.A.2B. The changing structure by economic class of EAP's population, 2002–15



Source: EAPPOV national surveys standardized.
Note: Poverty rates where household surveys are unavailable have been estimated by interpolating and extrapolating based on GDP per capita growth and growth elasticities of poverty between the two closest available surveys.

Figure II.A.3A. Indonesia, 2002–15

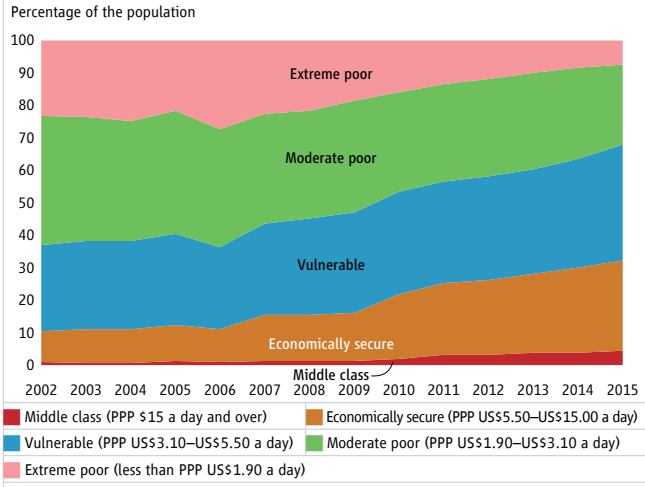
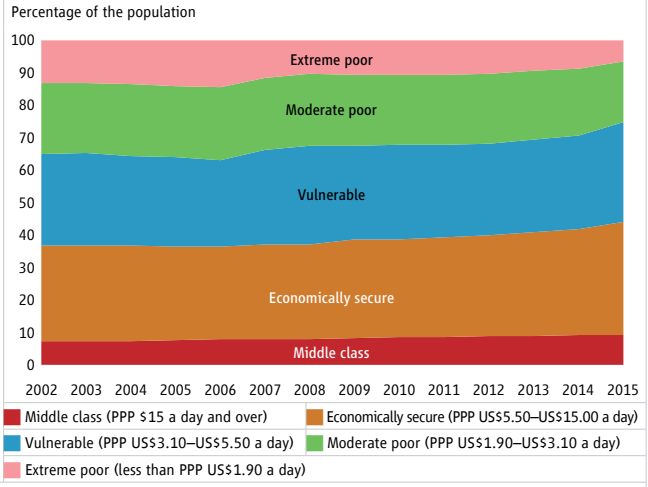


Figure II.A.3B. The Philippines, 2002–15[a]



Source: EAPPOV national surveys standardized.
Note: Poverty rates where household surveys are unavailable have been estimated by interpolating and extrapolating based on GDP per capita growth and growth elasticities of poverty between the two closest available surveys. (a) Based on income rather than consumption.

Class analysis also provides interesting insights on differences among countries. Indonesia and the Philippines, for example, show very different patterns of class structure (Figure II.A.3). In Indonesia after the 2008 global financial crisis, extreme and moderate poverty seem to have started to decline more than in the past, so that developments at the low end of the distribution now follow the same pattern as the rest of the distribution. In the Philippines, despite some decline in poverty since the global financial crisis, particularly over 2014 and 2015, there appears to be significant stability in the class composition of the population, suggesting that there is limited mobility overall.

Class analysis can also be useful in comparisons across world regions. In Figure II.A.4, EAP's experience is contrasted with the other middle-income regions of the world. A note of caution is warranted, as for comparability purposes the figure adopts the same "class" cut-offs adopted for the EAP analysis, although they might not fully represent local realities.[13] Nevertheless, the partition of the income distribution highlights how since 2008 there has been much more "stability" in LAC and ECA than in EAP. Whatever the extent of "churning" between segments (which cannot be detected with these data), the net effect has been that roughly the same proportion of people occupied each segment in these two regions. In contrast, in EAP, while movement into the higher segment (the middle class) appears to have slowed, the share of both extreme and moderate poverty has continued to decline in EAP, resulting in an increase in the share of households that enjoy economic security.

Figure II.A.4A. Latin America and the Caribbean: evolution of class structure 2002–13

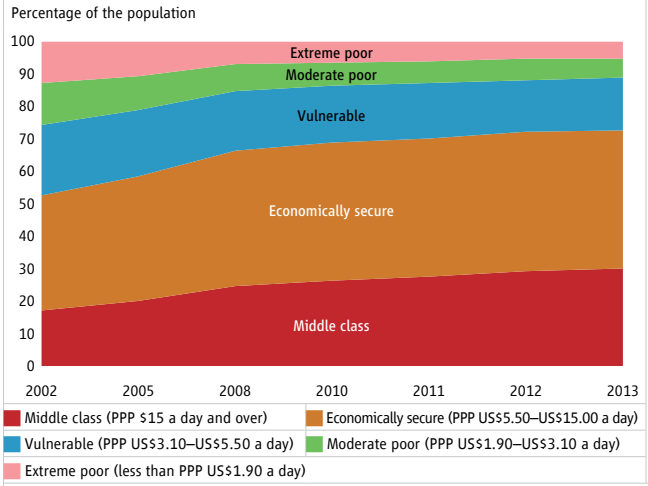
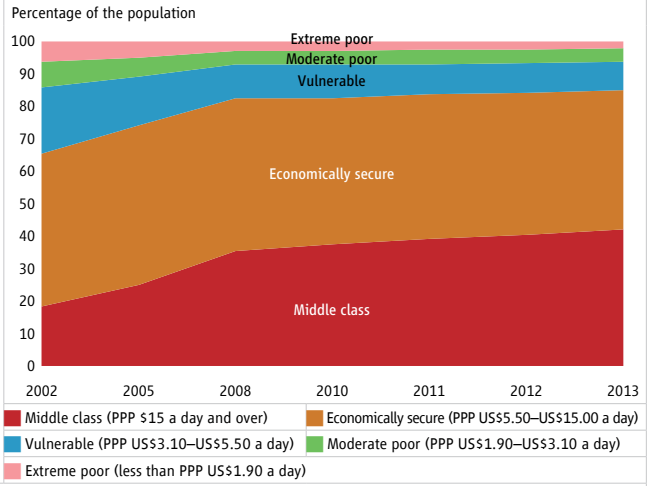


Figure II.A.4B. Eastern Europe and Central Asia: evolution of class structure 2002–13



Source: Povcalnet and linear interpolations for the inter-survey years.

The three pillars of inclusive growth

Riding the Wave (Ruggeri Laderchi et al. 2017) **underscores how a focus on inclusive growth—defined as fostering upward economic mobility (improving one's lot in life) and economic security (being able to hold onto gains made) for all, in addition to eliminating extreme poverty—can form the basis for a new social contract in middle-income countries such as those in East Asia and the Pacific.** Such a concept of

13 Based on earlier estimates mentioned above (see footnotes 9–11), as earlier research set the "economic security line" at US$10 dollars in 2005 PPP, it can be expected that the economic security line for those regions lies closer to the "middle class line" of US$15 a day 2011 PPP than to US$5.50.

inclusive growth goes beyond a binary view of societies in terms of the poor and the nonpoor, and seeks to address the needs and aspirations of all citizens.

Eliminating extreme poverty

Eliminating extreme poverty is a key element in characterizing inclusive growth. While its incidence in the region as a whole is low, it remains high in a few countries. Extreme poverty rates, as a share of the population, are relatively high in Timor Leste, Papua New Guinea, Lao PDR, and the Pacific Island countries of Kiribati, the Federated States of Micronesia, the Solomon Islands, and Vanuatu (all above 10 percent).[14] Conversely, the incidence of extreme poverty is negligible in Malaysia and Thailand, both upper-middle-income countries. Yet, most of the extreme poor are now spread across the three larger middle-income countries: Indonesia, China, and the Philippines together account for more than 80 percent of the total. Indonesia alone accounts for two-fifths of all extreme poor.

The evidence on the incidence and distribution of extreme poverty across the region suggests that the "last mile" challenge of eliminating extreme poverty means very different things in different contexts. This is all the more so because, even in a given country, those living in extreme poverty can be very heterogenous—think, for example, of the differences between an ethnic minority child living in a remote rural community who cannot access schooling in his or her own language, and an elderly urban inhabitant who does not have access to jobs outside the slum in which he or she lives because of ill health.

In the few countries where the incidence of extreme poverty still reaches double digits, eliminating extreme poverty at its core involves providing income generation opportunities for unskilled workers, following the path of the successful countries in the region. In this vein, for example, Lao PDR has focused on improving human capital and access to land for the poor (Pimhidzai 2015). Yet, even in these countries, specific groups may face sources of exclusion, or be located in areas too remote or underserved to benefit from such opportunities—Lao PDR again is a case in point.

In countries with lower overall poverty incidence, where extreme poverty is concentrated in small pockets of the population, in contrast, identifying the exclusionary processes that perpetuate extreme poverty is key. Those are often linked to ethnicity and location.[15] In Vietnam, for instance, ethnic minorities account for 15 percent of the total population but for over two-thirds of the extreme poor. Identifying, measuring, and tackling the exclusion of ethnic minorities is difficult. Vietnam is again a case in point: ethnic minorities have experienced gains in welfare since the early 1990s, but in recent years progress reducing poverty and child mortality has stalled. Poor education, malnutrition, and low access to sanitation are exerting mutually reinforcing, adverse effects on equality of opportunity for ethnic minority children. While these countries may already have the necessary resources and institutional capacity to run effective programs, the fragmentation of target groups, and their specific needs and constraints, may pose significant challenges in designing and implementing such interventions.

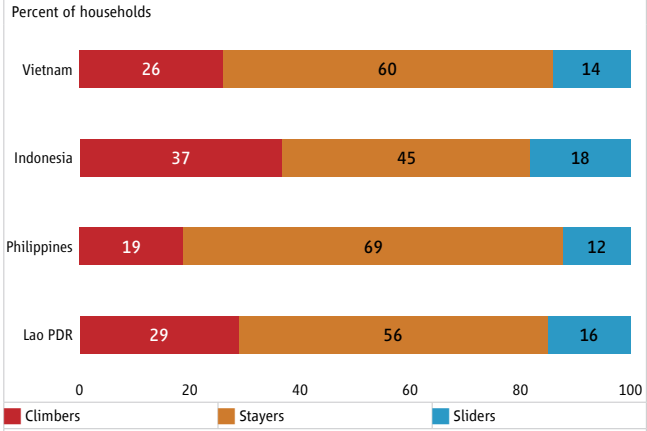
14 For Myanmar, for which poverty data are not available, extreme poverty is likely to be high, as well.

15 These two factors also affect the profile of the extreme poor in some countries with high poverty incidence, such as Lao PDR, though tackling them in low-incidence countries means a more deliberate focus on small subgroups of the population.

Fostering Upward Mobility

Tracking the same households over time provides a nuanced view of mobility in a high growth-high poverty reduction region such as EAP. Country evidence shows that in each class other than the middle class, most people experienced a positive increase in consumption over a two-year period, and the increases were proportionally larger for poorer classes.[16,17] However, while at least one in five people moved to a higher economic class, people from all economic classes experienced downward transitions. And despite all these movements, the largest share of households remained in the same class, even over the long term.

Figure II.A.5. Class mobility, aggregate, short run



Source: Cunningham 2017.
Note: "Climbers" denotes households that moved up in economic status, "stayers" those that remained in the same economic class, and "sliders" those that moved to a lower economic class. Data cover different time periods: Indonesia 2008–10; Lao PDR 2008–12/13; Philippines 2006–09; Vietnam 2010–12.

However, mobility patterns are very country specific, partly reflecting the different country situations during the period covered. This is highlighted by Figure II.A.5, which summarizes movements across classes in terms of climbers (those who improve economic class), sliders (those who moved to a lower economic class), and stayers (those who saw no change). The contrast between the Philippines and Indonesia is telling. In Indonesia, which experienced the highest incidence of upward moves, the chances of sliding back were also comparatively large. In the Philippines, most people did not move, but the chances of backsliding were also the least. This pattern is striking because the Philippines panel data covers a period that includes both growth and crisis (2006–09). The lack of overall economic dynamism (which can also be seen for the first part of the period shown in Figure 3.B) seems to also have implied greater resilience (lack of backsliding) during the period of economic stagnation.

Looking at the characteristics of different groups helps highlight the differences in the trajectories of people over time:

The "climbers," those who improved their class, accounted for one-fifth (the Philippines) to one-third (Indonesia and Lao PDR) of households. Households in poorer classes were more likely to improve their class than their richer counterparts (Figure II.A.5). Country patterns differed, with the economically secure being the big winners in Indonesia, while the extreme poor experienced the largest gains in Lao PDR. Those who climbed out of (moderate) poverty and out of economic vulnerability tended to have better access to public services (education, health, and other services) and more physical and financial assets, as well as a broader social network than other households in the same economic class. Those who moved out of economic security into the middle class had more education, were living in an urban area, had access to better jobs, and recorded higher levels of female paid employment.

16 Our evidence on short-term mobility (2 to 3 years) refers to Indonesia, Lao PDR, the Philippines, and Vietnam. Long-term mobility (10 years) refers to evidence from Cambodia, Indonesia, and Vietnam.

17 Our evidence on short-term mobility (2 to 3 years) refers to Indonesia, Lao PDR, the Philippines, and Vietnam. Long-term mobility (10 years) refers to evidence from Cambodia, Indonesia, and Vietnam.

The "stayers," who did not change their economic class, account for between 45 percent of the population (Indonesia) and 69 percent (the Philippines). The class composition of this group varies by country, with the extreme poor being more likely not to change class in Lao PDR and the Philippines, and the economically secure in Indonesia and Vietnam. In Vietnam, those who do not change class tend to be older, more urban, and more educated, compared with those who change class. In contrast, stayers in the Philippines tended to be younger and have greater house assets than those who move.[18]

The "sliders," who moved to a lower economic class, represent, on average, about a sixth of all samples. The profile of the backsliders varies by country, with less educated, those receiving less transfers, more rural, and asset-poor households being particularly likely to slide in Vietnam. In the Philippines, only 17 percent of the population moved to a lower class. In the Philippines, sliders are older, with more formal jobs.

This analysis suggests that addressing the gaps in terms of access to jobs and services, improving the quality of jobs, and furthering financial inclusion to improve the productivity of micro and small enterprises, are the priorities to foster mobility. Given the country-specific nature of mobility patterns, however, the precise interventions will need to be tailored to country contexts.

Enhancing economic security

Economic security, which enables individuals to hold onto their gains, is a third essential element in this concept of inclusive growth. Lack of security reflects both a high exposure to risks and a limited ability to manage adverse shocks for some. Shocks include economic shocks that affect prices and asset returns, personal shocks such as illness, and natural shocks.

EAP, as other parts of the world such as LAC, seems to be very vulnerable to large-scale aggregate shocks such as natural disasters. In the last two decades, different parts of the region have been affected by two major financial crises, several spikes in food prices, natural disasters ranging from earthquakes to tsunamis, and repeated hits by massive cyclones.[19] In addition, millions of the region's inhabitants are exposed to the consequences of large natural shocks, because populations are concentrated in low-lying coastal areas or on marginal and hazardous lands within cities. In these areas, insecurity of tenure provides little incentive for households to invest in risk management, and poor provision of services such as health care compounds the effects of disasters such as flooding (Baker and Gadgil 2017).

There are limited data on exposure to and impacts of shocks by class, but Vietnam's nationally representative panel and other smaller sources offer some insights. One important aspect that emerges from the Vietnam data is that exposure to shocks as reported by households is constant across classes.[20] Also, the nature of the shock is similar across class, with economic shocks being the most prevalent (for example, low income, and high

18 Receipt of transfers, degree of job formality, and household wealth (as proxied by household characteristics) do not seem to affect the likelihood of being a stayer in our samples.

19 More rigorous analysis shows how seriously EAP has been hit in the recent past. For example, in the first nine months of 2011, EAP experienced 80 percent of the global losses due to natural disasters (Jha and Stanton-Geddes 2013).

20 Note that shocks are not identified endogenously in the survey data as drops in income, but are self-reported (through questions such as "did you experience a shock" and "what kind"). Their identification, therefore, is not linked to income gains or losses, or to a specific magnitude of the shock (for example, a drop of more than 10 percent of income) or to the specific duration of the shock.

food prices), followed by personal shocks such as bad health or the death of a family member. Natural disasters, however, mostly affect lower-income groups.

Despite similarities across classes in terms of shock exposure, negative shocks are associated with a greater probability of moving down the class ladder among the moderate poor and the economically vulnerable. However, even the middle class, despite its affluence, faces risks. Conversely, the moderate poor who do not receive a shock are 50 percent more likely than those who do to move up one class over a two-year period and 34 percent more likely to move up two classes.[21] While these findings underline the significance of shocks, they also show that even the moderate poor can overcome negative circumstances if they have the appropriate asset base, as lack of assets rather than shocks appear to explain the slide into poverty. Addressing the overall risk management agenda, covering both idiosyncratic and aggregate shocks and including both ex-ante and ex-post measures, must therefore be a key element of any strategy aimed at supporting inclusive growth.

Conclusion

Now that developing EAP is made up of middle-income countries, policy making needs to adapt to the changing needs and aspirations of its population. While broad-based manufacturing growth has provided the key to an unprecedented path of poverty reduction, the sustainability of this model is put in question by global as well as regional developments. Factors such as aging and urbanization, which have helped support progress, could now be turning into challenges, while the economic dynamism of the region has been accompanied by high or growing inequalities, and new concerns as to whether avenues for upward economic mobility are still open to all.

By raising the bar on its policy priorities—going beyond a primary focus on reducing poverty to a broader emphasis on ensuring economic mobility and security for all—governments in the region can address the needs of their diverse populations, which is highlighted by the analysis by economic class. Such an emphasis will entail tailoring poverty reduction interventions to address the heterogeneity of extreme poverty at the country level, fostering mobility by closing gaps in access to jobs and services and seeking to improve the quality and productivity of those jobs, and increasing economic security by putting in place mechanisms that can help reduce households' exposure to risks while enhancing their ability to cope with the consequences of shocks when they do occur.

21 The qualitative results are broadly similar across countries. For instance, in rural, marginalized Cambodia, 32 percent of the moderate poor who do not receive a shock move up one or two classes over a two-year period, compared with 26 percent of those who receive a shock. Conversely, the moderate poor who do receive a shock are more likely than those who do not to become extreme poor (the probabilities are, respectively, 32 percent and 3 percent) (Ruggeri Laderchi et al. 2017).

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II.B. Tourism in Developing East Asia: Managing Growth and Maximizing Future Benefits[1]

Tourism in developing East Asia is growing rapidly, and the region enjoys the highest level of tourism receipts among developing regions globally. For many of the smaller economies in the region, such as Cambodia, Lao PDR, and Myanmar, tourism has been one of the main exports and sources of foreign exchange. Most of the growth in international arrivals has been fueled by intraregional travel—especially from Chinese outbound tourism. China has been by far the fastest-growing source of tourism in recent years and the world's top spender in international tourism since 2012. An additional 61 million Chinese households are expected to be able to afford long-haul international travel by 2023. Based on recent and expected demographic, economic, and technological trends, tourism growth will only accelerate in coming years. This should generate increased opportunities to develop tourism destinations in the region and capture the economic benefits of tourism. At the same time, this growth, if not properly managed, will place greater pressures on the sector's economic, social, and environmental sustainability. Therefore, countries in developing East Asia must address key market and policy failures to properly manage and benefit from the expected growth. Priorities for action include a stronger emphasis on demand-driven integrated master planning, improvements in the enabling business environment for tourism, better environmental quality standards, the development of more eco-friendly tourism product offerings, and stronger links with the local economies.

Tourism and its economic significance in developing East Asia

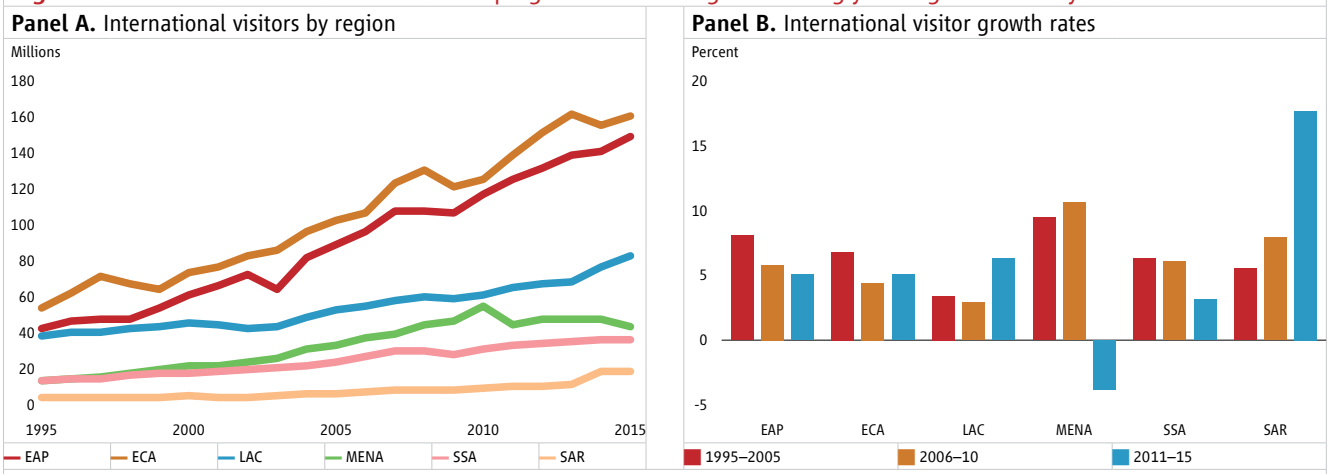
Trends and Profiles of Visitors

Tourism activity in developing East Asia has grown significantly over the last 20 years.[2] Expanding economies, a growing consumer class, and easing of travel restrictions have combined with increased capacity, infrastructure development, and air connectivity to support tourism growth. Between 1995 and 2015, international arrivals to developing East Asia grew at an average annual growth rate of 6.8 percent, the second-fastest among developing regions (behind South Asia, with 9.2 percent). By 2015, developing East Asia was receiving over 150 million international tourists annually, second only to Eastern Europe and Central Asia, which received over 160 million (Figure II.B.1). In the last five years, this visitor growth trend has begun to slow somewhat compared to earlier periods and relative to South Asia and the Latin America and the Caribbean regions—where visitor growth has been accelerating (Figure II.B.1)—but remains a robust 5 percent.

1 This chapter was prepared by Andres F. Garcia and Nikola Kojucharov of the World Bank's Trade & Competitiveness Global Practice. The analysis is based on an extensive background report prepared by Andres F. Garcia, Kristin Lamoureaux, Hannah Messerli, Bradley Weiss, Elliot Wright, and Vera Jiazhen Zhou. It also benefited from contributions and comments by Asya Akhlaque, Antoine Coste, Paramita Dasgupta, Ahmed Eiweida, Mona Haddad, Birgit Hansl, Jessie McComb, Dina Nicholas, John Perrottet, Wouter Schalken, Sudhir Shetty, Damien Shiels, Congyan Tan and Louise Twinning-Ward.

2 Regional groupings in this report are based on International Development Association (IDA) and International Bank for Reconstruction and Development (IBRD) countries only. IDA and IBRD countries in developing East Asia include Cambodia, China, Indonesia, Lao PDR, Malaysia, Mongolia, Myanmar, the Philippines, Thailand, and Vietnam. "Developing East Asia" will be used in this report to refer to these countries. In 2015, they represented 57 percent of the East Asia and Pacific region's international tourism arrivals and 52 percent of receipts. Countries in the Pacific are covered in the tourism chapter of *Pacific Possible: Tourism* (World Bank 2017).

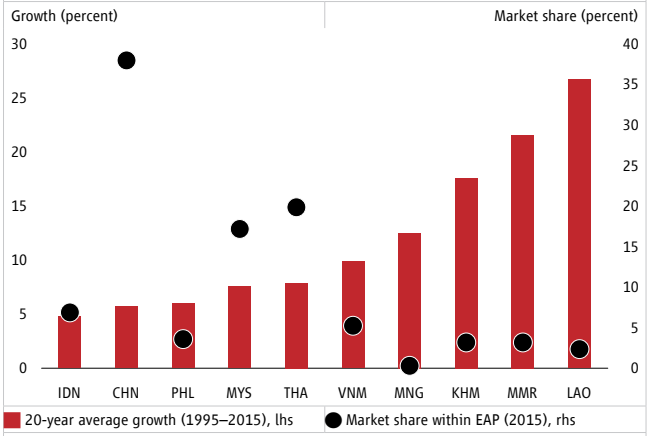
Figure II.B.1. International arrivals to developing East Asia have grown strongly during the last 20 years



Source: WDI 2017.
Note: Country aggregates include IBRD and IDA countries only.

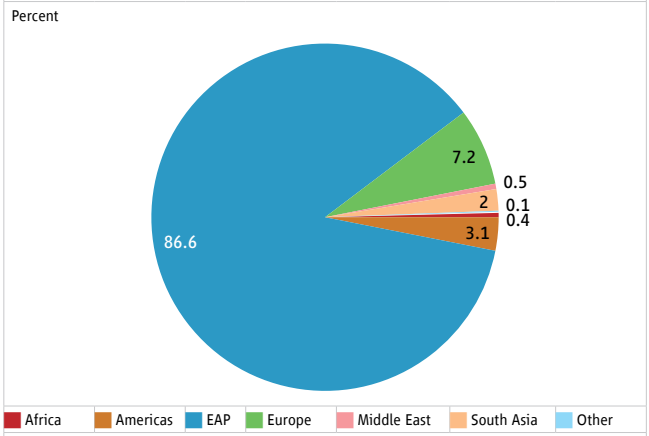
Across the different countries in developing East Asia, visitor inflows and growth rates vary widely. The fastest visitor growth has come to countries newly open to tourism and transitioning to market economies: Lao PDR, Myanmar, Cambodia, Mongolia, and Vietnam (Figure II.B.2). However, as they began the period with low arrivals, they still received only small fractions of regional totals in 2015: 1.8 percent in Lao PDR, 2.4 percent in Cambodia, 2.4 percent in Myanmar, and 4 percent in Vietnam. The largest shares of tourists to the region in 2015 went to more established destinations, with China receiving 29 percent (56.9 million), Thailand 15.2 percent (29.9 million), and Malaysia 13.1 percent (25.7 million). In addition, China (4th), Thailand (11th), and Malaysia (14th) were among the top tourism destinations in the world, as measured by the total number of international visitors.

Figure II.B.2. Visitor inflows and growth rates within developing East Asia vary widely



Source: Author's calculations based on WDI data.

Figure II.B.3. Most international tourists originate from within the region



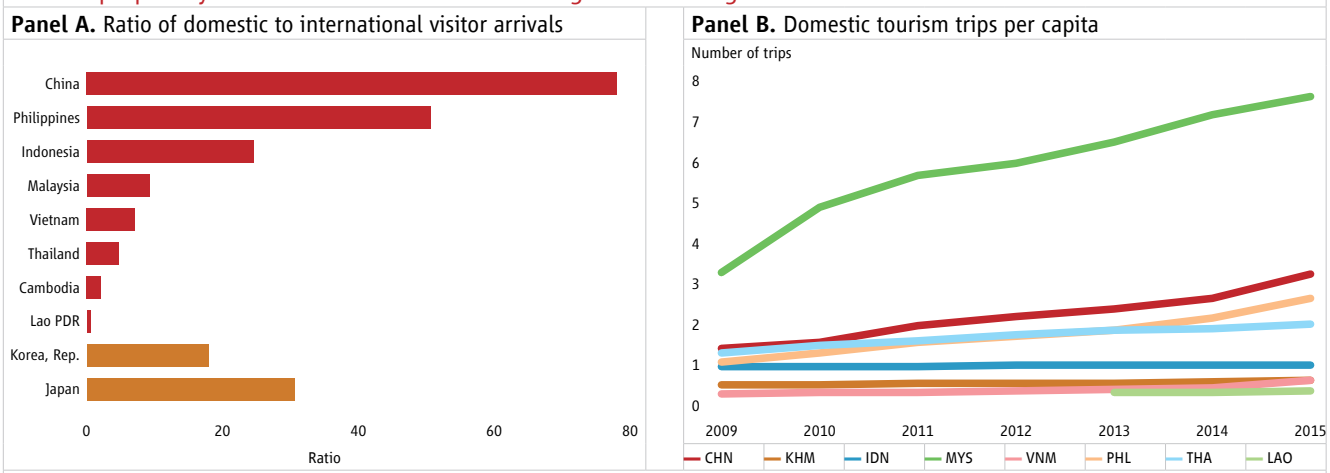
Source: UNWTO.

The vast majority of international visitors to developing East Asia originate from within the region (Figure II.B.3). Over 85 percent of tourists visiting developing East Asia come from within the broader East Asia region.

This share has remained stable over the last 20 years. Europe has long provided the second-largest source of arrivals, maintaining a 6.4 to 8 percent share, but this share shrank by 1 percentage point from 2014 to 2015 (to 7 percent) as growth in arrivals slowed. The Americas, including the Caribbean, have generated the third-largest share historically and accounted for 3 percent in 2015. Their share has declined gradually since 1996 from 4.2 percent.

While international visitors are often the focus of policy makers, the scale and pace of growth of domestic tourism in many developing East Asian countries has actually exceeded that of international tourism. As disposable incomes across the region have grown, so have the opportunities and propensities for domestic travel, which is generally more affordable than overseas travel, and in many cases also an appealing substitute, particularly in the larger countries with diverse destinations and tourism offerings (including Thailand, China, Indonesia, and the Philippines). Within the region, only Cambodia, China, Indonesia, Lao PDR, Malaysia, the Philippines, Thailand, and Vietnam report data on domestic tourism (Figure II.B.4). Within this sample, domestic tourism arrivals are 4 to 9 times greater than international arrivals in Malaysia, Vietnam, and Thailand, around 25 times greater in Indonesia, 50 times greater in the Philippines, and over 75 times greater in China.[3] The volume of domestic arrivals also exceeds the total population in several of these countries, highlighting the significant scale and economic importance of this domestic market. Moreover, this domestic-arrivals-per-capita ratio has been rising steadily in almost all these countries (Indonesia being the exception), reflecting the rising domestic propensity to travel.

Figure II.B.4. Domestic tourism in developing East Asia tends to dwarf international tourism in terms of magnitude, and the propensity for domestic travel has been rising across the region



Source: Authors' calculations based on UNWTO and WDI data.

Economic Impacts of Tourism

The growth patterns of visitor arrivals represent only one dimension of the tourism story in developing East Asia, and the economic impact of this tourism activity must also be considered. While data to comprehensively trace the economic impact channels of tourism activity are not available for most countries in the region, two high-level indicators can provide a broad sense of the magnitude and dynamics of tourism's economic

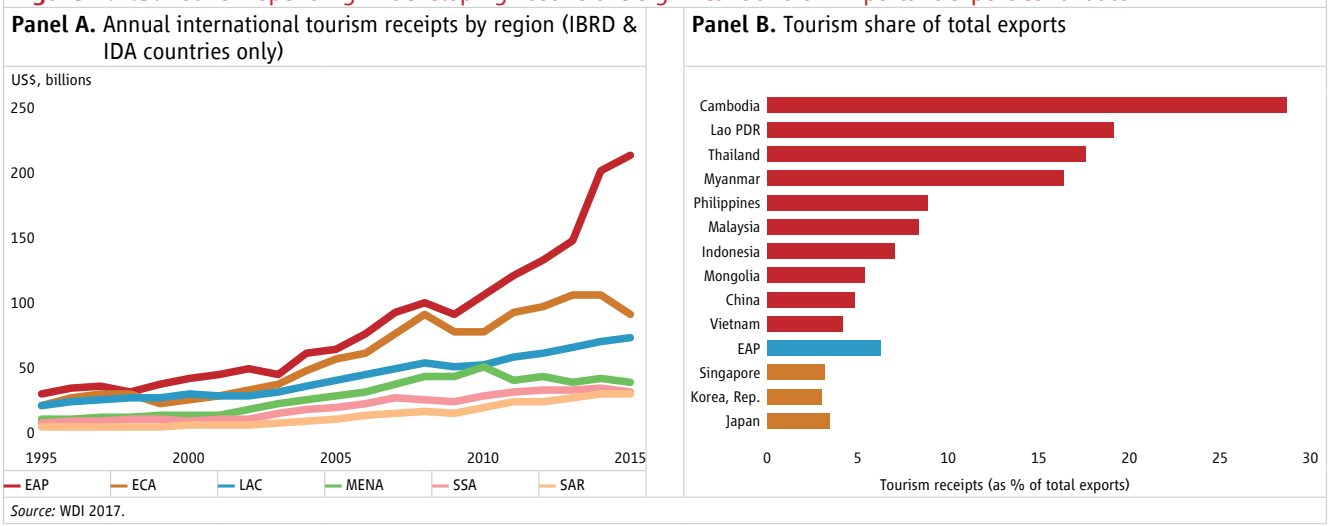
3 These figures include both overnight trips and same-day trips, as most countries in the sample currently do not disaggregate the data.

contributions: the direct spending of visitors (tourism receipts), and the multiplier effects of this spending on employment and on activity in sectors with backward and forward links to tourism.

▪ *International Visitor Spending*

International visitor spending in developing East Asia has grown faster than arrivals over the last two decades. Developing East Asia generated a total of US$212 billion in international tourism receipts in 2015, over twice the US$91 billion earned by Eastern Europe and Central Asia, and more than the combined earnings of Latin America and the Caribbean, South Asia, the Middle East and North Africa, and Sub-Saharan Africa (Figure II.B.5). Receipts in developing East Asia have doubled since 2010, and have grown at over 11 percent on average per year since 1995. The vast majority of these regional receipts were concentrated in two countries, however—China (54 percent of the total) and Thailand (23 percent).

Figure II.B.5. Tourism spending in developing East Asia is significant and an important export contributor



Source: WDI 2017.

For many of the smaller economies in the region, tourism is one of the main exports and sources of foreign exchange. In Cambodia, tourism income from international visitors (which is classified as a services export) accounts for 29 percent of the value of the country's total export earnings (Figure II.B.5). This share is lower, but still significant, in some of the region's other small economies—Lao PDR and Myanmar—ranging from 16 to 19 percent. In the larger and more sectorally diversified economies, such as China and Indonesia, tourism's exports contribution is still a notable 5 to 10 percent. For developing East Asia as a whole, international tourism receipts represent 6.3 percent of total goods and services exports, greater than in the three largest high-income countries in the region (Japan, Singapore, and the Republic of Korea).

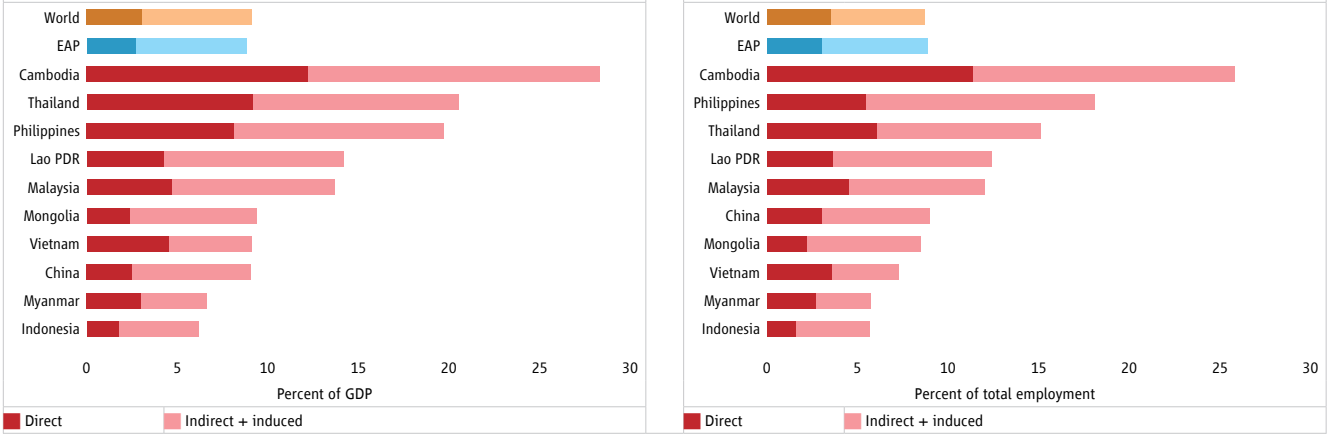
▪ *Employment and Multiplier Effects*

The economic impact of tourism goes beyond investment and the direct spending of visitors. First, for each dollar of direct visitor spending on tourism-linked activities (travel, accommodation, tour services), a portion goes

toward imported goods and services (also known as spending "leakage"), meaning its direct contribution to GDP is generally less than one-for-one. The spending that does remain in the domestic economy subsequently generates additional indirect demand for other economic sectors with backward and forward links to tourism, while income earned by employees in these linked sectors induces additional spending in the economy. These combined indirect and induced impacts on output, income, and employment are known as spending "multiplier" effects, and must be factored in when estimating the overall tourism contribution to GDP.

Accounting for multiplier effects, tourism's overall contribution to GDP and employment in developing East Asia is on par with global averages, but varies widely within the region. The World Travel & Tourism Council (WTTC) provides country-specific estimates for the direct, indirect, and induced impacts of travel and tourism on the economy (Figure II.B.6). In the developing East Asia region as a whole, the overall contribution (direct plus indirect and induced) of travel and tourism to both GDP and employment was estimated at around 9 percent in 2016—roughly equal to the worldwide average, with a slightly smaller direct contribution and slightly larger indirect and induced contribution. Within the region, however, the variation is large: the largest tourism contribution to the economy is found in Cambodia, where the sector contributes 28.3 percent of GDP and nearly 25.9 percent of total employment. At the other end of the spectrum, the overall tourism contribution to GDP in Indonesia is 6.2 percent, and 5.6 percent to employment. In terms of the magnitude of the tourism multiplier (the ratio of the total tourism contribution to the direct contribution), the largest is in Mongolia, at 3.9 for both GDP and employment, and the smallest is in Vietnam (2.0).

Figure II.B.6. The economic contribution of tourism to GDP and employment varies greatly across the region

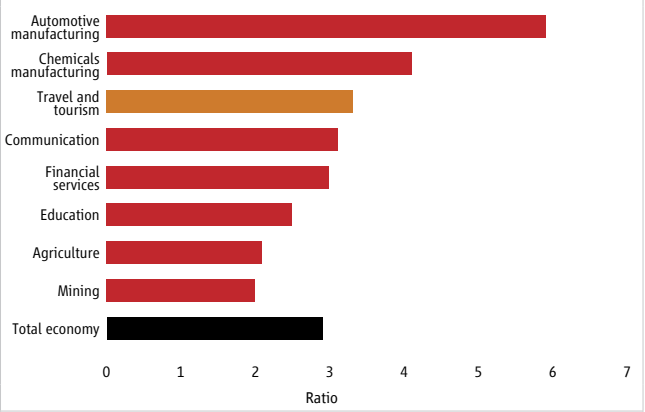


Source: WTTC 2017.

The multiplier effect of spending on tourism is the highest among services sectors. The WTTC estimates the total GDP multiplier of the tourism sector to average 3.2 globally, the highest among services sectors and second only to automotive and chemicals manufacturing (Figure II.B.7). Within developing East Asia, country-specific benchmarking of the strength of the tourism multiplier relative to other sectors is constrained by data limitations, but WTTC estimates are available for Indonesia, Malaysia, Thailand, and China. For these four countries, the ratio of tourism GDP and employment multipliers to the average economy-wide multipliers is greater than 1, implying that, on balance, spending on travel and tourism delivers a stronger overall economic impact compared to other sectors.

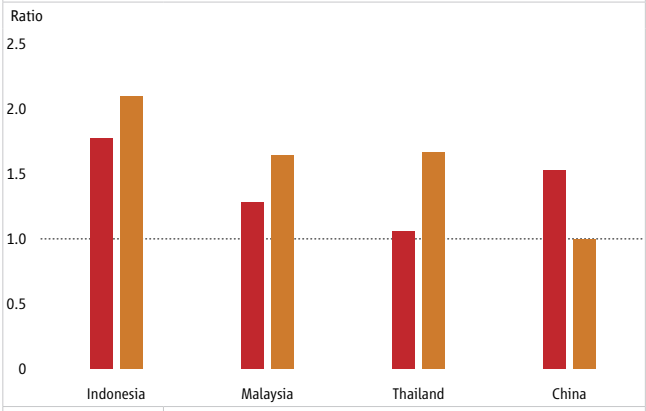
Figure II.B.7. The multiplier effect of spending on tourism tends to be stronger than for other sectors

Panel A. World average GDP multipliers



Source: WTTC 2012.

Panel B. Tourism sector multipliers (relative to economy-wide average)



Source: Authors' calculations based on WTTC (2017) data.

Emerging Trends

Demographic, economic, and technological shifts

Demographic, economic, and technological shifts are fueling tourism growth in developing East Asia. Millennials travel more than any other generation, including baby boomers, and they will likely travel more as their income and wealth grow. Increasing urbanization and a growing middle class will raise the population's desire and ability to engage in tourism. The spread of internet access and mobile technology has also empowered travel consumers and spawned a new sharing economy. While travel suppliers and intermediaries maintain ownership of their customers and data, they also collaborate to deliver improved travel experiences and generate new sources of revenue (McKinsey & Company 2017). For example, the Chinese e-commerce platform, Alibaba, is offering a cloud-based hotel management system to hotel brands on its platform and is planning to integrate virtual reality technology into an online hotel reservation system, enabling its users to have an immersive view of a hotel on its app.

Growth in the Chinese outbound market

China has been by far the fastest-growing tourism source market in recent years and has been the world's top spender in international tourism since 2012. Boosted by rising disposable incomes, an appreciating currency, improved travel facilitation, and an easing of restrictions on international travel, Chinese outbound travel has been growing exceptionally over the last two decades. According to WTTC (2016), Chinese tourists spent US$215 billion outside mainland China in 2015, a 53 percent rise from the US$140 billion spent in 2014, despite the country's economic slowdown.

Continued robust income growth and expansion of China's middle class will make long-haul travel even more achievable in the coming decades. In China, the number of Chinese households earning above US$35,000 per year—a key income level at which long-haul *international* travel becomes affordable—rose by 21 million from 2003 to 2013 (InterContinental Hotels Group 2015). As Table 1 shows, an additional 61 million households will pass this threshold by 2023.

Table II.B.1. Chinese travel behavior varies based on household income, with an increasing share able to afford short- and long-haul trips

Household income level (US$)	*2013 (millions of households)*	*2023 (millions of households)*	*Market segments*
Up to US$20,000	364	312	Domestic travel
US$20,000 to US$35,000	44	93	Short-haul trips and low-cost accommodations
US$35,000 to US$70,000	21	63	Long-haul trips and higher-cost accommodations
US$70,000 to US$150,000	5	21	Luxury accommodations and tend to spend more while on long-haul trips
Over US$150,000	1	4	Customized luxury travel

Source: InterContinental Hotels Group 2015.

China has multiple market segments looking for new experiences. A study conducted by the Boston Consulting Group (2013) projects that, from 2012 to 2030, three segments of China's outbound leisure market will grow the fastest: young "affluents" (ages 18 to 30), senior professionals (ages 45 to 55, traveling without an organized tour group), and small groups of families and friends (ages 30 to 45, also traveling without an organized tour group). By 2030, these segments combined will account for an additional 100 million annual trips and US$340 billion in annual spending. This trend implies significant economic opportunities for developing East Asian countries that can offer niche and higher-end products to capture this market of more experienced travelers.

Tourism drivers and challenges

Tourism is a complex activity that engages both public and private sectors, as well as civil society, at different points and in a multitude of ways throughout its development lifecycle. Moreover, tourism is multisectoral in nature and its successful development requires coordinated improvements along several dimensions, including infrastructure, finance, and education, among many others. Although there is no one accepted structure or model for tourism development, the World Economic Forum's Travel & Tourism Competitiveness Index (WEF TTCI) identifies the key tourism market enablers (Box II.B.1). The results of the 2017 WEF TTCI help identify the main drivers and challenges faced by developing East Asia (Figure II.B.8).

Box II.B.1. The World Economic Forum Travel and Tourism Competitiveness Index (WEF TTCI)

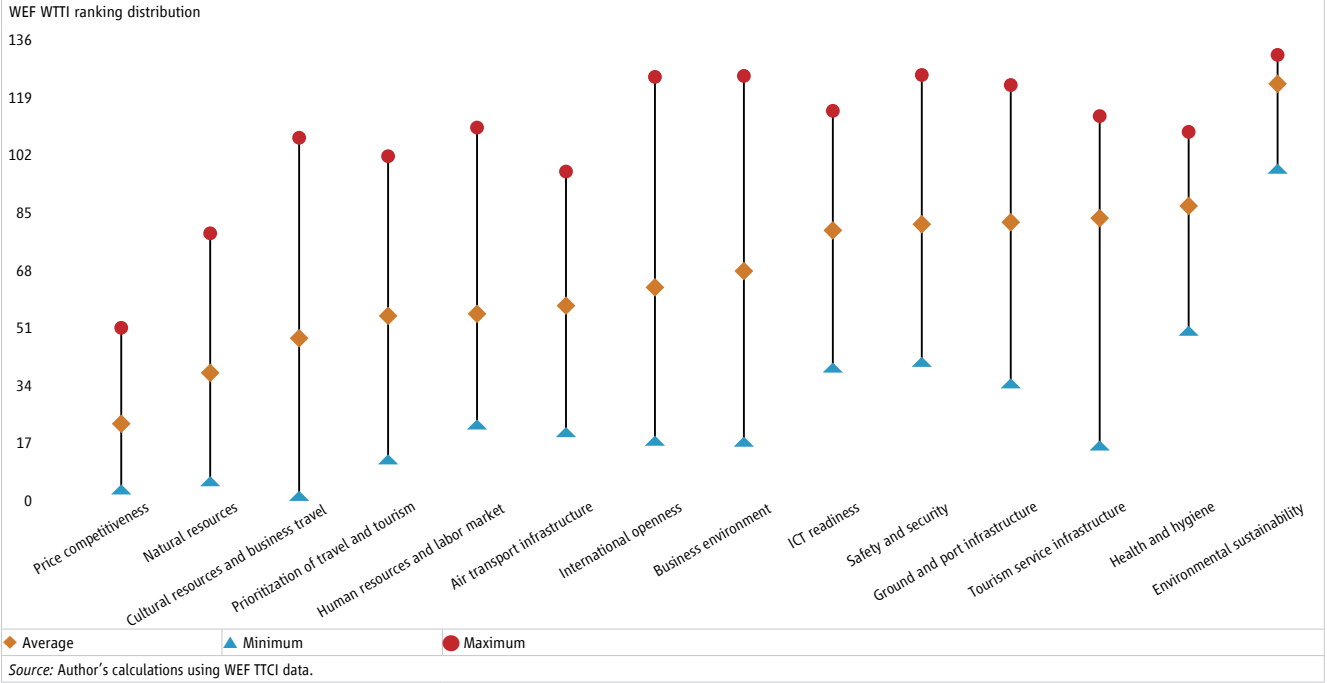
The WEF TTCI measures countries' tourism competitiveness across four major categories, broken down into 14 pillars and 93 separate indicators. In the latest version, published in 2017, 136 countries are ranked, with Spain (1), France, Germany (3), Japan (4), and the United Kingdom (5) in the top five. While scores for most indicators are based on secondary data, a portion of the information comes from the Executive Opinion Survey that WEF administers annually to over 14,000 global business leaders.

Travel & Tourism Competitive Index

Enabling environment	T&T policy and enabling conditions	Infrastructure	Natural and cultural resources
Business environment	Prioritization of travel & tourism	Air transport infrastructure	Natural resources
Safety and security	International openness	Ground and port infrastructure	Cultural resources and business travel
Health and hygiene	Price competitiveness	Tourist service infrastructure	
Human resources and labour market	Environmental sustainability		
ICT readiness			

Source: WEF 2017.

Figure II.B.8. Tourism in developing East Asia is driven by its price competitiveness but suffers from low environmental sustainability

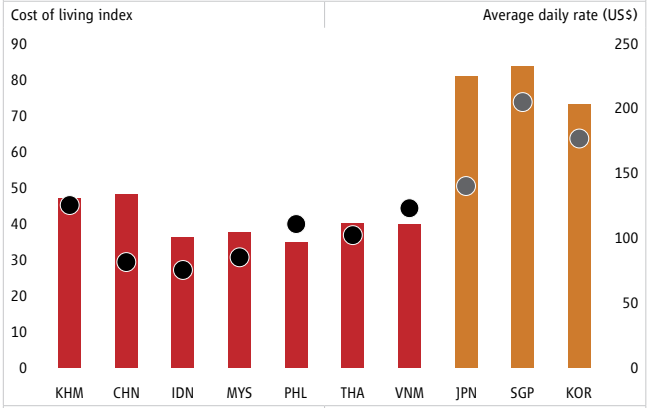


Source: Author's calculations using WEF TTCI data.

Drivers

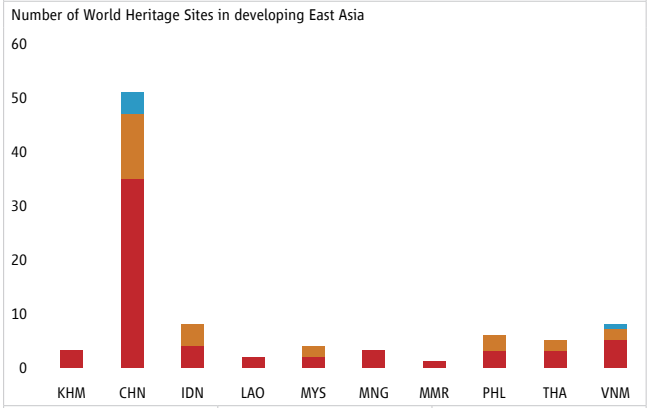
One of the region's most important drivers is its price affordability as a tourism destination. Based on the cost of living, the region includes some of the world's most affordable destinations, with Cambodia, Indonesia, and Vietnam the most affordable.[4] Moreover, the region benefits from having some of the world's most affordable first-class hotels, which can be found in China, Indonesia, and Malaysia under US$100 a night. This compares positively with the neighboring high-income destinations of Japan, Singapore, and Korea (Figure II.B.9).

Figure II.B.9. Developing East Asia benefits from being a price-competitive region



Sources: Numbeo (www.numbeo.com) and WEF 2017.

Figure II.B.10. Developing East Asia benefits from having multiple cultural heritage sites



Source: Authors' estimations using UNESCO data (2017).

Overall, the region benefits from good air transport infrastructure, but has some lagging countries. The number of takeoffs (domestic and international) per capita can be used as an estimate of the effectiveness of the country's air transport infrastructure. In this case, Malaysia leads the region with 14 takeoffs for every 1,000 citizens, while Cambodia, Myanmar, and Lao PDR lag with around one takeoff per 1,000 citizens.

Tourism in developing East Asia also benefits from its many natural and cultural attractions. The region hosts 92 World Heritage Sites, including 61 cultural, 26 natural, and 5 mixed World Heritage Sites (Figure II.B.10).[5] China, with 50, has the second-largest number of World Heritage Sites (35 cultural, 11 natural, and 4 mixed) in the world, trailing only Italy, with 51. Indonesia (4 cultural and 4 natural) and Vietnam (5 cultural, 2 natural, and 1 mixed) are followed by the Philippines, which has 6 sites (3 cultural and 3 natural), and Thailand, which has 5 sites (3 cultural and 2 natural). Indonesia has a site on the List of World Heritage in Danger, meaning its World Heritage status could be removed if corrective actions are not taken (UNESCO 2017).

Market and Policy Failures

The competitiveness of the tourism sector in developing East Asia is hindered by market and policy failures. The region performs poorly on environmental sustainability, health and hygiene, tourism service infrastructure,

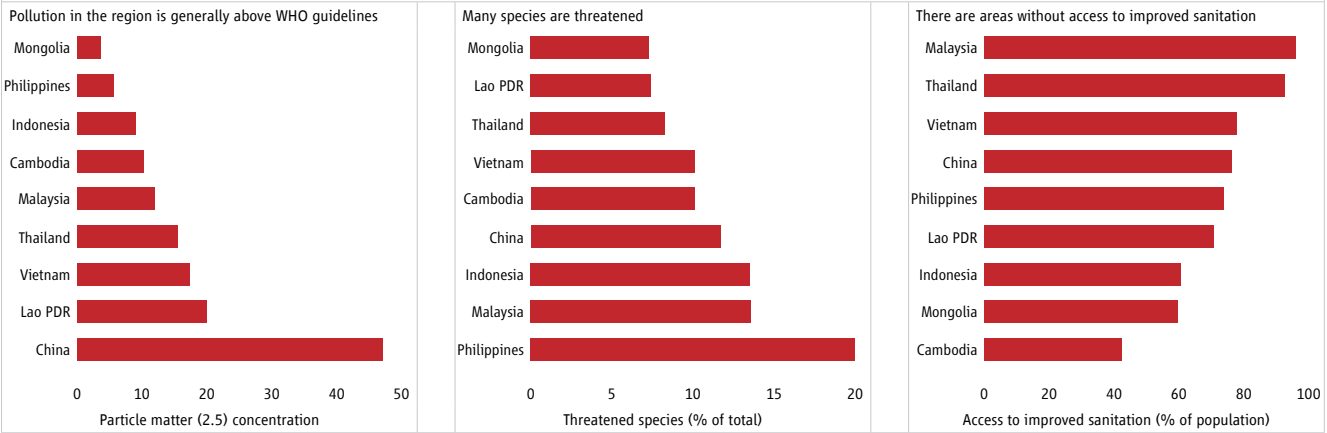
4 Based on Numbeo's cost of living index, which is relative to New York City. The index is a relative indicator of consumer goods prices, including groceries, restaurants, transportation, and unitalities.

5 The number of World Heritage Sites is not entirely indicative of the economy's cultural and natural resources. The World Heritage application process requires financial and technical resources that not all economies possess. Yet World Heritage status is probably one of the most powerful marketing labels for tourism sites.

and information and communications technology (ICT) readiness. This was previously depicted in the poor WEF WTTI rankings (Figure II.B.8).

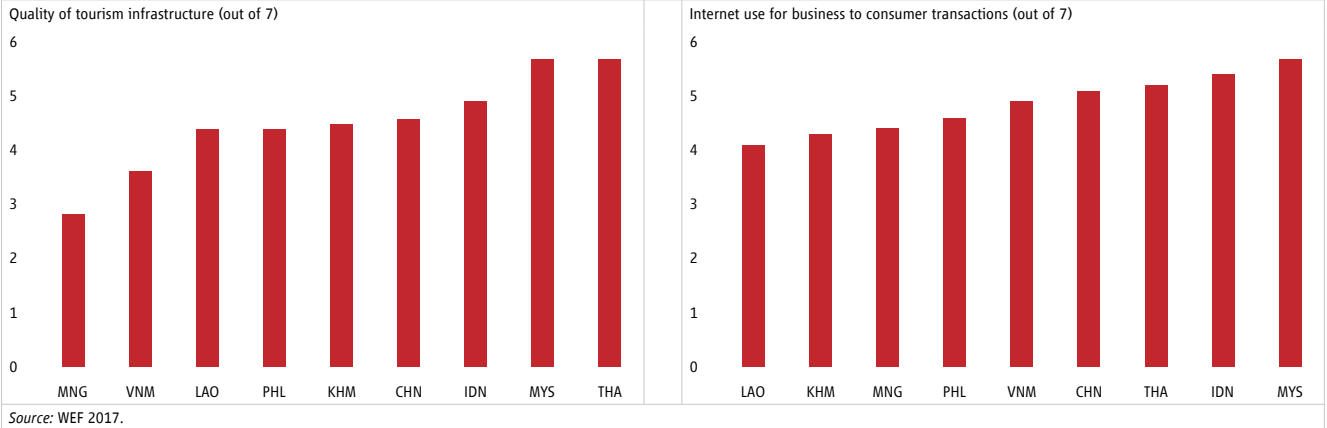
The environmental sustainability of the tourism sector is affected by pollution, threatened species, and health and hygiene. In Beijing, haze pollution has an impact on the tourists' decision-making processes, causing a portion of potential tourists to cancel tourism plans and avoid certain times of the year (Zhang et al. 2015). In the region, only Indonesia, Mongolia, and the Philippines have average pollution levels below the World Health Organization recommendations. Similarly, poor access to improved sanitation can deter tourism development. This is especially important to countries such as Cambodia, Indonesia, Lao PDR, Mongolia, and the Philippines, where less than 75 percent of the population have access to improved sanitation. In Indonesia, poor sanitation contributed to US$166 million per year in tourism loses (World Bank 2008). Finally, the region also hosts a significant share of threatened species, such as the tarsier, which draws tourists to the southeastern part of the Philippines. In the Philippines, 20 percent of total species are considered under threat, followed by Malaysia and Indonesia, with 14 percent.

Figure II.B.11. Tourism in developing East Asia is negatively affected by pollution, threatened species, and limited access to improved sanitation



Source: WEF 2017.

Figure II.B.12. There is room to improve tourism infrastructure and use of internet for business transactions



Source: WEF 2017.

The relatively poor quality of tourism and ICT infrastructure is also a notable problem. When asked to assess the quality of tourism infrastructure (that is, hotels, resorts, entertainment facilities), investors characterized the infrastructure in Mongolia and Vietnam as poor. Similarly, they rated the infrastructure in Lao PDR, the Philippines, Cambodia, China, and Indonesia to be just above average. Similarly, the availability of ICT infrastructure can impact tourism development. For example, the use of the internet for e-commerce can promote tourism development by creating transactions that were not possible before (inclusion), lowering the costs of existing transactions (efficiency), and giving rise to various types of scale economies (innovation) (World Bank 2016a).[6] As part of 2017 WEF TTCI, investors were asked about the use of the internet for selling their goods and services to consumers. In this area, Malaysia, Indonesia, and Thailand have the greatest use of e-commerce, compared to Lao PDR, Cambodia, and Mongolia, with the lowest.

Country Groupings

Given the region's diverse composition, countries can be grouped based on their level of tourism development. Based on the previous analyses of tourism performance and competitiveness, three country groups were identified for tourism in developing East Asia: Potential, Emerging, and Consolidating[7] (Table II.B.2).

- **Potential** countries are working on governance issues, have shown some interest in developing their tourism sectors, have some basic infrastructure for tourism, but still face difficulties with tourism regulation, resources, and institutions.
- **Emerging** countries have improved their governance indicators, are prioritizing tourism sector development, and are gradually increasing their tourism flows.
- **Consolidating** countries have relatively mature tourism sectors, are committed to continued support for the sector, and are top performers on various economic and tourism indicators.

Table II.B.2. Developing East Asia's economies can be grouped based on their level of tourism development

Group / income	*Lower-middle income*	*Upper-middle income*
Consolidating	Indonesia	Malaysia, Thailand
Emerging	Cambodia, Philippines, Vietnam	China[a]
Potential	Lao PDR, Mongolia, Myanmar,	—

Note: a. China is categorized as Emerging based on the relative nascence of its international tourism sector, low per capita arrivals, and environmental sustainability concerns.

Countries in all groups face fundamental market and policy failures that inhibit the competitiveness of their tourism markets. The most problematic issue in developing East Asia is environmental sustainability. A WEF-sponsored study examining the correlation between WEF TTCI scores and tourism performance identified environmental sustainability as the pillar that most closely correlates with tourism performance among emerging economies (WEF 2013).[8] Yet, other constraints vary considerably among developing East Asia's economies. They are summarized below for the different country groupings.

6 For example, Airbnb created competition in the lodging industry, providing more options for travelers and lowering the high rents previously enjoyed by the lodging sector. Similarly, Uber and Grab had a similar impact on the local transportation sector.

7 These categories and descriptions were developed by Trade & Competitiveness for the *Tourism in Africa: Harnessing Tourism for Growth and Improved Livelihoods* report (World Bank 2014).

8 To determine an economy's "tourism performance," the study considered its tourism arrivals (simple average growth rate of inbound tourism from 2007 to 2011) as well as its arrivals volatility rate (standard deviation of annual growth rates during the same period).

The "potential" countries of Lao PDR, Mongolia, and Myanmar primarily face problems linked to the availability and quality of infrastructure. Their weakest performance is on ICT readiness (average ranking of 113), followed by ground and port infrastructure (average ranking of 111), and air transport infrastructure (average ranking of 105).

Tourist service infrastructure and the business environment are the key issues among developing East Asia's "emerging" countries of Cambodia, China, the Philippines, and Vietnam. Particularly weak pillars for these emerging economies are tourist service infrastructure (average ranking of 99) and the business environment (average ranking of 92).

Among the "consolidating" countries of Indonesia, Malaysia, and Thailand, safety and sanitation issues are prominent. The "consolidating economies," with the exception of Malaysia, struggle with the safety and security pillar (average ranking of 92) and health and hygiene (average ranking of 92).

Policy Priorities

Understanding the role of the public and private sectors in the development of tourism is critical to fostering its sustainable growth. Failure to properly engage stakeholders during the planning and management phases of destination development may result in lack of support for the sector or poorly implemented, ineffective, or potentially detrimental tourism. In fact, sustaining tourism growth requires continuous stakeholder engagement and adapting of policies. Based on the challenges faced by the region as a whole and specific constraints for the different country groupings identified above, the following policy priorities are key to managing growth and maximizing the future benefits of tourism in developing East Asia.

Demand-Driven Investment Planning

Across all three country groupings in the region, tourism master planning is crucial for identifying and phasing public and private investments. The public sector is strategically placed to spearhead master planning initiatives that establish a common framework for the development of destinations and the management of their tourism carrying capacity. Countries can benefit from the preparation of integrated tourism master plans (ITMPs) for destination areas, based on a rigorous assessment of tourism demand and economic analysis for each destination, and prepared in close consultation with all stakeholders, including local communities and the private sector (see Indonesia example in Box II.B.2).

ITMPs provide the basis for identifying and prioritizing the public investments that are most critical to unlocking the demand potential of a given destination—that is, transport infrastructure, basic services, and amenities. ITMPs are an important input into the overall strategy and vision for a destination, helping to outline the investment gaps where private investment will most likely be needed (that is, for accommodation), and thus establishing the focus areas for promotion of private investment. Finally, ITMPs provide a unified planning framework for the multitude of stakeholders engaged in the destination development process to ensure that

their expenditures and activities are (a) consistent with the environmental, social, and cultural opportunities and constraints of the destinations; and (b) avoid degradation of the natural and cultural assets that attract visitors.

The preparation of these ITMPs is particularly important for countries in the "potential" country group, which have fewer established destinations and are more likely to embark on developing new destinations. Since a large share of up-front investment for these destinations will relate to enabling physical infrastructure—particularly to address the noted deficiencies in ICT and transport infrastructure—systematic planning and screening of these investments will be crucial to ensure scarce public resources are deployed in the most efficient manner.

The "consolidating" group of countries can also benefit from strengthening systems for tourism planning and investment as their mature tourism destinations begin to reach infrastructure and service capacity limits. Lingering issues with safety and security, as well as health and hygiene in these countries partly reflect the increased strain on public services (that is, local law enforcement and tourist police) and basic sanitation

Box II.B.2. Demand assessments and integrated tourism master planning in Indonesia

In an effort to capitalize on the country's diversity of natural and cultural assets and close the tourism competitiveness gap with neighboring countries, the Government of Indonesia, in late 2015, identified 10 high-potential tourism destinations for priority development, and decided to start with three of them—Lombok, Borobudur, and Lake Toba.

At the outset of this initiative, however, coordination mechanisms for tourism development at the national level were nascent, and those at the province and destination level were weak or absent, which was especially problematic given Indonesia's highly decentralized governance structure. In planning their budgets for the different priority destinations, different ministries and local authorities were using different sets of assumptions about the scale of tourism activity that could be expected, and not screening their investments for tourism relevance. Growth targets for visitors, tourism GDP, and employment were being set without a comprehensive and systematic assessment of future demand and the competitiveness of each destination. This raised the risk of overly costly public spending scenarios with limited impact on tourism or local economic development.

To prepare integrated destination master plans, the government initiated market demand and investment needs assessments for each priority destination, which provided a rigorous forecast of the magnitude and composition of future tourism demand, and the supply-side requirements to accommodate this demand. Based on the results of these assessments, integrated tourism master plans and investment budgets are being prepared for each destination. These master plans will be validated and adopted at all layers of government, to ensure that relevant agencies are working off a unified set of objectives, plans, and assumptions, thus helping to improve intragovernmental coordination and reduce the risk of duplicative public spending. Indonesia aims to strike a balance between the political temptation to rush into developing destinations and long-term comprehensive planning by starting destination development with "no regret" investments, while waiting for the master plans for those investments that need stronger planning.

infrastructure to keep up with growing tourism demand. A periodic reassessment of demand trends and investment gaps is therefore an important input into ongoing destination management efforts, helping to inform and guide the planning and execution of investments needed to alleviate emerging capacity constraints and improve the overall visitor experience.

Environmental Sustainability

While public and private sectors both have a significant role to play in improving the environmental sustainability of tourism, governments must lead. Improving environmental sustainability is a priority for all three country groupings, which perform poorly in multiple environmental sustainability areas including pollution, water and sanitation, and threatened species.

Managing sustainability requires both infrastructure investments and the development and enforcement of quality standards in all countries. Developing East Asian economies across country groupings can benefit from infrastructure investments that increase access to improved sanitation, waste management, and drinking water. The private sector will have a greater incentive to connect to central systems if those systems provide the services that they demand (as identified in ITMP). Moreover, standards in the industry can hold the private sector accountable in areas such as waste management and pollution, among others. For example, the Singapore Tourism Board (STB) developed the sustainability guidelines for the Singapore meetings, incentive travel, conferences, and

Box II.B.3. The effectiveness of ecotourism as a means of protecting the local environment: An example from Cambodia

Cambodia is one of the world's conservation frontlines, with forests home to 45 species of mammals, 46 species of birds, and 17 species of reptiles on the International Conservation Union's Red List of endangered species. To help protect bird species from mounting threats, ecotourism programs have been developed in villages such as Tmatboey. Key elements of programs include the development of community-wide awareness campaigns, creation of village committees to help manage the program, training of community members in tour guiding and hospitality training, development of birdwatching tours and local accommodations, and the marketing of ecotourism packages.

The program in Tmatboey was highly successful. From 2005 to 2008, the number of visitors increased by an average of 36 percent per year and revenues doubled. Overall, 40 percent of the village's families earned income from tourism services. In addition, 24 percent of revenues went to a village fund used to pay for a new school, build a road, repair water pumps, and dig new wells. This gave all villagers a strong incentive to protect their natural assets. Indeed, substantial increases of wildlife were noted. For example, the population of White-shouldered ibis, one of the rarest birds on the planet, increased from a single pair in 2002 to at least 23 individual birds in 2008.

Source: Clements et al. 2010.

exhibitions (MICE) industry (Singapore Tourism Board 2013). These guidelines are referenced from international standards such as ISO 20121 and the APEX/ASTM Environmentally Sustainable Meeting Standards. The sustainability guidelines cover seven industry categories from across the business events ecosystem, including hotels, venues, event organizers and meeting planners, transportation, food and beverage, and audiovisual setup. Areas covered under the guidelines include advice on waste management and the efficient use of water and energy, as well as initiatives that encourage employees to develop a commitment to sustainable practices.

Tourism products can be leveraged to protect the local environment, including threatened species. Studies on tourist consumer behavior indicate that there is also a growing awareness of environmental, social, and cultural impacts that tourism can generate. Tourists who seek sustainable tourism activities are sensitive to their impacts. In addition, some research indicates that the sustainable tourism market is willing to pay more to visit a destination that demonstrates responsible practices (Pulido-Fernández and López-Sánchez 2016). The combination of sustainable behavior and potential higher spending provides evidence of a market segment that can be beneficial to destinations where environmental or cultural assets may be at risk from low-yielding mass tourism. This is exemplified in the case of Cambodia, where tourism products are being used to protect the local environment (Box II.B.3).

Box II.B.4. Maximizing backward links of tourism activities in Lao PDR

Despite strong growth in tourism arrivals at the UNESCO World Heritage Site of Luang Prabang, poverty levels were still high (over 30 percent) as local communities struggled to enter the tourism value chain. To improve local links and better distribute tourism spending, a cluster of UN agencies with funding from Switzerland's State Secretariat for Economic Affairs launched the "Enhancing Sustainable Tourism, Clean Production, and Export Capacity in Lao PDR" project in 2011. The project targeted two sectors: agriculture and handicrafts (OECD, UNWTO, WTO 2013).

In the agricultural sector, over 100 farmers were organized into producer groups, given technical assistance on improving the quality and variety of their produce, and connected to hotel and restaurant owners. In addition, the fee-based "Luang Prabang Organic Agriculture" association was set up to support quality control and marketing efforts. The association is now the main supplier of fresh vegetables to high-class hotels and restaurants in the area. During July 2012 to January 2013 alone, they sold 450 tons of vegetables (30 different varieties) worth US$193,000 (ITC 2017). Members earn up to US$700 a month, compared with previous average revenues of US$300 per month (OECD, UNWTO, WTO 2013).

The project also provided training and marketing support to over 250 cotton and silk craft artisans. The quality of their weavings was enhanced through support from an international designer. To market the products, the Luang Prabang Handicraft Association was formed, the "Handmade in Luang Prabang" label of origin was developed, and on-site weaving demonstrations were organized at hotels and museums. Over 120 producers and traders adopted the label and sales at the night market increased by 60 percent. Producers purchase each label for US$0.10, which covers LPHA's administrative costs and thereby ensures the sustainability of the initiative (ITC 2017).

Fostering Tourism Links to Local Economies

Promoting the participation of local workers and firms in the tourism value chain is essential to maximizing the "multiplier" effect of tourism spending. The strongest multiplier impact comes when forward and backward tourism links to other economic sectors are maximized, and leakages (that is, need to import goods and services) are minimized. Fostering such local links involves ensuring that there is (a) a sufficient quantity of local workers and firms in the linked sectors that produce the various goods and services demanded by tourists (for example, hotels, restaurants, agriculture, transport, recreation), and (b) that these local goods and services meet the quality standards required by different tourism market segments (from low-end domestic visitors to 5-star hotels and luxury-seeking international visitors). In many cases, these skills and quality shortages can begin to be addressed through targeted training programs for tourism sector professionals, and technical assistance to firms to obtain various product and service quality certifications. A package of such assistance has been used with considerable success in Lao PDR (Box II.B.4).

Box II.B.5. Promoting tourism by reforming the business environment: An example from Peru

The Cusco region received over 2.7 million tourists in 2014. Its top draw is Machu Picchu, the iconic 15th century Incan citadel that was inducted as a World Heritage Site in 1983. While visitation to the region increased 150 percent from 2005 to 2014, excessive government red tape meant that the private sector was unable to satisfy the surging demand (DIRCETUR Cusco 2015).

For the people of Cusco to fully benefit from the tourism boom, the government had to ease its burdensome business regulations. In fact, a 2012 study conducted by the Peru Hotel Association found that government obstacles were delaying half of the expected amount of new hotel investments in Cusco. These delayed investments were valued at approximately US$776 million. To support the government in reducing the bureaucratic barriers to opening a new business, the World Bank Group launched an advisory project in 2012. The project worked toward reducing processing time and costs by increasing administrative efficiency. This was achieved by automating some processes, elaborating clearer and specific requirements for others, and providing extensive training for public servants.

By the end of the project, over 150 unnecessary business registration processes were eliminated. These included duplicative forms, official letters to mayors, photos of buildings in process, and copies of worker IDs. Through the elimination of so many processes and the streamlining of others, the business registration process has been reduced by an average of three years (World Bank 2016b). These reforms are also estimated to save businesses several million U.S. dollars per year—with most of the savings being experienced by small businesses (SECO 2015).

Conducive business environment for tourism

Creating a conducive business environment for tourism investment and business entry is key for the "emerging" group of economies. As the case of Peru, which is illustrated in Box II.B.5, shows simplifying the bureaucratic burdens to business entry and investment can unlock the sector's potential to attract more investment and for local firms to respond to and capture tourism demand.

Conclusion

The rapid tourism growth experienced in developing East Asia over the last decade set to continue on the back of favorable economic, demographic, and technological tailwinds, but its associated opportunities and risks must be carefully managed. Sustained or increased tourism growth from both international and domestic arrivals—supported by increasing urbanization, middle-class incomes, propensity to travel among millennials, e-enabled tourism services, and Chinese outbound tourism—will generate significant new opportunities to develop tourism destinations in the region. At the same time, this growth, if not properly managed, will place greater pressures on the sector's economic, social, and environmental sustainability.

While the public sector cannot singlehandedly steer the tourism sector on a sustainable growth path, targeted policy interventions can go a long away in facilitating stronger private investment in the sector, promoting tourism's links with the broader economy, and ensuring that the natural and cultural assets which attract tourists in the first place are adequately protected. Depending on their stage of tourism development, different developing East Asian economies will need to prioritize certain policy initiatives over others, but the general menu of issues to be addressed is broadly similar across the region. These include a stronger policy emphasis on conducting demand-driven integrated planning, improvements in the enabling business environment for tourism, better environmental quality standards, the development of more eco-friendly tourism product offerings, and boosting the participation of local workers and firms in the economic opportunities created by tourism.

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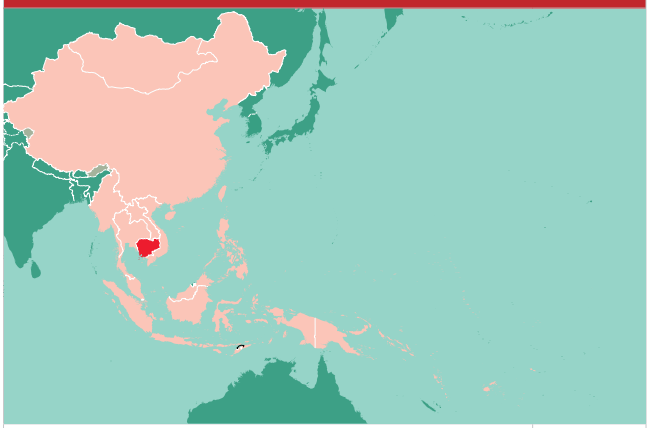
Part III. Country Summaries and Key Indicators

CAMBODIA



	2016
Population, million	15.8
GDP, US$ billion	20.0
GDP per capita, US$	1,265
School enrolment rate, primary (% gross)[a]	116.4
Life expectancy at birth, years[a]	68.2

Sources: World Bank WDI and Macro Poverty Outlook.
Notes: a. Most recent WDI value (2014).

Summary

Growth is projected to ease slightly to 6.8 percent in 2017, from 7.0 percent in 2016. Textile exports have decelerated, while the exports of electrical machinery, equipment and parts have picked-up. Authorities' efforts to attract international tourists also seem to have paid off. Growth is projected to remain strong, expanding at 6.9 percent in 2018. Downside risks to the outlook include a sharp slowdown in the Chinese economy and potential election-related uncertainty.

Recent Developments

Growth remained strong in 2016, at 7.0 percent, while there are signs of moderation (Figure 1). Owing to rising real wages and declining export prices, textile product exports growth decelerated to 5.4 percent year on year (y/y) in the first half of 2017, compared with 8.4 percent in 2016. Partly offsetting this deceleration, exports of electrical machinery, equipment and parts have picked-up. The share of the newly emerging exported products rose to 8.7 percent of total exports in 2016, up from less than two percent in 2010.[1] Authorities' efforts to attract international tourists seem to have paid off. Tourist arrivals accelerated to 12.8 percent growth (y/y) during the first six months of 2017, compared with 5 percent in 2016.

Credit growth has slowed, decelerating to 18.2 percent y/y in mid-2017, down from 25.8 percent in 2016. Deposits growth remained strong, increasing at 20 percent, reflecting healthy capital inflows. Rising foreign currency deposits have contributed to the expansion of broad money, which grew by 19.7 percent by mid-2017, compared with 17.9 percent in 2016.

The current account deficit is estimated to have narrowed to 10.2 percent of GDP in 2016, compared to 11.5 percent in 2015, given lackluster imports. Continued strong FDI inflows supported rapid accumulation of foreign reserves, reaching US$7.8 billion (or 6 months of imports).

Inflation moderated to 2.3 percent at mid-2017, down from 3.9 percent in 2016. Recent moderation reflects weaker demand, and there are signs that construction activity is slowing down. Cambodian riel (CR)/US dollar exchange rate depreciated to CR 4,086 in June 2017, up from CR 4,037 in December 2016.

The fiscal position remained stable and broadly supportive of growth. In 2016, strong revenue collection continued. Rising current expenditure boosted by growing wage bill was more than offset by the decline in capital spending. The deficit (excluding grants) is estimated to have narrowed to 3.0 percent of GDP in 2016, down from 3.5 percent in 2015.[2] Cambodia's

1 The newly emerging exported products include machinery, mechanical appliances, nuclear reactors, boilers; parts thereof (Harmonized System or HS 84), electrical machinery and equipment and parts thereof; sound recorders and reproducers, television (HS 85), and vehicles other than railway or tramway rolling stock, and parts and accessories thereof.

2 2016 fiscal data remains preliminary.

debt distress level remained low as per the 2017 WB/ IMF Debt Sustainability Analysis.

Outlook

The growth outlook is favorable. Growth is projected to expand at 6.8 percent in 2017 and 6.9 percent in 2018, underpinned by export diversification, increased public spending and recovery of the tourism sector.

Downside risks to the outlook include a sharp slowdown in the Chinese economy and potential election-related uncertainty. The deceleration of textile and construction sector could affect the income earnings of the poor in terms of less overtime working hours or days. The most recent preliminary quarterly survey of garment workers in Phnom Penh also confirmed that daily income earnings of garment workers declined in May 2017 compared to February 2017. Consequently, remittances originating from these sectors could possibly decline, tightening the household budget and decreasing the expenditure in education, health and investment in agricultural activities in the rural areas, too, if the trend continues.

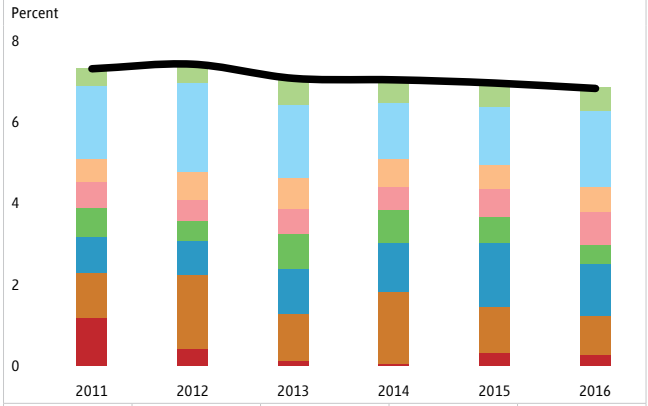
Risks and Challenges

It is crucial to nurture the incipient high value-added manufacturing industries. Adopting cost-effective and competitive electricity tariffs will support high value-added manufacturing sectors that are energy-intensive. Identifying skills gaps to design courses and programs that address such gaps as targeted under the 2017–25 National Technical and Vocational Education and Training Policy is a priority.

Further facilitating investment in the manufacturing sector is needed, given the recent slowdown in foreign direct investment in the textile sector. Cambodia's doing business ranking remains relatively low. As real wages increase, Cambodia's external competitiveness, which primarily relies on cheap labor, is gradually diminishing. It is therefore important to further improve the ease of doing business through sound regulatory environment, targeting high-value added industries as envisaged by the 2015–25 Industrial Development Policy.

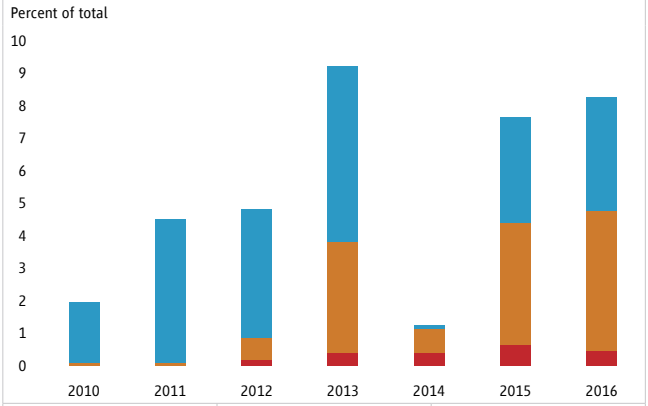
Mitigating measures are necessary to support rural households who have been hard hit by continued low agricultural prices. In addition, the potential negative impacts of the slowdown of textile and construction sectors will need to be closely monitored. Successfully implementing the two main pillars, social assistance and social security, envisaged under the 2016–25 national social protection policy framework will help prevent rural households from falling back into poverty.

Figure 1. Real GDP growth, contribution to real growth



Sources: Cambodian authorities and World Bank staff estimates.

Figure 2. Exports of electrical machinery, equipment and parts

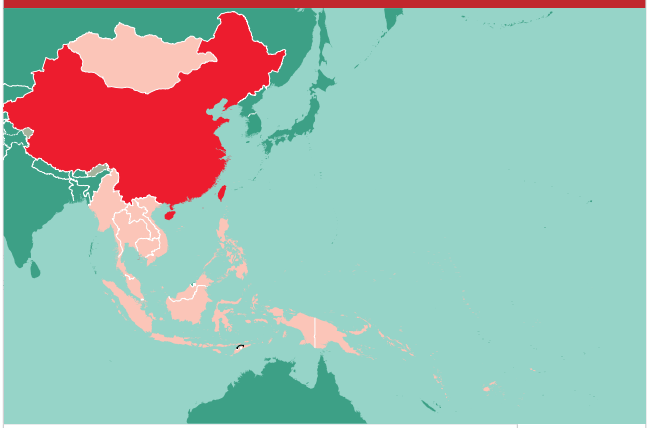


Source: UN Comtrade; HS = Harmonized system.

CAMBODIA Selected Indicators	*2014*	*2015*	*2016e*	*2017f*	*2018f*	*2019f*
Real GDP growth, at constant market prices	7.1	7.0	7.0	6.8	6.9	6.7
Private Consumption	4.5	5.9	6.7	4.3	4.3	4.3
Government Consumption	2.4	4.4	5.7	7.8	10.5	10.8
Gross Fixed Capital Investment	9.1	10.6	10.1	9.7	10.4	7.8
Exports, Goods and Services	11.3	7.2	8.6	7.1	7.2	8.2
Imports, Goods and Services	10.1	6.5	8.6	6.0	6.4	7.0
Real GDP growth, at constant factor prices	6.9	6.9	6.9	6.7	6.8	6.6
Agriculture	0.3	0.2	1.4	1.2	1.1	1.0
Industry	9.8	11.7	10.5	9.2	8.3	6.8
Services	8.7	7.1	6.8	7.4	8.3	8.9
Inflation (Consumer Price Index)	1.7	1.3	3.5	2.9	3.2	3.5
Current Account Balance (% of GDP)	-11.3	-11.5	-10.2	-9.6	-9.2	-8.9
Financial and Capital Account (% of GDP)	14.6	14.2	14.3	13.9	14.4	14.0
Net Foreign Direct Investment (% of GDP)	10.0	9.1	10.8	11.0	11.0	10.7
Fiscal Balance (% of GDP)	-5.0	-3.5	-3.0	-4.5	-5.3	-5.1
Debt (% of GDP)	32.1	31.3	32.4	34.0	35.5	36.3
Primary Balance (% of GDP)	-4.3	-3.2	-2.7	-4.2	-4.9	-4.7

Sources: World Bank, Macroeconomics and Fiscal Management Global Practice, and Poverty Global Practice.
Note: e=estimate and f = forecast.

CHINA



	2016
Population, million	1,378.7
GDP, current US$ billion	11,227.7
GDP per capita, current US$	8,144
International poverty rate ($1.9)[a]	1.9
Lower middle-income poverty rate ($3.2)[a]	12.1
School enrolment, primary (% gross)[b]	103.9
Life expectancy at birth, years[b]	75.8

Source: WDI, Macro Poverty Outlook, and official data.
Notes: (a) Most recent value (2013), 2011 PPPs. (b) Most recent WDI value (2014).

Summary

Supported by consumption and improving external conditions, GDP grew by 6.9 percent year on year in the first half of 2017. Growth is projected to moderate in 2018–19, as the authorities continue to pursue policies to constrain debt growth. Poverty reduction is expected to continue, with the extreme poverty rate projected to decline to 0.8 percent by 2019. China's key policy challenge is managing an orderly transition to more equitable and sustainable growth through continued reduction in macroeconomic imbalances and a greater orientation toward domestic consumption.

Recent Developments

China's GDP grew by 6.9 percent yoy in the first half of 2017, up from an average of 6.7 percent in 2016. Growth continues to be driven primarily by consumption, which contributed 4.4 percentage points of growth as opposed to 2.8 percentage points from investment. Growth has also been positively affected by improving global trade conditions. For the first half of the year, net exports contributed positively to growth (0.3 percentage points) as compared to a negative contribution (-0.5 percentage points) in 2016. Export growth also has important multiplier effects for China's economy. Overall, growth continues to be led by services, although real estate and finance growth moderated somewhat in the first half of 2017 relative to 2016.

In contrast to 2016, growth in average disposable income at 7.3 percent yoy in the first half of 2017 exceeded growth in GDP, thereby contributing to consumption-led rebalancing. However, a decline in agricultural prices and associated slower growth in rural business incomes appear to have moderated income growth in rural areas, including among poorer segments of the population. While average income growth accelerated in the first half of 2017, median disposable income per capita (deflated by CPI) increased yoy by 5.6 percent in the first half of 2017, down from 6.2 percent and 9.2 percent in the first half of 2016 and 2015, respectively. Growth in rural business incomes declined from 6.5 percent yoy in H1 2016 to 3.5 percent in H1 2017. Consumer price inflation remained subdued in both rural and urban areas (1.0 and 1.5 percent monthly average yoy in the first half of 2017), with food price inflation below the recent average and health expenditures experiencing above average price increases (-2.1 and 5.5 percent average monthly yoy, respectively). World Bank estimates suggest that the proportion of the population consuming less than the international poverty line ($1.9/day in 2011 PPP) fell from 1.4 percent in 2015 to 1.2 percent in 2016. The poverty rate calculated using the lower middle-income class poverty line (US$3.2/day in 2011 PPP) fell from 9.9 percent in 2015 to 9.1 percent in 2016.

Tighter monetary policy and new regulations on shadow financing have slowed growth in commercial bank assets notably, consistent with the mitigation of macroeconomic risks. Total credit to the non-financial sector grew at an annualized rate of 15.3 percent in the first six months of 2016, down from 15.7 percent

average growth in 2016. More significant signs of deleveraging are observed in bank asset data, with growth in total assets slowing down from 16.5 percent in 2016 to an annualized rate of 9.3 percent in the first half of 2017. Bank assets in China partly reflect shadow financing products, many of which are not included in the "total credit" measure cited above.

The recovery in global trade has been an important factor supporting growth so far in 2017. In the first half of 2017, the US dollar value of exports and imports increased by 5.3 and 18.4 percent, respectively, mainly due to higher trade volumes. This can be compared to a contraction of 6.4 and 5.4 percent, respectively, in 2016. The current account balance was US$71 billion or 1.3 percent of GDP in the first half of 2017, down from 1.8 percent in 2016.

Owing in part to greater market confidence and stricter capital controls, capital outflows from China stabilized considerably in the first half of 2017. Gross foreign exchange reserves increased by US$29.4 billion to US$3.1 trillion, compared to a decline of US$163.6 billion during the same period in 2016. Capital outflows, including errors and omissions, declined to US$42.2 billion in H1 2017, down from US$268.0 billion in H1 2016. In the context of broad US dollar depreciation, the Renminbi appreciated by 2.3 percent against the US dollar in the first six months of 2017.

Outlook

GDP growth is revised upward to 6.7 percent in 2017 in light of better-than-expected performance in the first half of the year. Nevertheless, growth is projected to moderate in the near future as the economy rebalances away from investment and external demand towards domestic consumption over the medium term. In addition, the authorities are expected to continue to pursue policies aimed at bringing the growth of debt under control to reduce macroeconomic risks and imbalances. Growth is projected at 6.4 percent in 2018–19. Despite recent improvement in the international environment, external risks to China's outlook remain considerable. These stem from the possibility of more restrictive trade policies and renewed strains on the financial sector associated with the withdrawal of accommodative monetary policies in advanced countries.

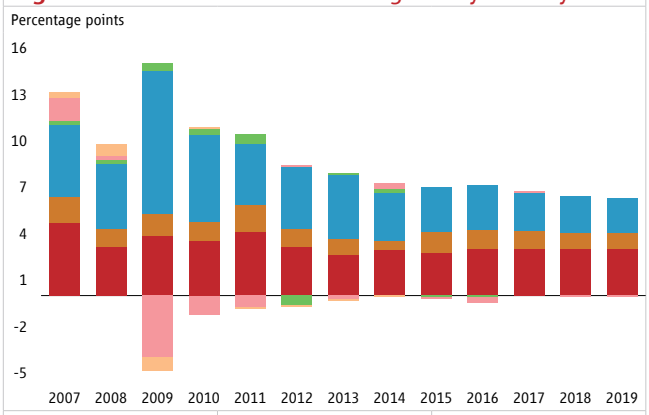
Given the positive medium-term growth outlook and the recent deceleration in disposable income growth, poverty rates are expected to continue to decline but at a slightly slower pace. The share of the population living below the international poverty line would likely reach 0.8 percent, and those living below the lower middle-income class line would reach 7.0 percent by 2019.

Risks and Challenges

The continued pursuit of policies to bring debt accumulation under control is critical for China's future growth prospects. Since the start of 2017, the Government has tightened monetary policy, introduced measures to strengthen financial regulation, and established a State Council Financial Stability and Development Commission to improve regulatory coordination. Serious progress toward deleveraging is well worth the cost of slower GDP growth in the short run.

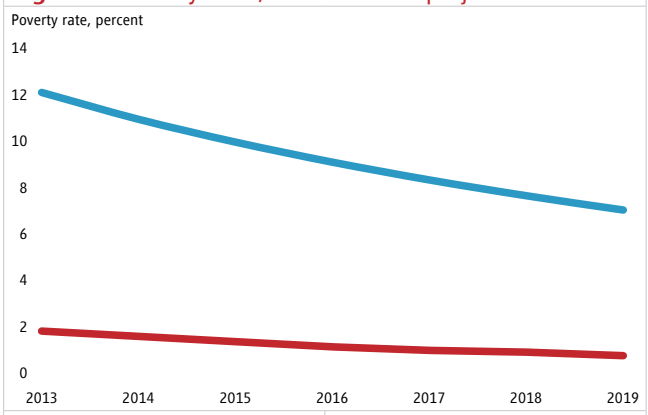
China's key medium-term challenge is to manage an orderly transition to more equitable and sustainable growth through a greater orientation toward domestic consumption. By ensuring that the income growth of the population exceeds the pace of GDP growth, a corresponding rise in domestic consumption can potentially support relatively high growth. Many important reforms in areas such as pensions and the hukou (household registration) system are key to creating opportunities for more rapid personal income growth.

Figure 1. Contribution to real GDP growth year-on-year



Sources: National Bureau of Statistics; World Bank estimates.

Figure 2. Poverty rates, estimates and projections

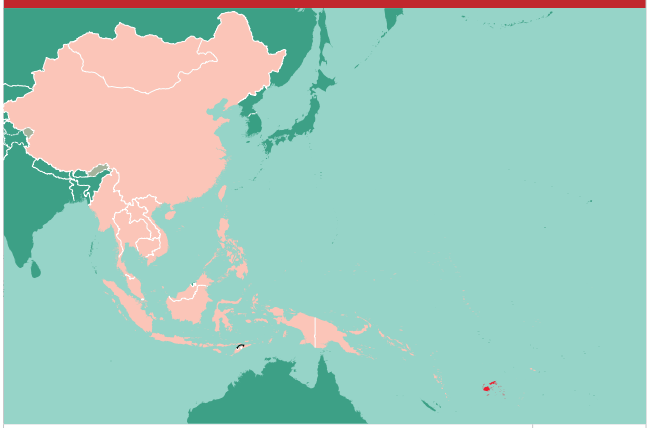


Sources: National Bureau of Statistics; World Bank estimates.

CHINA Selected Indicators	*2014*	*2015*	*2016e*	*2017f*	*2018f*	*2019f*
Real GDP growth, at constant market prices	7.3	6.9	6.7	6.7	6.4	6.3
Private Consumption	8.0	7.4	7.9	7.9	7.7	7.6
Government Consumption	4.1	9.9	9.5	7.8	7.6	7.4
Gross Fixed Capital Investment	7.4	7.0	6.7	5.8	5.5	5.4
Exports, Goods and Services	8.0	-0.9	2.7	5.8	4.7	4.7
Imports, Goods and Services	7.9	-0.6	5.8	6.5	5.5	5.5
Real GDP growth, at constant factor prices	7.3	6.9	6.7	6.7	6.4	6.3
Agriculture	4.1	3.9	3.3	3.3	3.3	3.3
Industry	7.4	6.2	6.1	6.1	5.7	5.5
Services	7.8	8.0	7.8	7.7	7.5	7.4
Inflation (Consumer Price Index)	2.0	1.4	2.0	2.0	2.0	2.0
Current Account Balance (% of GDP)	2.2	2.7	1.7	1.4	1.2	1.1
Financial and Capital Account (% of GDP)	-1.6	-0.8	0.3	-0.2	-0.1	-0.1
Net Foreign Direct Investment (% of GDP)	1.4	0.6	-0.4	0.1	0.1	0.1
Fiscal Balance (% of GDP)	-0.3	-2.3	-3.2	-3.1	-3.1	-3.0
Debt (% of GDP)	38.0	36.2	36.6	36.8	37.0	37.1
Primary Balance (% of GDP)	0.7	-1.4	-2.3	-1.9	-1.9	-1.7
International poverty rate ($1.9 in 2011 PPP)[a,b]	1.6	1.4	1.2	1.1	0.9	0.8
Lower middle-income poverty rate ($3.2 in 2011 PPP)[a,b]	10.9	9.9	9.1	8.3	7.6	7.0

Sources: World Bank, Macroeconomics and Fiscal Management Global Practice, and Poverty Global Practice.
Note: f = forecast. (a) 2013 is actual based on group data provided by Povcal, 2014 onwards are projections using annual growth elasticity. (b) 2013 survey is a break and not comparable with previous surveys.

FIJI



	2016
Population, million	0.9
GDP, current US$ billion	4.7
GDP per capita, current US$	5,247
Life expectancy at birth, years[a]	70.1

Sources: WDI, Macro Poverty Outlook, and official data.
Notes: a) Most recent WDI value (2014).

Summary

Growth is set to accelerate to 3.8 percent in 2017 from 0.4 percent last year supported by the ongoing reconstruction work following Cyclone Winston, strong visitor arrivals, and domestic consumption. Inflation has moderated to 2 percent as the cyclone-related supply shortages eased. Growth is expected to remain above-trend in the forecasting period on strong private consumption and public investment. Downside risks include another natural disasters and acceleration in domestic inflation. Building climate resilience is key to maintaining Fiji's macroeconomic stability and inclusive growth.

Recent Developments

GDP growth is expected to reach 3.8 percent this year, recovering from 0.4 percent last year following Cyclone Winston (Figure 1). The resurgent growth is supported by the ongoing reconstruction work, buoyant visitor arrivals (up 5.7 percent in the year to July), and strong consumer demand from higher incomes, lower unemployment (5.5 percent, the lowest on record in 15 years), and continued strength in remittances. The remittances make an important contribution to welfare across all income groups, and historically have been an important contributor to poverty reduction in Fiji.

The annual inflation has moderated to 2.0 percent in July from a high of 6.8 percent in January this year, which also likely to have benefited the poor, as the cyclone-related supply shortages eased and the effect of higher duties on alcohol and tobacco tailed off. The Fiji dollar continues to remain stable against the basket of currencies, appreciating modestly against the US dollar and Japanese Yen (3.3 and 8.5 percent, respectively), while depreciating against the NZ dollar, the Australian dollar, and the Euro (-2.5, -2.9, and -2.6 percent, respectively) in the year to July. The Real Effective Exchange Rate index has appreciated marginally over the same period by 0.6 percent.

The external deficit remains elevated at 6 percent of GDP, reflecting large shortfall on the merchandise trade account. Import demand for raw materials and capital equipment continues to be strong as reconstruction activities gather pace. A large surplus in the services account (relating to tourism and transport) and the continued strength in remittances are providing needed offsets. Foreign reserves remain adequate, however, which stood at F$2,349 million in end-August, sufficient to cover 5.8 months of imports.

The fiscal deficit for 2016/17 is estimated to be around 2 percent of GDP—lower than the planned deficit of 7.3 percent (4.7 percent according to the national convention of counting privatization receipt as revenue) mainly due to delays in reconstruction activities. The 2017/18 budget remains focused on completing the reconstruction projects, with a planned deficit of 7.9 percent of GDP (4.5 percent according to the national convention), mainly reflecting a rollover of capital expenditure from last year's reconstruction

spending and increases in civil service wages and social welfare payments.

Government debt is expected to remain around 50 percent of GDP. It had been falling as a share of GDP in recent years on the back of strong growth, but increased last year owing to additional borrowing for post-Winston reconstruction. This year, F$717 million in new borrowing is expected in the budget, of which 74 percent is expected to be met from domestic sources and 26 percent from external sources. Domestic bonds are issued with maturities of 1 to 15 years, and are mostly held by the nonbank financial institutions. This year, the government is looking to issue "Green Bonds" denominated in local currency to attract funding for projects to address climate change.

Poverty rates in Fiji are among the lowest in the Pacific. Based on the lower middle-income class poverty line (US$3.2/day in 2011PPP), 14.2 percent of the population live in poverty; based on the international poverty line (US$1.9/day in 2011PPP), less than two percent of the population lived in extreme poverty in 2013/2014. These rates are among the lowest rates in the Pacific although they are similar to those in other upper-middle-income countries. Although poverty rates have been falling in the last decade (Figure 2), the averages mask divergence across regions. In particular, between the 2008/09 and 2013/14 surveys, urban poverty has increased (from 12 to 13 percent based on the lower middle-income class poverty line) even as the aggregate poverty and rural poverty have declined (from 17 to 14 percent and 22 to 16 percent, respectively).

Outlook

GDP Growth is expected to remain above-trend, moderating from 3.7 percent this year to 3.3 percent in 2019, on continued strength in consumption and public investment in infrastructure. The year-end inflation is expected to be around 3.0 percent and to moderate only slowly in 2018–19, as several policy measures announced in the national budget add inflationary pressures, such as increases in the minimum wage, social protection payments, and civil service wages.

The fiscal deficit will likely remain elevated throughout the forecasting period, as the government accelerates the reconstruction effort while continuing to focus on spending on priority sectors—health, education, and infrastructure, the central elements of the previous three budgets—until the next election in 2018. The government's medium term fiscal projections imply fiscal consolidation starting in 2018/19, with the deficit narrowing from 4.5 percent of GDP this year to 3.0 percent and 2.5 percent in the following two years, mainly through greater revenue mobilization and moderation in capital spending from the post-Winston peaks.

Risks and Challenges

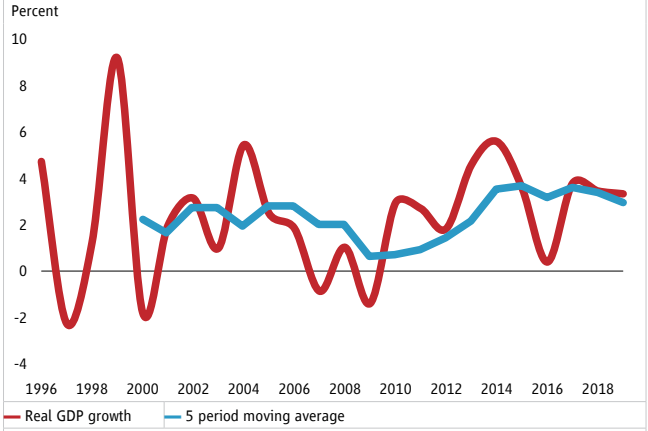
There are several risks to the outlook. Another natural disaster or a sharper-than-expected slowdown in growth in Fiji's major export or tourism source markets—including China and the United Kingdom—could sidetrack the timely completion of the recovery program; divergent monetary policy among advanced economies could cause financial market disruptions and raise costs of external borrowing; domestic inflation could re-accelerate with the expansionary budget which, If not stemmed by prompt monetary tightening, could raise inflation expectation.

Building climate resilience remains a priority. Fiji is one of the most vulnerable in the world, where, each year, natural disasters cost on average 2 percent of GDP. Last year's Cyclone Winston caused damage of F$2 billion, or 25 percent of GDP. With climate change, the frequency and the cost of disasters are expected to increase. As an upper middle-income country with limited access to grants, Fiji will find it increasingly difficult to finance the rising cost of disasters and the needed adaptation

while continuing to invest in growth- and welfare-enhancing infrastructure, education, and health.

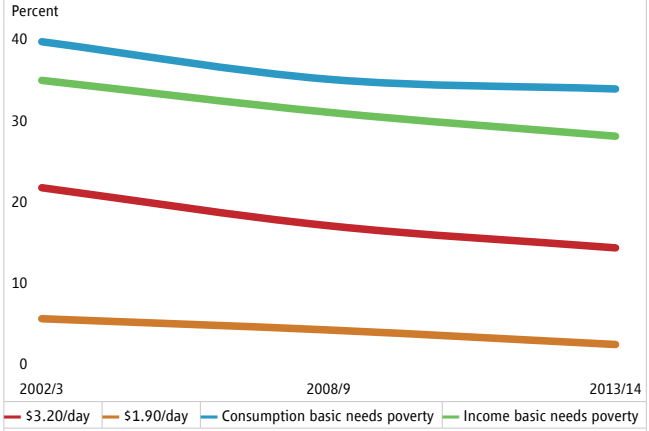
Encouraging private sector growth by providing a more supportive business environment also remains a priority. Fiji's overall Doing Business ranking declined to 97 in 2017, down from 84 in 2016, and its "distance to frontier" score declined to 60.7 from 62.5. Fiji's worsening performance was due to deterioration in getting credit (due to closure of the credit bureau in 2016) and lack of progress in those areas where Fiji had already ranked low, including starting a business, getting permits, paying taxes, and registering property. Fiji scores particularly poorly in starting a business—159th of 190 countries—with 40 days required to start one.

Figure 1. Real GDP growth



Source: World Development Indicators and staff estimates.

Figure 2. International and national poverty rates

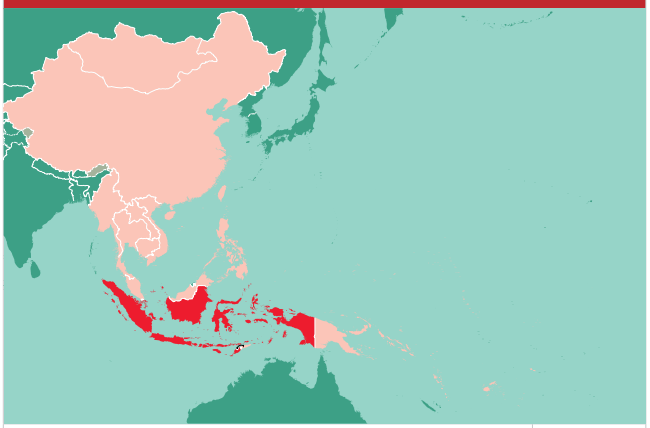


Sources: Fiji Bureau of Statistics, WB staff calculations.

FIJI Selected Indicators	*2014*	*2015*	*2016e*	*2017f*	*2018f*	*2019f*
Real gross domestic product	5.6	3.6	0.4	3.8	3.5	3.3
Agriculture	1.9	6.3	-9.7	3.8	2.1	2.3
Industry	0.4	1.1	-0.7	4.7	3.5	3.1
Services	7.2	3.7	4.1	3.7	3.1	3.0
Inflation (Consumer Price Index)	1.4	1.6	3.7	3.5	2.7	2.9
Current Account Balance (% of GDP)	-7.6	-1.5	-3.4	-5.8	-6.2	-6.0
Fiscal Balance (% of GDP)[a]	-4.2	-2.3	-4.7	-2.0	-4.5	-2.4
Debt (% of GDP)	48.4	45.9	46.2	47.8	50.4	51.6
Primary Balance (% of GDP)	-1.0	-0.6	-1.9	-0.8	-1.7	-0.4

Sources: Fiji Bureau of Statistics, Reserve Bank of Fiji, World Development Indicators, and staff estimates.
Note: (a) Fiji changed the government fiscal year from the calendar to the August-July fiscal year starting 2016.

INDONESIA



	2016
Population, million	260.6
GDP, current US$ billion	932.8
GDP per capita, current US$	3580
International poverty rate ($1.9)[a]	6.8
Lower middle-income poverty rate ($3.2)[a]	31.6
Upper middle-income poverty rate ($5.5)[a]	63.3
Gini coefficient[a]	38.4
School enrolment, primary (% gross)[b]	105.7
Life expectancy at birth, years[b]	68.9

Sources: WDI, Macro Poverty Outlook, and official data.
Notes: (a) Most recent value (2016), 2011 PPPs; (b) Most recent WDI value (2014).

Summary

The Indonesian economy continues to enjoy robust economic growth and macroeconomic stability, with low inflation, a widening but still benign current account deficit, a conservative fiscal budget deficit and a supportive external environment. Amid pockets of softness, the economic outlook is moderately positive, with strengthening domestic demand, in light of the upcoming elections and accommodative monetary conditions. Political and policy uncertainty, and elevated inflation pose downside risks.

Recent Developments

Indonesia's real GDP growth was 5.0 percent yoy in Q2, unchanged from Q1 as stronger investment was offset by contracting government consumption and slower net export growth. Growth rates have been around 5 percent since Q1 2014, significantly lower than those recorded at the beginning of the decade, as the economy continues to adjust to lower global commodity prices.

Despite strong real wage growth and the unemployment rate hitting a record low, private consumption growth remained tepid due to administrative price hikes and the side-effects of measures to improve tax compliance. Government consumption saw a notable contraction, partly reflecting base effects of a surge in Q2 last year and the shift in the Hari Raya Idul Fitri holidays to Q2 this year.

Investment growth rose to the highest since Q4 2015, partly due to lower lending rates for investment loans, in line with the 150-basis point reduction in the policy rate last year. After surging in Q1, export and import growth both slowed significantly, in part reflecting weakening commodity prices in Q2, despite a stronger economic growth. The current account deficit to doubled to 2.0 percent of GDP in Q2. A seasonal rise in the primary income deficit and a widening of the services trade deficit, as transport and travel imports jumped during Idul Fitri, also contributed to the larger current account deficit.

After climbing in H1 2017 due to administrative price hikes, inflation has begun to ease. Bank Indonesia recently cut the policy rate by 25 basis points, to support growth, after keeping it unchanged for nine months.

Revenue collections surged in H1 2017, while expenditure growth was weak. The revised 2017 Budget sets out a higher fiscal deficit of 2.9 percent, up from 2.4 percent of GDP in the original 2017 Budget, due to both a reduction in revenue targets and an increase in expenditure.

Reflecting enhanced fiscal credibility, Standard and Poor's upgraded Indonesia's sovereign bond rating to an investment grade in May. Since then, capital flows

saw some strengthening with net FDI in Q2 at a near three-year high. The banking sector continues to be well capitalized. Against the U.S. dollar, the Rupiah has been remarkably stable. In real trade weighted terms, the Rupiah depreciated slightly.

In the year to March 2017, the official poverty rate, fell by 0.2 percentage points to 10.6 percent, partly reflecting a surge in real wages, broad unemployment falling to its lowest recorded levels, and a contained inflation rate. However, the decline in poverty is still lower than those achieved between 2006 and 2010, which averaged 1.1 percentage points annually.

Outlook

Real GDP growth is expected at 5.1 percent in 2017, climbing to 5.3 percent in 2018–19 on a stronger global growth and domestic demand. Private consumption is projected to climb in line with gains in real wages. Private investment faces headwinds of global and domestic uncertainty and soft global commodity prices, but tailwinds of lower borrowing costs and robust domestic demand. The external sector is expected to contribute positively given stronger global growth, partially offset by easing coal prices and a deteriorating terms-of-trade. The current account deficit is projected to gradually widen from 1.7 percent in 2017 to 1.9 percent in 2019.

Government consumption is forecast to rise in 2018 and 2019 supported by enhanced revenue performance linked to stronger economic growth and tax reforms. In a signal of its commitment to fiscal discipline, the Government's proposed 2018 budget implies a of deficit at 2.2 percent of GDP.

Consumer price inflation is expected to average at 4.0 percent this year as the effects of the electricity price hikes dissipate and food inflation remains low. Assuming the current weather conditions persist and further fuel and energy hikes remain on pause, inflation will ease to 3.5 percent in 2018–19.

With stronger economic growth and lower inflation, the extreme poverty rate, based on the international poverty line of US$1.90 per day, is anticipated to fall by 0.9 percentage points in 2017, then a further 0.8 percentage points in 2018 and 0.7 percentage points in 2019. This corresponds to an average annual decline of 0.8 percentage points between 2014 and 2019, substantially less than the annual average decline of 2.9 percentage points witnessed between 2006 and 2010.

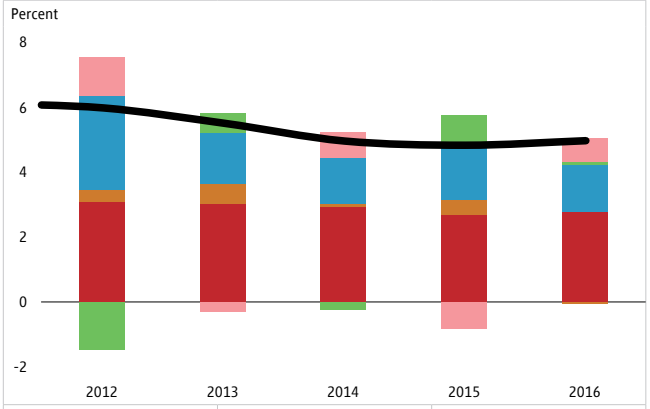
Risks and Challenges

Global policy uncertainty, especially the threat of increased international protectionism, continue to pose substantial downside risks to the nascent recovery in global trade. Geopolitical risks within the region and across the world are also substantial. Remaining uncertainties over the pace of monetary tightening by the U.S. Federal Reserve and the continued divergence from the accommodative policies of the ECB and Bank of Japan, also pose risks.

Domestic risks are also substantial. Political and policy uncertainty remain heightened with the looming regional and presidential elections. Meanwhile, both expansionary monetary and fiscal policy with a tight labor market could lead to a bout of elevated inflationary pressures, which would have a dampening effect on private consumption growth, and hence GDP growth.

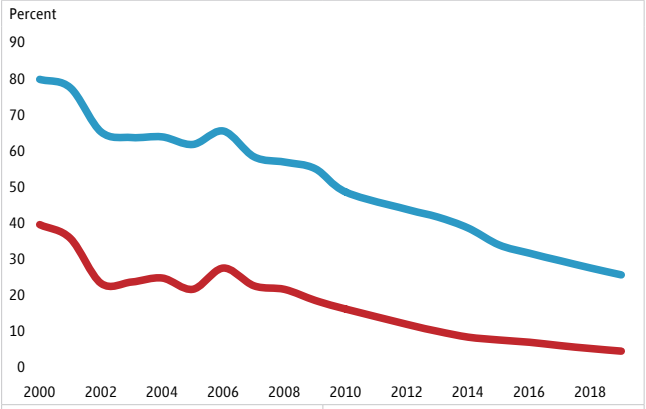
Poverty is becoming an increasingly urban phenomenon in Indonesia. In March 2017, the proportion of Indonesia's poor in urban areas was 38.4 percent, up 1.5 percentage points from March 2016. Back in the year 2000, urban dwellers comprised just 31.8 percent of Indonesia's poor. This trend presents policy makers with a fresh set of challenges, as poor urban dwellers may face certain non-monetary deprivations—including lack of access to healthcare, education, transportation, good housing, and clean water—while issues like crime, congestion, and pollution are likely to be more prevalent in cities than in rural areas.

Figure 1. Real GDP growth and contribution to growth



Sources: National Statistics Agency (BPS); World Bank staff calculations.

Figure 2. Poverty rate, actuals and projections

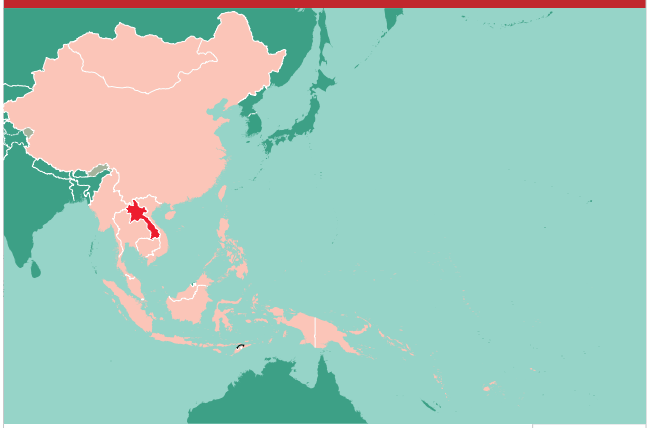


Sources: National Socioeconomic Survey (SUSENAS); World Bank staff calculations.

INDONESIA Selected Indicators	*2014*	*2015*	*2016e*	*2017f*	*2018f*	*2019f*
Real GDP growth, at constant market prices	5.0	4.9	5.0	5.1	5.3	5.3
Private Consumption	5.3	4.8	5.0	5.0	5.2	5.2
Government Consumption	1.2	5.3	-0.1	3.5	5.0	6.0
Gross Fixed Capital Investment	4.4	5.0	4.5	5.0	5.1	5.2
Exports, Goods and Services	1.1	-2.1	-1.7	5.0	4.8	4.8
Imports, Goods and Services	2.1	-6.4	-2.3	3.2	3.8	4.0
Real GDP growth, at constant factor prices	5.2	4.1	5.2	5.1	5.3	5.3
Agriculture	4.6	3.5	3.4	3.8	4.2	4.6
Industry	4.4	2.8	4.1	4.2	4.4	4.7
Services	6.1	5.5	6.8	6.4	6.3	6.0
Inflation (Consumer Price Index)	6.4	6.4	3.5	4.0	3.5	3.5
Current Account Balance (% of GDP)	-3.1	-2.0	-1.8	-1.7	-1.8	-1.9
Financial and Capital Account (% of GDP)	3.3	2.1	1.7	3.3	3.4	3.5
Net Foreign Direct Investment (% of GDP)	1.7	1.2	1.7	1.9	3.0	3.6
Fiscal Balance (% of GDP)	-2.1	-2.6	-2.5	-2.7	-2.2	-2.1
Debt (% of GDP)	24.7	27.4	27.9	29.1	29.1	29.2
Primary Balance (% of GDP)	-0.9	-1.2	-1.0	-1.1	-0.5	-0.4
International poverty rate ($1.9 in 2011 PPP)[a,b]	8.3	7.5	6.8	5.9	5.1	4.4
Lower middle-income poverty rate ($3.2 in 2011 PPP)[a,b]	38.6	34.0	31.6	29.6	27.6	25.6
Upper middle-income poverty rate ($5.5 in 2011 PPP)[a,b]	69.9	68.0	63.3	61.8	60.4	58.9

Sources: World Bank, Macroeconomics and Fiscal Management Global Practice, and Poverty Global Practice.
Notes: e = estimate, f = forecast. (a) Calculations based on EAPPOV harmonization, using 2010-SUSENAS, 2015-SUSENAS, and 2016-SUSENAS. Actual data: 2016. Forecast are from 2017 to 2019. (b) Projection using annualized elasticity (2010-2015).

LAO PDR



	2016
Population, million	6.9
GDP, current US$ billion	13.5
GDP per capita, current US$	1,957
International poverty rate ($1.9)[a]	22.1
Lower middle-income poverty rate ($3.2)[a]	57.8
Upper middle-income poverty rate ($5.5)[a]	84.7
Gini coefficient[a]	36.4
School enrolment, primary (% gross)[b]	116.3
Life expectancy at birth, years[b]	66.1

Source: WDI, Macro Poverty Outlook, and official data.
Notes: (a) Most recent value (2012), 2011 PPPs. (b) Most recent WDI value (2014)

Summary

Economic growth decelerated in 2017 compared to earlier years. An expansion in power generation, manufacturing and agriculture is offset by slight deceleration in investment and a drop in tourism. The recent growth in agriculture and manufacturing, albeit from a low base, created more jobs and contributed to poverty reduction. The fiscal deficit remains elevated keeping public debt high. The external balance will narrow slightly in 2017. Fiscal and external buffers remain thin, signaling remaining vulnerabilities of the economy.

Recent Developments

Growth is projected to further moderate to 6.7 percent in 2017 as strong exports are weighed down by slowdown in investment, weaker tourism and stronger controls over government spending. An additional 250MW of power generation is expected to come on stream in 2017, bringing total installed capacity to around 6,600 MW, most of which is exported. Manufacturing exports continued to expand as new companies entered the two special economic zones while a good harvest and some recovery in commodity prices gave a boost to agriculture and mining exports. On the other hand, delays on some power projects as well as a tighter fiscal stance resulted in slower investment activity. Output in mining stagnated due to lower grade ores at one of the mines. The trend of declining number of tourist arrivals during 2016 continued in the first half of 2017. Weak oil prices, well-stocked food markets and moderating demand kept inflation pressures subdued.

The growth in agriculture exports, in part reflects a restructuring in the agriculture sector, characterized by increased participation of traditionally small scale farming households in the production of export linked commodities. Taken together with continued expansion in the special export zones, this points to better economic opportunities and improvements in household welfare in both rural and urban areas. Poverty reduction is thus expected to have continued.

The fiscal deficit is projected to reach 6.2% of GDP in FY2017. The removal of exemptions on fuel imports in 2016, recovering commodity prices (resulting in higher royalties and import duties) as well as efforts to expand tax base and improve compliance is helping offset the impact of moderating economic growth. Still, revenues are likely to remain below ambitious target levels triggering an adjustment in spending, including stronger control on purchase of goods and services and lower transfers. Public debt is expected to edge towards 70 percent of GDP by the end of 2017.

The current account balance is expected to narrow this year. Exports of electricity, manufactures and agriculture products continue to perform well, while recovering copper prices supported mining exports. Imports increased at a slower pace reflecting the slow recovery in oil prices, completion of some power project

construction and gradual launch of the construction works on the Kunming—Vientiane railway line. Imports are expected to pick-up in the second half of the year as the project construction picks up. Net services will decline as tourism activities slow. Reserves are expected to increase only slightly this year, but remain at around 2 months of imports and less than 25 percent of foreign currency deposits.

In response to the large current account deficit and limited reserves, the kip depreciated by 2.1 percent and almost 7 percent, against the US dollar and the Thai baht, respectively since the start of 2017, helping reverse some of the strong appreciation in recent years. Consequently, the gap between the official and parallel market rate narrowed to 1.5 percent compared to above 3 percent at the start of the year.

While monetary conditions remain unchanged, credit growth decelerated to 17 percent yoy in June this year compared to 22 percent a year ago due to slight weakening in the loan portfolio, more modest deposit growth as well as tighter fiscal space. Risks in the financial sector persist as some banks remain undercapitalized and overall profitability, while recovering, remains low. The authorities are in the process of restructuring two state-owned banks and revising the regulatory framework.

Outlook

The medium term outlook remains broadly favorable. Growth will continue to be driven by the power sector, while greater ASEAN integration opens opportunities, especially in agriculture, tourism, retail trade as well as some manufacturing as part of regional value chain. These sectors have significant potential to create jobs and lower poverty further.

The five-year fiscal plan envisaged a narrowing of the fiscal deficit over the medium term helping, to stabilize and eventually put public debt as a share of GDP on a declining trend. Revenues are expected to increase due to planned hike in excise tax rates, strengthened revenue administration, improved tax-payer services and the launch of modern revenue management information system. At the same time, spending growth will be controlled through strong check over the wage bill and public recruitment, cancelation of some of the public investment projects as well as cuts on non-essential spending. Improved public spending efficiency and service delivery can improve living conditions and help lower poverty.

The external account is expected to widen in 2018 reflecting the large import content of the infrastructure projects, including the railway, but enter a declining trend as the power generation capacity comes on stream and increases exports. The current account will continue to be financed by FDI and external borrowing, increasingly on less concessional terms.

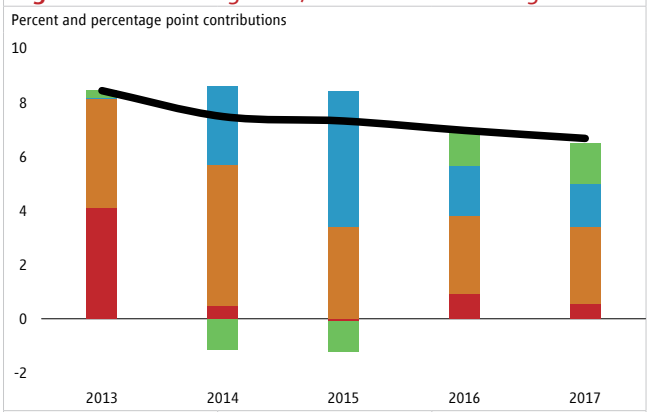
Risks and Challenges

There are significant risks to this outlook. Opportunities outside of the power sector are likely to materialize only if challenges related to the business environment (creating level playing field, simplifying tax administration, building human resources) are gradually addressed. Failure to create jobs will keep the link between economic growth and poverty reduction relatively weak.

Furthermore, reversal of commodity prices, particularly metals and some agriculture products can affect Lao exports and livelihoods. Weaker oil and metal prices will also affect government revenues, putting further pressure on the fiscal position.

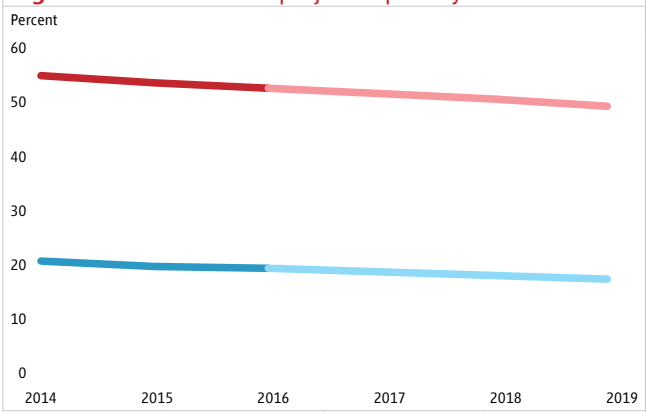
Fiscal slippage, continued low external buffers and failure to deal with weaknesses in the financial sector could threaten macroeconomic stability, with a disproportionate impact over the poor and future growth prospects.

Figure 1. Real GDP growth, contribution to real growth



Source: Staff estimate and based on national statistics.

Figure 2. Estimated and projected poverty rates

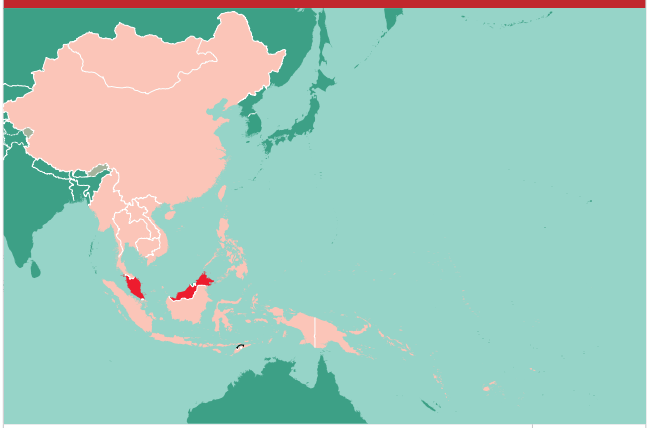


Source: Staff calculations based on LECS 4-5.

LAO PDR Selected Indicators	*2014*	*2015*	*2016e*	*2017f*	*2018f*	*2019f*
Real GDP growth, at constant market prices	7.5	7.4	7.0	6.7	6.6	6.9
Private Consumption	8.0	5.2	4.5	4.5	4.6	4.6
Government Consumption	3.7	-0.4	7.4	4.5	4.5	4.7
Gross Fixed Capital Investment	9.9	17.3	6.1	5.5	10.5	8.1
Exports, Goods and Services	16.6	-6.5	7.2	8.0	9.0	10.5
Imports, Goods and Services	15.8	-3.0	3.0	3.0	8.0	7.0
Real GDP growth, at constant factor prices	7.5	7.4	7.0	6.8	6.6	6.9
Agriculture	8.0	1.4	0.5	2.8	3.2	3.2
Industry	7.2	11.1	11.3	9.2	8.5	9.2
Services	7.5	8.1	7.2	6.8	6.9	6.6
Inflation (Consumer Price Index)	4.1	1.3	1.5	2.0	3.0	3.0
Current Account Balance (% of GDP)	-17.7	-17.3	-14.2	-14.0	-17.0	-16.6
Fiscal Balance (% of GDP)	-4.4	-3.7	-5.6	-6.2	-4.8	-3.5
Debt (% of GDP)	63.0	64.8	68.1	70.5	70.4	68.5
Primary Balance (% of GDP)	-3.5	-2.5	-4.1	-4.7	-3.2	-1.8
International poverty rate ($1.9 in 2011 PPP)[a,b]	17.5	15.8	13.9	12.7	11.3	9.9
Lower middle-income poverty rate ($3.2 in 2011 PPP)[a,b]	51.5	48.9	46.3	43.7	41.2	38.5
Upper middle-income poverty rate ($5.5 in 2011 PPP)[a,b]	82.0	80.6	79.0	77.6	76.0	74.5

Sources: World Bank, Macroeconomics and Fiscal Management Global Practice, and Poverty Global Practice.
Notes: f = forecast. (a) Calculations based on EAPPOV harmonization, using 2012-LECS. Nowcast: 2014-2016. Forecast are from 2017 to 2019. (b) Projection using neutral distribution (2012) with pass-through = 0.7 based on GDP per capita in constant LCU.

MALAYSIA



	2016
Population, million	30.8
GDP, current US$ billion	290.5
GDP per capita, current US$	9,445
School enrolment, primary (% gross)[a]	102.8
Life expectancy at birth, years[a]	74.7

Source: WDI, Macro Poverty Outlook, and official data.
Notes: (a) Most recent WDI value (2014).

Summary

GDP growth in Malaysia accelerated during the first half of 2017 to 5.7 percent (y-on-y), supported by strengthening domestic and external demand. As a result, Malaysia's economy is expected to grow at 5.2 percent in 2017. The outlook remains positive as the Malaysian economy continues to experience broad-based growth across a range of diversified sectors. Nevertheless, as an open economy, risks relating to changes in the global economic outlook weigh on Malaysia's growth as the economy is vulnerable to shifts in external demand and market sentiment.

Recent Developments

The Malaysian economy experienced robust growth of 5.7 percent in the first half of 2017, underpinned by strong private sector expenditure with additional impetus from an improvement in external demand. Private consumption expanded firmly, supported by favorable income growth amid stable labor market conditions, and improved consumer confidence. Private investment also sustained rapid growth rates during the period, reflecting mainly continued capital spending in the manufacturing and services sectors. The higher public sector expenditures seen in Q1 2017 moderated in the subsequent quarter, following lower spending on emoluments, and supplies and services, as well as fixed assets by public corporations.

On the external front, gross exports rebounded strongly from the subdued growth experienced in 2016, in line with the ongoing improvement in global demand. The positive external performance was broad-based, underpinned by double-digit growth in commodity and manufactured exports. Continued strength in global demand for Malaysia's Electrical and Electronic (E&E) products, particularly for semiconductors, remained the main driver of growth in gross exports. Gross imports also registered a robust expansion during the period on account of higher intermediate imports and capital imports, particularly in Q1 2017.

Labor market conditions remained favorable during the period. The unemployment rate stood at 3.4 percent of the labor force, while the labor force participation rate was sustained, in Q2 2017, at 67.8 percent of the total working-age population. Private sector wage growth was sustained, supported by broad-based wage expansion in domestic- and export-oriented manufacturing and services industries.

Headline inflation was higher at 4.1 percent in the first half of 2017, driven mainly by cost factors. In particular, higher domestic petrol prices during the period resulted in higher inflation in the transport category. Prices of food, which accounts for nearly 40 percent of low-income households' budgets, were also significantly higher (4.2 percent y/y to July 2017) following reductions in cooking oil subsidies and disruptions in fresh food supplies due to adverse weather conditions. Housing continues to be a significant contributor to cost of living pressures, with growth in mean housing prices outpacing mean income growth and continued decline

in new construction at the lower end of the housing market.

The financial account recorded a reduced net outflow of RM8.8 billion in Q1 2017, followed by a net inflow of RM7.3 billion in Q2 2017. The reversal of capital flows was due mainly to a resumption of portfolio investment by non-residents, amid improved market sentiment and confidence against the backdrop of a positive domestic growth outlook. The renewed non-resident investor interest in the domestic financial market also contributed to the strengthening of the ringgit amid a broad weakening of the US dollar.

Domestic monetary and financial conditions remained supportive of economic activity throughout the first half of 2017. Bond yields declined during Q2 2017 on account of non-resident inflows and continued demand from domestic institutional investors. Stable retail funding costs continued to support financing to the private sector, which reflected in an improvement in the growth of net financing consistent with the pace of the economic activity. Banking system liquidity remains sufficient for financial intermediation with most banks continuing to maintain surplus liquidity positions.

Outlook

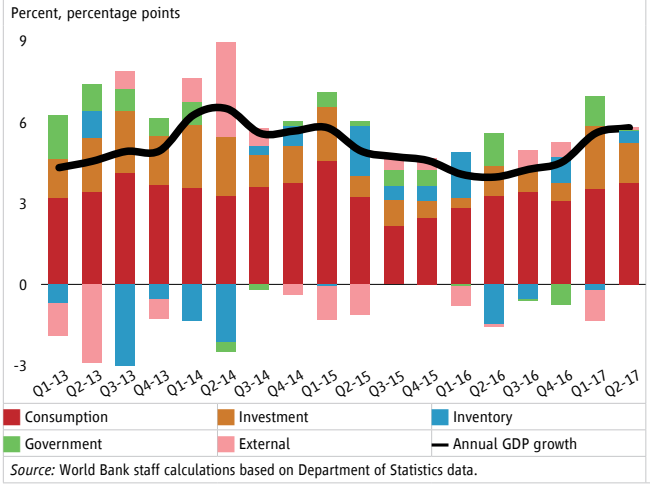
Economic activity in Malaysia is projected to expand by 5.2 percent in 2017, in line with continued favorable leading indicators of near-term private sector activity and confidence. Domestic demand is expected to remain the primary anchor of growth, underpinned by robust growth in private sector expenditure. Stable labor market conditions, sustained consumer confidence and ongoing income-support measures would continue to lend support to private consumption. Private investment activity is expected to be sustained by the implementation of existing and new investment projects, especially in the manufacturing and services sector. Continued public infrastructure investments would also lend support to domestic growth and contribute towards sustained demand for capital imports going forward. The improvement in export performance is expected to continue into the second half of 2017, in tandem with the ongoing expansion in global demand. Meanwhile, the government remains committed to fiscal reforms amid a continued expectation of the fiscal deficit target of 3.0 percent of GDP being achieved in 2017. The Malaysian economy is expected to sustain its current growth momentum into 2018 and 2019, albeit at a more moderate pace amid expectation of lower capital expenditure growth.

Risks and Challenges

Notwithstanding the better-than-expected growth performance, the Malaysian economy continues to face uncertainties and risks emanating mainly from the external environment. The main risks to growth arise from the policy uncertainty in the major economies, geopolitical developments and commodity price volatility. Ongoing adjustments to the rising cost of living amid continued fiscal consolidation and elevated household indebtedness could also weigh on the strength of private sector demand. Monetary policy will continue to operate in a complex environment, characterized by robust domestic demand and higher prices amid continued uncertainty in the global economic and financial market developments. Exchange rate flexibility and responsive macroeconomic management are therefore crucial in absorbing negative shocks from the external environment.

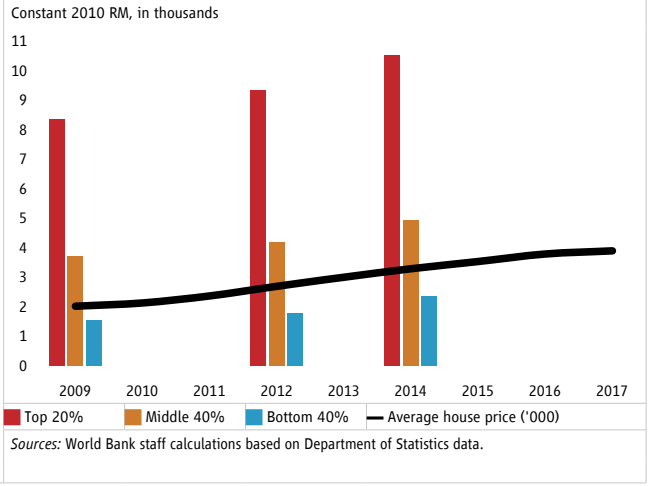
The favorable domestic environment provides a crucial opportunity for the Federal Government to further strengthen its finances towards a more sustainable debt path. Broadening of revenue sources and reducing exemptions on Goods and Services Tax (GST) could further enhance revenue collection, while addressing the rising civil servants' salaries and pensions could contain the expansion in operating expenditures. Accelerating structural reforms to improve both private-sector productivity and public-sector efficiency should be accorded significant priority for Malaysia to sustain its current growth momentum in the medium term.

Figure 1. Real GDP growth, contribution to real growth



Source: World Bank staff calculations based on Department of Statistics data.

Figure 2. Housing prices and median monthly household income, by income group

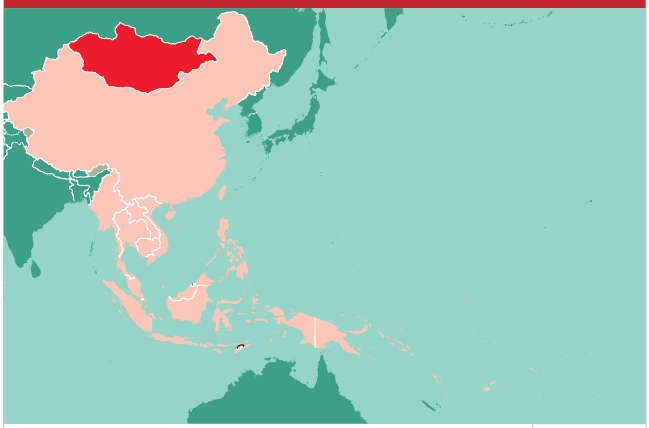


Sources: World Bank staff calculations based on Department of Statistics data.

MALAYSIA Selected Indicators	*2014*	*2015*	*2016e*	*2017f*	*2018f*	*2019f*
Real GDP growth, at constant market prices	6.0	5.0	4.2	5.2	5.0	4.8
Private Consumption	7.0	6.0	6.1	6.6	6.5	5.9
Government Consumption	4.3	4.4	1.0	4.4	3.3	2.8
Gross Fixed Capital Investment	4.8	3.7	2.5	6.1	3.2	4.2
Exports, Goods and Services	5.0	0.6	0.1	7.3	0.8	0.6
Imports, Goods and Services	4.0	1.2	0.4	8.9	0.5	0.0
Real GDP growth, at constant factor prices	6.0	5.0	4.2	5.2	5.0	4.8
Agriculture	2.0	1.2	-5.1	7.1	2.1	1.1
Industry	6.1	5.2	4.8	4.1	4.0	4.2
Services	6.6	5.4	5.3	5.7	6.1	5.7
Inflation (Consumer Price Index)	3.2	2.1	2.1	2.2	2.3	2.3
Current Account Balance (% of GDP)	4.2	3.0	2.6	2.6	3.0	3.6
Fiscal Balance (% of GDP)	-3.6	-3.2	-3.1	-3.0	-2.8	-2.7
Debt (% of GDP)	55.6	57.7	57.9	55.2	56.0	55.5
Primary Balance (% of GDP)	-1.4	-1.0	-0.8	-0.7	-0.6	-1.4

Sources: World Bank, Macroeconomics and Fiscal Management Global Practice, and Poverty Global Practice.
Notes: e = estimate; f = forecast.

MONGOLIA



	2016
Population, million	3.0
GDP, current US$ billion	11.4
GDP per capita, current US$	3,809
School enrolment, primary (% gross)[a]	101.7
Life expectancy at birth, years[a]	69.5

Source: WDI, Macro Poverty Outlook, and official data.
Notes: (a) Most recent WDI value (2014).

Summary

Following positive developments in the mineral sector, real GDP growth is expected to improve to 2.8 percent in 2017 compared to -0.2 percent initially projected. Growth outlook remains positive in 2018 and beyond mainly on account of increased private investment in the mining sector and new impetus in trade and transport services. Early signs of improvements in household incomes in 2017 augur a decline in poverty after sharp increase between 2014 and 2016. Risks to the outlook include political uncertainty, climate shocks, commodity shocks, and regional instability.

Recent Developments

Following the 2016 economic slowdown, recovery has been modest as growth is estimated to increase to 2.8 percent in 2017. This performance is largely driven by positive developments in the mineral sector (mainly coal) as well as stronger performance in private investment following substantial FDI inflows in the mineral sector. Private consumption is also expected to recover by 2.9 percentage points in 2017 from a negative growth in 2016 following positive developments on the labor market. Unemployment rates declined to 8.6 percent in 2017H1 from about 10 percent in 2016. Real household income per capita increased by 2.6 percent (y/y) in the 2017H1, up from the 11.3 percent decline in 2016H1. Largely driven by a reduction in non-food inflation, headline inflation slightly dropped below 3.5 percent (y/y) in July 2017. It will remain at moderate level and below the Central Bank target of 8 percent for the rest of 2017.

The fiscal stance will improve in 2017 as deficit will decrease by almost half from 17 percent of GDP in 2016 following better than expected revenue performance in a context of a fiscal adjustment program agreed with the Fund, the Bank and other development partners. This program includes eliminating capital expenditures financed by the Development Bank of Mongolia (DBM), and the net financing by Bank of Mongolia (BOM) of the Housing Mortgage program. It also focuses on strengthening revenue mobilization while improving efficiency of public investment. Current account balance will improve on account of positive developments on the trade and services accounts during the 2017H1. Total exports will likely rise by 15 percent in 2017 from 3 percent during the previous year. Mongolia's buffers to external shocks are improving as gross international reserves are estimated to substantially increase.

Outlook

Economic growth is projected to further improve modestly to 3.1 percent in 2018 from about 2.8 percent in 2017, and to accelerate to over 7 percent in 2019 and beyond. Private investment will remain a key driver for the medium-term growth, especially in mining, and trade and transport services. Inflation will remain modest and below the central bank medium term target of 8 percent. Therefore, the BOM is likely

to pursue an accommodating monetary policy, which should stimulate growth. Private consumption is also projected to further improve over the medium term. Consequently, the poverty rates are expected to decline.

Agriculture is projected to grow at about 4 percent over the medium term. This is below the sector's 2014–15 performance, mainly as climate change continues to adversely affect Mongolia through drought, and harsh winter. Industry is projected to grow at 7.5 percent in 2018–19, following substantial developments expected in the mining sector. Services sector would also grow strongly over the same period on account of strong backward linkages between mining and transport services. Moreover, trade and transport sectors may also benefit from the recent intensification of relations with Russia, especially in the transit for the China-Russia trade.

The fiscal deficit is projected to further decline substantially in the medium term, as government remains committed to implement its fiscal consolidation program. The balance of payments will continue to face structural vulnerabilities exacerbated by developments on the country's debt situation. Construction-related imports over the next two years are expected to outpace export growth, and put upward pressure on the current account balance. Exchange rate volatility will subside following the disbursement of donors' support and further FDI inflows. Moreover, gross international reserves would significantly improve to 6.5 months of imports in 2019 from 3.2 months in 2017.

Risks and Challenges

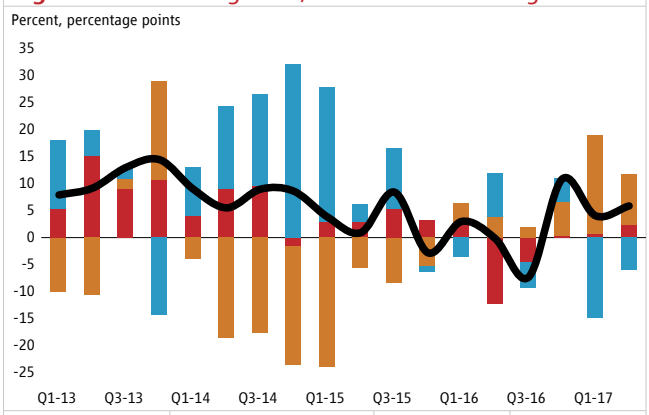
While growth has been better than expected in 2017 due to coal prices, underlying structural issues remain. There are substantial domestic and external exogenous risks to the outlook. These risks include persistent political uncertainty, climate shocks, commodity market volatility, and regional instability.

The recent dismissal by Parliament of the cabinet raises uncertainty about the government's commitment to implementation of the fiscal consolidation program, as well as commitment to a positive environment for FDI, both critical for Mongolia's medium term growth. Moreover, the political changes will complicate government efforts to refinance outstanding sovereign bonds; given Mongolia's weak external position, if such risks should materialize this would slow down the recovery process. Efforts to reduce poverty and promote shared prosperity sustainably may also be affected, as a result. In fact, fiscally sustainable labor and social protection policies will be key to reducing poverty in the coming years. In contrast, if the new cabinet maintains fiscal discipline and an open stance toward FDI, Mongolia's prospects for growth and poverty reduction in the medium term are more positive.

Weather-related shocks will remain an important challenge to Mongolia's economy and meeting food security needs to the rural population. Adaptation to climate change should therefore be prioritized to help mitigate food production shocks.

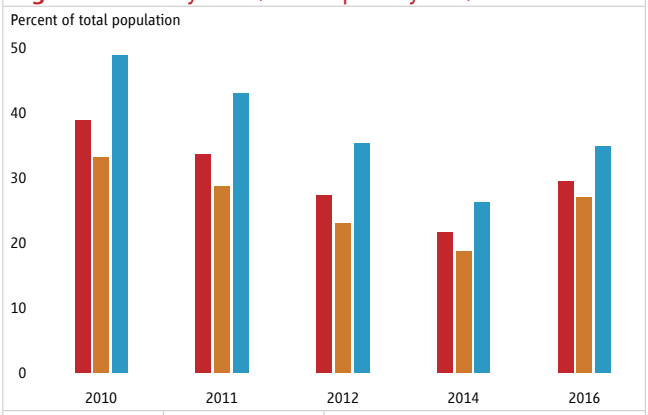
Commodity market volatility is likely to affect Mongolia's growth prospects. Improving government's management of proceeds from minerals is therefore critical. Recent efforts by the government to promote export diversification through improved trade cooperation is also a positive step.

Figure 1. Real GDP growth, contribution to real growth



Source: National Statistics Office.

Figure 2. Poverty rate (official poverty line): 2010–16

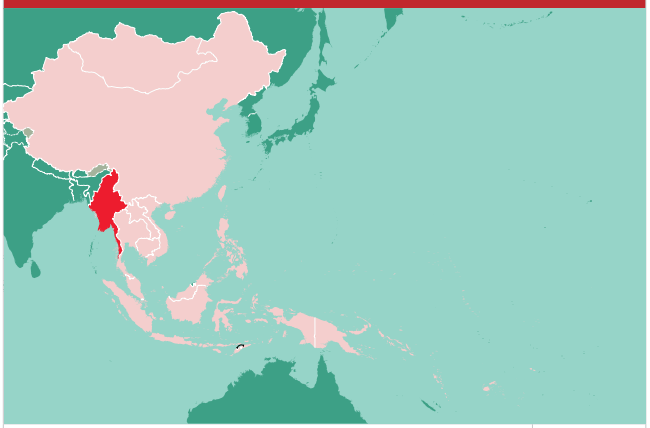


Source: National Statistics Office.

MONGOLIA Selected Indicators	*2014*	*2015*	*2016e*	*2017f*	*2018f*	*2019f*
Real GDP growth, at constant market prices	6.9	2.2	1.4	2.8	3.1	7.3
Private Consumption	6.3	7.2	-8.2	2.9	8.0	10.0
Government Consumption	3.4	-4.5	11.0	-7.1	-3.4	-0.9
Gross Fixed Capital Investment	-21.7	-34.4	7.8	18.7	35.0	25.0
Exports, Goods and Services	53.2	1.2	12.6	15.2	6.0	8.1
Imports, Goods and Services	6.8	-11.5	12.4	19.1	17.5	14.0
Real GDP growth, at constant factor prices	9.2	5.4	1.5	2.0	3.1	7.3
Agriculture	13.7	10.7	6.2	3.0	3.5	4.0
Industry	12.7	9.9	-0.6	1.7	4.0	11.0
Services	5.4	0.4	1.9	2.0	2.2	5.2
Inflation (Private Consumption Deflator)	10.7	1.1	0.9	8.0	6.5	6.9
Current Account Balance (% of GDP)	-11.5	-4.8	-6.3	-5.3	-9.1	-12.4
Financial and Capital Account (% of GDP)	8.3	3.5	7.9	7.0	15.2	20.8
Net Foreign Direct Investment (% of GDP)	2.1	1.5	1.1	8.5	13.9	19.8
Fiscal Balance (% of GDP)	-10.5	-8.5	-17.0	-8.4	-7.1	-4.6
Debt (% of GDP)	58.4	60.4	87.3	84.8	88.9	85.5
Primary Balance (% of GDP)	-8.4	-5.2	-13.3	-4.0	-2.2	-0.3

Sources: World Bank, Macroeconomics and Fiscal Management Global Practice, and Poverty Global Practice.
Notes: e = estimate; f = forecast.

MYANMAR



	2016
Population, million	54.4
GDP, current US$ billion	73.7
GDP per capita, current US$	1355
International poverty rate ($1.9)[a]	6.5
Lower middle-income poverty rate ($3.2)[a]	30.2
Upper middle-income poverty rate ($5.5)[a]	67.9
School enrolment, primary (% gross)[a]	99.7
Life expectancy at birth, years[a]	65.9

Source: WDI, Macro Poverty Outlook, and official data.
Notes: (a) Most recent value (2015), 2011 PPPs. (a) Most recent WDI value (2014).

Summary

Myanmar's macroeconomic environment remains stable, though economic growth is slowing to 5.9 percent in 2016/17 compared to 7 percent in 2015/16, weighed down by slower investment demand. Growth is projected to recover to 6.4 percent in 2017/18. Near term macroeconomic vulnerabilities from the projected decline in global gas prices call for continued fiscal and monetary discipline. The economic impact of recent insecurity in Rakhine State may be substantial. Accelerating private and public investment are high priorities.

Recent Developments

Myanmar's macroeconomic environment over the course of 2016/17 has remained relatively stable following a challenging 2015/2016. Economic growth moderated to 5.9 percent, below expectations and lower than the 7 percent of the previous year (Figure 1). Despite notable reforms and strong foreign investment commitments, investment demand decelerated as private investors bided their time pending greater clarity in the government's economic agenda. Public investments declined from 6.2 percent of GDP in 2015/16 to 5 percent in 2016/17 in response to fiscal constraints.

Private consumption, which accounts for close to 50 percent of GDP, has remained strong particularly in urban areas. Rising consumer purchasing power and greater access to markets have contributed to substantial growth in household asset ownership. Using the international poverty line (US$1.9/day in 2011PPP), poverty is estimated to be 6.5 percent in 2015 and 93 percent of the extreme poor are estimated to live in rural areas. Although historical trends in global poverty measures are not available, trends in national estimates of poverty point to a decline in poverty between 2004/05 and 2015. Poverty is estimated to have declined from 32.1 percent in 2004/05 to 25.6 percent in 2009/10 and to 19.4 percent in 2015. Urban areas have seen faster growth in household welfare and a sharper decline in poverty in percentage point terms.

Inflation pressures abated over the course of 2016/17, averaging 6.8 percent compared to 10 percent the previous year (Figure 2). Food price inflation moderated throughout the year, except for a short spike in late 2016 coinciding with a sharp depreciation in the kyat making imports more expensive. The Real Effective Exchange Rate depreciated by 9 percent between August 2016 and March 2017.

Consistent with falling inflation, annual growth in money stock moderated from 26 percent in 2015/16 to 19 percent in 2016/17. This is in part thanks to a policy on limiting Central Bank financing of the Union Budget following a spike the previous year. Growth in credit to the private sector remained high at 33 percent in 2016/17.

The current account and fiscal deficits have narrowed from 7.2 percent of GDP in 2015/16 to 5.3 percent in 2016/17, and from 4.4 percent of GDP to 3 percent over the same period, respectively. The trade deficit has remained large (8.5 percent of GDP) as gas export receipts have continued to decline. The demand for merchandise imports is picking while demand for investment goods has contracted sharply. Fiscal adjustment was driven more by cuts to public investment than improvements in general government revenue collection, which, at 11 percent of GDP, remain significantly below potential and regional peers.

Outlook

Economic growth is projected to recover to 6.4 percent in 2017/18 and average 6.9 percent per year over the medium-term. An expected bounce in agriculture activity is likely to support stronger growth in rural incomes and to contribute to declining poverty. Poverty is projected to decline from 6.5 percent in 2015 to 4 percent in 2020, in particular if agricultural growth and higher agricultural incomes translate into higher rural labor demand and wages, but productivity bottlenecks remain. Other areas with potential include construction of infrastructure including power, telecommunications and housing, as well as hospitality services, and financial services.

Inflation is projected to decline to 5.2 percent by year end 2017/18, thanks to a continued pick up in agriculture output. A gradual reprioritization of public investments, government revenue reforms, and higher concessional loan disbursements are expected to help ease fiscal constraints. The public sector deficit is projected at 4.3 percent of GDP, lower than the 5.9 percent in the 2017/18 Budget. The current account deficit is projected to increase to 6.8 percent of GDP due to a continued decline in gas sector receipts and a pick-up in investment related imports.

Risks and Challenges

Low gas prices could impact significantly on fiscal and external balances, and exacerbate financing pressures. A recent import ban by India on pulses and beans may affect Myanmar's exports and the incomes of farmers reliant on these key imports. The 2017/18 Union Budget proposes continued rebalancing of expenditure towards higher quality public investments and services that benefit notably the poor but, unless revenue efforts and cash management reforms accelerate, it will be difficult to eliminate central bank financing of the deficit and related pressure on inflation.

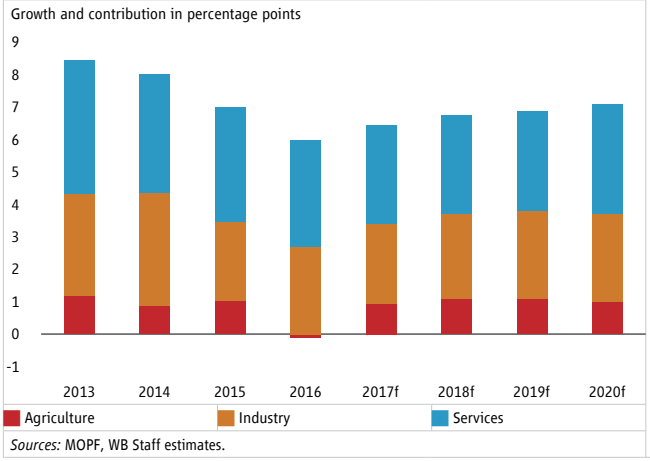
Continued monetary discipline and exchange rate flexibility are important for containing external pressures, as consumer imports continue to grow fast. The economic impacts of recent insecurity in Rakhine State may be substantial if it deters investors. Appropriate implementation of recently adopted prudential regulations are critical for financial sector stability. Lending to agriculture, manufacturing, and construction—all sectors that have faced a relatively difficult year—have increased sharply, reiterating concerns over credit concentration and asset quality, which are not reflected in official figures.

Whilst Myanmar's recent consumption boom is associated with improved household welfare, accelerating investments in productive capital is critical to long-term growth and job creation. Structural reform is important for domestic value addition, job creation and managing import demand, as well as capturing foreign investment flows to emerging and developing economies.

The government has indicated that it is developing an economic strategy, which is expected to build investor confidence and accelerate the implementation of investment commitments. Policy priorities should include, among other things: cost reflective electricity tariff policy with protection of vulnerable groups to promote financial viability of the power sector;

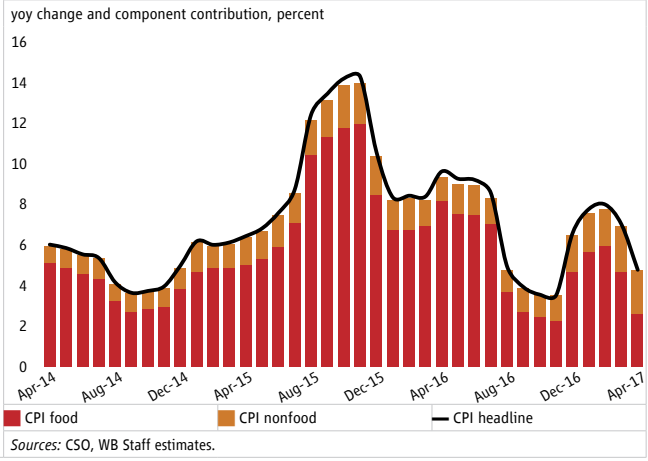
implementation of the Regulation on Credit Information Reporting Systems to improve lending decisions; and adoption and implementation of the Companies Act.

Figure 1. Real GDP growth and sector contribution to real GDP growth



Sources: MOPF, WB Staff estimates.

Figure 2. CPI inflation and food/non-food contribution to CPI inflation



Sources: CSO, WB Staff estimates.

MYANMAR Selected Indicators	*2014*	*2015*	*2016e*	*2017f*	*2018f*	*2019f*
Real GDP growth, at constant market prices	8.0	7.0	5.9	6.4	6.7	6.9
Real GDP growth, at constant prices	8.0	7.0	5.9	6.4	6.7	6.9
Agriculture	2.8	3.4	-0.4	3.5	4.0	4.1
Industry	12.1	8.7	8.9	8.0	8.3	8.5
Services	9.1	8.4	8.0	7.2	7.3	7.4
Inflation (Consumer Price Index)	6.1	8.4	7.0	5.2	4.9	5.3
Current Account Balance (% of GDP)	-2.9	-7.2	-5.3	-4.7	-4.7	-4.1
Fiscal Balance (% of GDP)	-0.9	-4.4	-3.0	-4.5	-4.6	-4.4
Primary Balance (% of GDP)	0.4	-2.6	-1.4	-3.2	-3.2	-3.4
International poverty rate ($1.9 in 2011 PPP)[a,b]	..	6.5	5.8	5.1	4.4	4.0
Lower middle-income poverty rate ($3.2 in 2011 PPP)[a,b]	..	30.2	28.1	25.4	22.9	20.1
Upper middle-income poverty rate ($5.5 in 2011 PPP)[a,b]	..	67.9	65.6	63.1	60.5	57.8

Sources: World Bank, Macroeconomics and Fiscal Management Global Practice, and Poverty Global Practice.
Notes: f = forecast. (a) Calculations based on EAPPOV harmonization, using 2015-MPLCS. Actual data: 2015. Nowcast: 2016 - 2016. Forecast are from 2017 to 2019. (b) Projection using neutral distribution (2015) with pass-through = 0.3 based on GDP per capita in constant LCU.

PAPUA NEW GUINEA

	2016
Population, million	7.9
GDP, US$, billion	22.1
GDP per capita, US$	2,787
GDP per capita, US$, PPP	3,541
National poverty rate, percent[a]	39.9
Gini coefficient, consumption[a]	0.4
School enrolment, primary (% gross)[b]	114
Life expectancy at birth, years	62.3

Source: WDI, Macro Poverty Outlook, and official data.
Notes: (a) 2009/10. (b) 2012

Summary

Following the 2017 National Elections, the relatively low global commodity price environment continues to place limits on GDP growth, revenue receipts and foreign exchange inflows.

Recent Developments

In late August, the elected government released the 100-Day Economic Stimulus Plan to address the fiscal stress and structural measures to strengthen growth.

Notwithstanding the higher growth in the agriculture and mining sector in the first half of 2017 owing to the end of the drought in 2016, GDP growth is projected to remain sluggish due to the ongoing weakness in commodity prices, further fiscal consolidation and a shortage of foreign currency coupled with an overvaluation of the Kina.

Growth in the non-resource sector has also been adversely affected by lower commodity prices due to a curtailing of public and private expenditure given lower revenue receipts and disposable income, respectively. The cash flow shortage in the public sector coupled with the shortage of foreign currency has contributed to fewer construction projects completed. Additionally, lower than expected log production has also negatively impacted growth in the non-resource sector. Therefore, overall economic growth is expected to decline to 2.1 percent of GDP in 2017 from 2.4 percent a year earlier.

Consequently, employment in the non-resource sector contracted by 2.5 percent through-the-year to March quarter 2017, reflecting sluggish performance from the non-resource sector. Non-resource employment contracted in a number of sectors including building and construction (down 13.6 percent), transport (down 10.0 percent), retail (down 5.6 percent), wholesale (down 3.1 percent), and finance and other services (down 1.3 percent). On the other hand, the manufacturing sector and the agriculture, forestry and fishery sector recorded growth in employment by 1.9 percent and 0.6 percent respectively.

Based on the latest household survey data, the national poverty rate in 2010 is 39.9 percent. The level of consumption inequality, measured by the Gini coefficient, is 0.41 in 2010.

Following the aftermath of the elections in June 2017, the Mid-Year Economic and Fiscal Outlook (MYEFO) revises the expected budget deficit in 2017 to 3.8 percent of GDP (or PGK 2.8 billion). This is higher than the deficit projected in the original 2017 Budget of 2.5 percent of GDP (or PGK 1.9 billion).

The reason for the upward revision in the deficit is the lower corporate tax revenue and higher expenditure

driven by higher than expected debt servicing costs and expenditure on wages and salaries. The higher deficit is projected to increase debt-to-GDP to 35 percent of GDP from 32.2 percent in 2016. This increase in debt, further pushes the debt level above the debt threshold of 30 percent of GDP.

In response, the recently elected government is preparing a supplementary budget. The latter undertakes fiscal consolidation which is estimated to lead to a fiscal deficit of 3.2 percent of GDP and public debt to slightly under 35 percent of GDP in 2017.

Notwithstanding the lower commodity prices, on the back of LNG exports, relatively sluggish GDP growth and significant import compression due to the limited availability of foreign exchange, the current account is expected to be in surplus (12.1 percent of GDP) in 2017. The surplus in the current account is largely offset by financial account outflows due to a build-up in foreign currency account balances of resident mineral companies coupled with net loan repayments by the government.

The preliminary balance of payments (BoP) data for the five months to May 2017 showed an overall surplus of PGK113.5 million, compared to a deficit of K88.0 million in the corresponding period of 2016. In 2017, the BoP is expected to show an overall surplus of 0.6 percent of GDP, marginally higher than 2016.

The low commodity-price environment and pressure on the currency (Kina) prompted the central bank to intervene to slow the rate of Kina/USD depreciation to limit pass-through to inflation. Central bank intervention in the foreign exchange (FX) market has resulted in the shortage forex liquidity. The latter continues to be a constraint to business activity. The central bank needs to improve the FX allocation mechanism, in concert with strengthening the effectiveness of monetary policy by mopping up excess Kina liquidity.

Headline inflation is projected to ease significantly to 4.1 percent in 2017, from 6.7 percent in 2016, owing the slowdown in the economy, fiscal consolidation and the stability of the currency. In PNG, the exchange rate is the primary anchor of inflation expectations.

Outlook

At least till 2020, growth in the resource sector is expected to remain subdued reflecting the low commodity-price environment coupled with the lack of any new resource projects expected before then.

In the non-resource sector, growth is expected to remain moderate due to the expected on-going shortage of FX and continued fiscal consolidation.

In the medium to longer-term, outlook for growth is relatively more sanguine with the establishment of more resource projects post-2020. GDP growth is expected to edge towards trend in the longer term, which is estimated at 4 percent.

Risks and Challenges

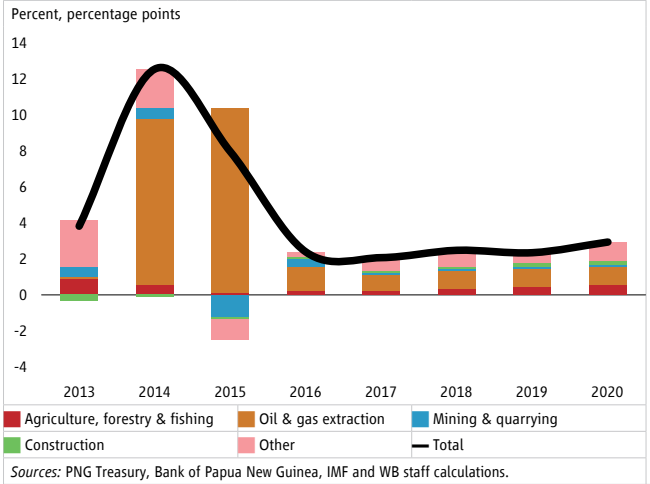
In the near term, risks are weighted to the downside. Fiscal stress and limited foreign currency inflows is expected to continue given the expected low commodity price environment in 2017 and 2018. Fiscal consolidation, while necessary in the face of lower commodity prices, runs the risk of further moderating growth while the foreign exchange shortage would continue to dampen necessary imports.

There are a number of challenges both in the near-term and the medium to longer-term. Firstly, maintaining macroeconomic stability and government's ability to maintain a prudent fiscal stance and ensure public service delivery (particularly infrastructure) in the face of limited revenue receipts. Second, there is a growing

risk that longer the FX shortage continue, a more active shadow FX market may emerge.

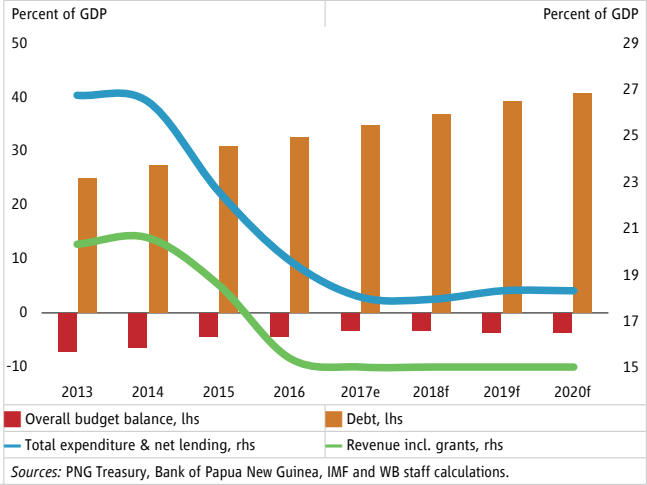
Possible upside risks: (i) new major resource project(s) commencing earlier than expected; and (ii) fiscal position improves with tax administration and policy measures are more successful than expected.

Figure 1. Real GDP growth, contribution to real growth



Sources: PNG Treasury, Bank of Papua New Guinea, IMF and WB staff calculations.

Figure 2. Key fiscal indicators (% GDP)

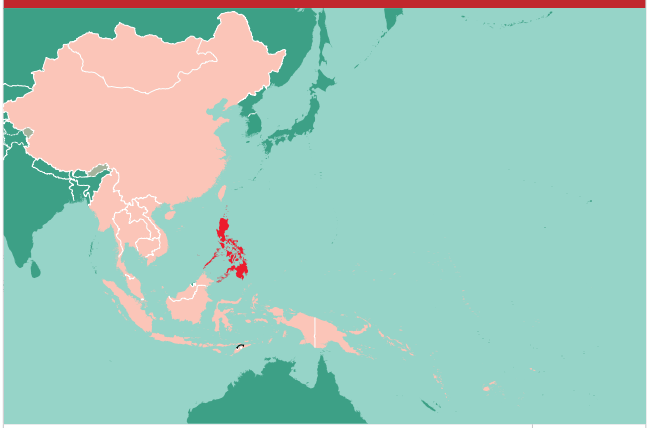


Sources: PNG Treasury, Bank of Papua New Guinea, IMF and WB staff calculations.

PAPUA NEW GUINEA Selected Indicators	*2015*	*2016*	*2017e*	*2018f*	*2019f*	*2020f*
GDP, at market prices	8.0	2.4	2.1	2.5	2.4	3.0
Mining and Petroleum	8.9	1.8	1.0	1.1	1.1	1.1
Non-mining and non-petroleum	-1.0	0.6	1.1	1.4	1.3	1.9
CPI inflation, period average	6.0	6.7	4.1	4.5	4.3	5.1
Fiscal						
Revenue	18.8	15.4	15.0	15.0	15.0	15.0
Expenditure	23.1	19.9	18.2	18.1	18.5	18.5
Balance	-4.3	-4.5	-3.2	-3.1	-3.5	-3.5
Debt	30.9	32.2	34.8	36.8	39.0	40.5
External						
Current account balance	13.5	12.0	12.1	11.4	10.9	11.1
Resource	13.9	11.5	11.1	10.4	10.4	10.0
Non-resource	-0.4	0.5	1.0	1.0	0.5	1.1
Debt	-0.7	-0.7	-0.7	-0.7	-0.7	-0.7

Sources: PNG Treasury, Bank of Papua New Guinea, IMF and WB Staff calculations.
Notes: e = estimate; f = forecast.

PHILIPPINES



	2016
Population, million	102.3
GDP, current US$ billion	304.9
GDP per capita, current US$	2982
International poverty rate ($1.9)[a]	6.6
Lower middle-income poverty rate ($3.2)[a]	27.0
Upper middle-income poverty rate ($5.5)[a]	56.1
Gini coefficient[a]	44.4
Life expectancy at birth, years[b]	68.3

Sources: World Bank WDI and Macro Poverty Outlook.
Notes: (a) Most recent value (2015). (b) Most recent WDI value (2014).

Summary

The Philippine economy had a slower start in 2017 compared to 2016, when government's election-related spending and front-loaded private investment fueled growth in the first half of the year. Besides solid consumption growth, a favorable external environment was the bright spot, pushing export growth to 20.0 percent year-on-year in H1 2017. Fiscal and monetary policies remained supportive of growth with on-target budget execution and successful inflation targeting which also makes it likely that poverty reduction has continued.

Recent Developments

The Philippines grew by 6.4 percent year-on-year in H1 2017, following strong growth of 6.8 percent year-on-year in H2 2016 after the new administration took over in July 2016. This pattern reflects the evolution of capital formation, which eased to 9.7 percent in H1 2017, following its outstanding performance of 30.9 percent in H1 2016 when rapid economic expansion was spurred by a stimulus from election-related spending and investment (Figure 1). In contrast, positive consumer sentiment, coupled with modest inflation and robust remittance growth boosted domestic consumption. Further, net exports improved as the Philippines' main exports, electronics, significantly rebounded. On the production side, the services sector remained the principal growth engine, while the agriculture sector recovered strongly, benefitting from favorable weather conditions.

The fiscal sector was supportive of growth at the expense of a widening deficit. Fiscal policy continued an expansionary path, leading to an increase in the deficit to 2.1 percent of GDP in H1 2017 compared to 1.7 percent of GDP in H1 2016. Total revenues expanded by 6.8 percent year-on-year in nominal terms to reach 15.6 percent of GDP in H1 2017, but fell short of the 16.0 percent of GDP in H1 2016, in large part due to a decline in non-tax revenues. Government expenditures increased, on the other hand, by 9.0 percent year-on-year in nominal terms in H1 2017, reaching 17.7 percent of GDP, the same level as in H1 2016. The increase in spending was driven by both higher capital outlays and current operating expenditures, such as personnel services and subsidies to government corporations. Subsidies are a relative small expenditure item, however, they increased by nearly sixty percent. The government relied primarily on domestic sources to finance the larger deficit while the total debt to GDP ratio declined to 42.5 percent in H1 2017 from 42.9 percent in H1 2016.

The central bank kept the key policy rate unchanged at 3.0 percent since June 2016 as inflation remained within its target range of 2–4 percent. In the earlier months of 2017, higher food and energy prices drove headline inflation up. But inflationary pressures subsided recently. Headline inflation peaked at 3.4 percent in

April and has since then decelerated to 3.1 percent in August. Ample liquidity allowed for credit expansion, with commercial bank loans expanding by 19.0 percent year-on-year in June. Key banking system indicators point to continued stability: nonperforming loans declined from 2.1 percent of the total loan portfolio in June 2016 to 1.9 percent in June 2017, and the banks' capital adequacy ratio stood at 15.3 percent as of March, well above the 10.0 percent regulatory minimum.

The balance of payments turned into deficit in H1 2017, driven by the higher capital outflows unmatched by the modest improvement in the current account. The capital and financial accounts reversed to net outflows in H1 2017 at US$81.9 million (0.1 percent of GDP), from US$1.5 billion (1.0 percent of GDP) net inflows in H1 2016.

Official poverty figures based on the most recent household survey data—from 2015—show an acceleration of poverty reduction. Sustained economic growth since 2015 make it likely that the poverty rate has continued to decline. Based on the lower middle-income class poverty line (US$3.2/day in 2011 PPP), poverty in 2015 is estimated at 27.0 and projected to be 24.2 percent in 2017, implying that 1 million Filipinos have exited poverty each year since 2015. Contributing factors to poverty reduction include a conditional cash transfer program that reaches one-fifth of the population and the ongoing transition of workers out of agriculture.

Outlook

In 2017, the economy is projected to expand at a slightly slower pace than 2016, at 6.6 percent. The delay in the anticipated push of the planned government infrastructure program has been contributing to the moderation of fixed capital formation growth, softening the growth prospect for the year. However, the medium-term growth outlook remains positive, and is expected to be anchored in growth in the Philippines' main trading partners which would lead to higher external demand, while imports would remain elevated due to necessary imports of intermediate and capital goods, including for the infrastructure program. As the public infrastructure program gains traction, capital outlays and construction activities are expected to rise. Consumption growth is expected to remain firm contingent on sustained remittances and expanding credit contributing to improving income levels. Local elections in 2019 will likely boost domestic activities as early as the latter half of 2018. Growth in 2018 and 2019 is projected at 6.7 percent.

Poverty based on the lower middle-income class line is projected to decline to 22.9 percent in 2018 (Figure 2). The pace of poverty reduction may drop slightly in the face of slightly lower overall growth, but poverty is expected to continue to fall as the economy continues its structural transformation. Increased spending in infrastructure would generate construction jobs that are expected to boost poverty reduction.

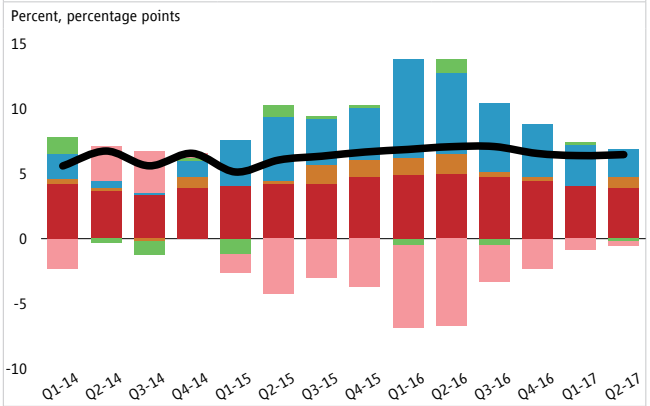
Risks and Challenges

Sustained investment in physical infrastructure and human capital development could create quality employment needed to safeguard the country's progress on delivering inclusive growth. To this end, the government has continued to expand its proposed 2018 budget, prioritizing such investments. More inclusive growth also requires government's commitment to structural reforms that promote competition in key sectors, secure property rights, and improve the investment climate.

A faster-than-expected increase in interest rates in advanced economies remains a source of external risk. Expectations of international interest rate tightening may lead to renewed capital outflows and volatility in the foreign exchange market. Meanwhile, the pace of economic growth could be slower if the government is unable to timely deliver on its planned infrastructure

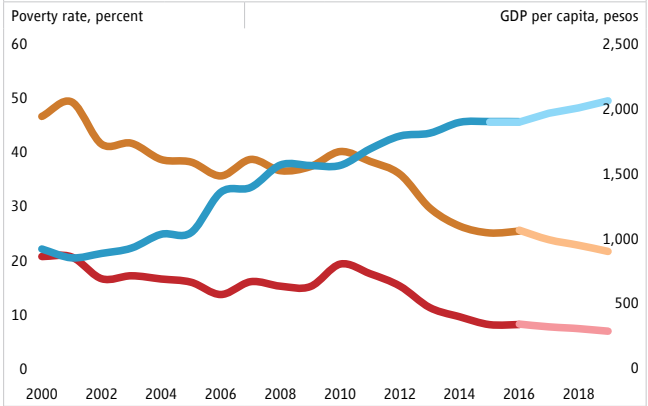
program. Complementary reforms to address budget execution and implementation bottlenecks and to ensure high quality of spending are needed. Maintaining fiscal sustainability over the medium-term will also depend on the success of the priority tax reforms.

Figure 1. Real GDP growth, contribution to real growth



Sources: Source: Philippine Statistics Authority.

Figure 2. Poverty rates and GDP per capita (constant 2000 pesos)

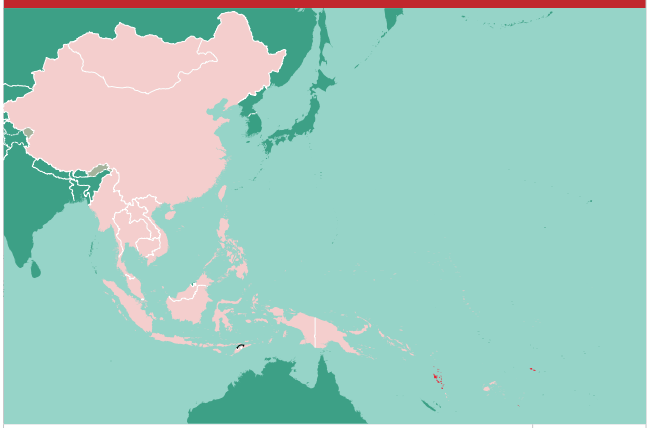


Sources: Source: Philippine Statistics Authority.

PHILIPPINES Selected Indicators	*2014*	*2015*	*2016*	*2017f*	*2018f*	*2019f*
Real GDP growth, at constant market prices	6.1	6.1	6.9	6.6	6.7	6.7
Private Consumption	5.6	6.3	7.0	6.0	6.1	6.3
Government Consumption	3.3	7.6	8.4	3.8	6.0	8.7
Gross Fixed Capital Investment	7.2	16.9	25.2	12.2	14.7	16.1
Exports, Goods and Services	12.6	8.5	10.7	17.1	12.2	12.4
Imports, Goods and Services	9.9	14.6	18.5	17.0	14.3	15.5
Real GDP growth, at constant factor prices	6.2	5.9	6.8	6.6	6.7	6.8
Agriculture	1.7	0.1	-1.3	4.2	4.0	3.5
Industry	7.8	6.0	8.0	6.8	6.8	7.0
Services	6.2	6.8	7.5	6.8	7.0	7.1
Inflation (Consumer Price Index)	4.1	1.4	1.8	3.0	2.6	2.8
Current Account Balance (% of GDP)	3.8	2.5	0.8	-0.2	-0.3	-0.5
Financial and Capital Account (% of GDP)	3.4	1.1	0.3	0.3	0.1	0.1
Net Foreign Direct Investment (% of GDP)	2.0	2.0	2.6	2.6	2.6	2.7
Fiscal Balance (% of GDP)	-0.6	-0.9	-2.4	-2.4	-2.5	-2.8
Debt (% of GDP)	45.4	44.8	42.0	41.8	41.2	40.8
Primary Balance (% of GDP)	1.7	1.4	-0.3	-0.1	-0.2	-0.4
International poverty rate ($1.9 in 2011 PPP)[a,b]	..	6.6	5.8	5.1	4.5	4.0
Lower middle-income poverty rate ($3.2 in 2011 PPP)[a,b]	..	27.0	25.6	24.2	22.9	21.7
Upper middle-income poverty rate ($5.5 in 2011 PPP)[a,b]	..	56.1	55.2	54.3	53.5	52.6

Sources: World Bank, Macroeconomics and Fiscal Management Global Practice, and Poverty Global Practice.
Notes: f = forecast. (a) Calculations based on EAPPOV harmonization, using 2006-FIES and 2015-FIES. Actual data: 2015. Nowcast: 2016 - 2016. Forecast are from 2017 to 2019. (b) Projection using annualized elasticity (2006-2015) with pass-through = 1 based on GDP per capita in constant LCU.

SMALL PACIFIC ISLAND COUNTRIES



	2015
Population, million	0.88
GDP, US$ billion	3.01
GDP per capita, current US$	4,406

Sources: WDI, World Bank staff estimates.

Summary

Most Small Pacific Island Countries (PICs) are experiencing moderate to strong growth, driven by stimulus from public and donor-funded investments, which has also supported job creation. Inflation remains modest due to relatively stable global commodity prices. Continued strong fishing license revenues have supported large fiscal and current account surpluses. Nevertheless, medium-term fiscal sustainability remains a challenge for most PICs, with both revenue and expenditure subject to large and frequent shocks.

Recent Developments

The economy of the **Federated States of Micronesia (FSM)** is expected to have grown 3.0 percent in FY2016 (ending September 30), continuing the recovery commenced in FY2015 (3.7 percent growth), after three years of contraction during FY2012–14. Recent growth has been driven by higher production in the fisheries sector and increased construction activity related to infrastructure projects. In FY2017, growth is expected to moderate to 2 percent, as the recovery continues at a slower pace. The recovery is expected to have supported increased formal sector employment, which contracted for four consecutive years during FY2012–FY2015, for a cumulative decline of 6.8 percent. Consumer prices fell in FY2016 and are expected to have remained flat in FY2017, due to lower domestic fuel prices and a stronger US dollar (the official currency of the FSM) holding down prices for some imports. After traditionally running large deficits, the current account moved into surplus in FY2014 and FY2015, and is expected to have registered surpluses again in FY 2016 and FY2017, reflecting higher fishing licence receipts.

FSM's macro-fiscal performance has improved significantly over the past three years, resulting in large fiscal surpluses of 6–12 percent of GDP during FY2014–FY2016. While general tax revenue has remained steady at around 12 percent of GDP, which is low relative to other countries in the Pacific, non-tax revenue (excluding grants) have almost tripled since 2011 to over 20 percent of GDP, reflecting higher fishing license fees resulting from the introduction of the Vessel Day Scheme (a regional agreement that establishes the minimum price of a vessel day and limits the total number of vessel days sold). Another large fiscal surplus is expected in FY2017. Along with increased Compact grants, higher revenues have been used to increase capital expenditure. The government has also prudently transferred fiscal surpluses to the FSM Trust Fund aimed at mitigating external shocks and potential future shortfall from the scheduled end of Compact grants from 2024.

In **Kiribati**, growth is expected to have been about 4.2 percent in 2016, representing Kiribati's sixth consecutive year of economic expansion. Growth is expected to moderate to about 2.8 percent this year, with the winding down of major donor-financed infrastructure projects. Inflation has remained around 2 percent, with the relative stability of food and commodity prices and the relative stability of the Australian dollar (which Kiribati uses as its currency). Despite large trade deficits, the current account balance has remained in surplus in

recent years due to high levels of fishing license fee revenue paid by foreign companies to fish in Kiribati's vast Exclusive Economic Zone and, to a lesser degree, solid investment incomes from the Revenue Equalization Reserve Fund (RERF), Kiribati's sovereign wealth fund, and stronger remittance inflows. Fishing license fee revenue in 2016 was equivalent to about 68 percent of GDP, down from the record 93 percent of GDP received in 2015, but still very strong by historical standards, driven by the effects of the Vessel Day Scheme and continued favorable weather conditions. The continued strong fishing license fee revenue supported a budget surplus in 2016, estimated at about 3.9 percent of GDP.

The strength of fishing license fee revenues in recent years and has resulted in the accumulation of substantial cash reserves. In 2015, the government made a net transfer of AUD 50 million to the RERF, and in 2016, the government made another transfer of AUD 70 million to the RERF. Cash reserves have now accumulated above the buffer required to deal with general volatility and shocks, and the government plans to use these funds to finance infrastructure investments in the outer islands, to improve connectivity and service delivery for remote populations.

Nauru grew by more than 20 percent annually on average from FY2011–FY2014 (year ending June) due in part to the reopening of Australia's Regional Processing Centre (RPC) for asylum-seekers in 2012, which is currently the main driver of economic activity in Nauru. The resumption of phosphate mining in 2011 and an increase in fishing license fees also spurred economic activity. However, growth in more recent years has been much slower on average and remains volatile, with Nauru's undiversified economy making it highly vulnerable to external shocks. After damage to seaport facilities, FY2015 saw only modest growth of around 3 percent, but the economy rebounded in FY2016, growing by about 10 percent due to seaport repairs, strong activity in the service sector, and a large increase in government spending. Growth is estimated to have slowed to 4 percent in FY2017 due to a slowdown in phosphate exports and a moderation in RPC-related activity.

Government revenue has increased substantially since FY2012 due to RPC-related revenues and fishing license fees, as well as increased tax collection from the implementation of employment and services taxes and improvements in tax administration. However, government spending has also increased rapidly, particularly on the wage bill (in an effort to retain key public employees), but also on goods, services, and social benefits. After accounting for a contribution to the Nauru trust fund, estimates suggest a small fiscal deficit of around 1 percent of GDP in FY2017.

The **Palauan** economy grew by 1.9 percent in FY2016, following growth of 11.4 percent in FY2015. The strong growth in FY2015 was driven by tourist arrivals (which increased by 34 percent) and construction activity. However, the rapid rise in tourism activity strained infrastructure, prompting the authorities to limit the number of charter flights in FY2016, resulting in a 13 percent fall in annual tourist arrivals. Lower tourism receipts, combined with higher imports for transport and medical equipment, also weakened the external position, with the current account deficit reaching 10.3 percent of GDP in FY2016. Despite slowing growth, the economy continued to create jobs (up 4.4 percent in FY2016), meaning formal employment has now increased by 16 percent since FY2012. Consumer prices fell by 1.3 percent in FY2016, as the stronger US dollar (the official currency of Palau) held down local prices for food and transport services. Economic growth is expected to rebound to around 5 percent in FY2017 as tourism activity recovers with the entry of new hotels, and construction picks up.

Palau's fiscal position has strengthened in recent years, with FY2016 registering a fiscal surplus (including grants) of 4.3 percent of GDP, the sixth consecutive annual surplus, underpinned by increased collections of income tax and import duties, and higher capital grants.

These were partially offset by increased SOE subsidies and higher contributions to public sector pensions.

Economic growth is expected to remain steady in the **Republic of Marshall Islands (MHL)**. Following growth of 0.4 percent in FY2015, the MHL economy is expected to expand by around 1.4 percent in FY2016 and 1.7 percent in FY2017, reflecting the recovery of agriculture production following the drought in early FY2016, and the resumption of delayed Compact-grant infrastructure projects. Increased capital spending is expected to increase imports, pushing the current account back into deficit following a large one-off surplus in FY2015. Inflation is expected to be around 1 percent in FY2016 and FY2017, and continued high fishing license fees are expected to underpin a continued small fiscal surplus in both years. However, larger fiscal surpluses will be required to build adequate buffers to sustain government spending following the scheduled end of Compact grants from 2024.

Economic growth in **Samoa** accelerated to around 7 percent in FY2016 (year ending June), much faster than originally forecast and a significant acceleration from growth of between 1 and 2 percent in the previous two years. Growth in FY2016 was driven by tourism arrivals, lower fuel prices, and new fish processing facilities, as well as two major sporting events. In the first three quarters of FY2017, the pace of growth has moderated to around 3 percent, due to slowing activity in the construction sector (reflecting the completion of major infrastructure works in 2016) and in the fishing industry. Average annual inflation was very subdued at 0.1 percent in FY2016, with declines in the prices of imported goods (particularly fuel) continuing to offset increases in domestic prices. In FY2017, inflation is expected to have remained contained at around 1.3 percent. Although the trade balance improved in FY16, the current account deficit widened to 6.1 percent of GDP (from 3.0 percent in FY15) due mainly to a reduction in remittances related to charities. Nevertheless, the current account deficit remains below levels observed in previous years, when disaster-recovery and other construction activities pushed up the import bill.

Comprehensive revenue policy and administrative reforms have led to significant increases in domestic revenue collection over the last five years. Combined with tighter controls on operating expenditure, these increases in revenue helped reduced the budget deficit to 0.4 percent of GDP in FY2016, from 3.9 percent in FY15 and 5.3 percent in FY2014, despite a pronounced decline in grants over the same period. Budgetary data for the first three quarters of FY2017 suggest that this solid revenue performance has been maintained, while operating expenditures of most ministries (apart from education and health) have been reduced by 10 percent from the previous year. While Samoa's external public debt remains high compared with most other small PICs, as a proportion of GDP it has declined to around the government's target of 50 percent, down from its peak of 55 percent in FY2015.

Growth has been relatively strong in **Tonga** in recent years. Growth in FY2016 (year ending June) is estimated at 3.4 percent, supported by one-off events, including the King's Coronation; post-cyclone reconstruction; private sector investment, including the re-development of the International Dateline Hotel; and a recovery in agricultural production following a severe drought in 2015. Growth in FY2017 is projected to have moderated to around 2.7 percent, due mainly to a delay in implementation of various construction projects. In May 2017, Tonga withdrew from hosting the 2019 Pacific Games. Nevertheless, the government continues to prioritize sports development, and the large majority of planned donor-funded construction related to the Games will go ahead as planned. While inflation has been very subdued in recent years, it spiked to around 9 percent in year-on-year terms in February 2017, due in large part to policy-driven increases in import duties and excise taxes on fuel, alcohol, tobacco, and less healthy foods and drinks. However, inflation should return to more modest rates as these one-off effects pass through. The current account deficit is estimated to

have narrowed to around 3 percent of GDP in FY2016, while official foreign exchange reserves stood at around 10 months of import cover in early 2017.

The government continues to focus on increasing domestic revenues, which have increased by over 5 percentage points of GDP over the last five years, supported by a series of policy and administration reforms. At the same time, total public expenditure has also increased, mostly in response to cyclone reconstruction needs and increases in wages for civil servants. The deficit is estimated to have risen to 2 percent of GDP in FY2016, from 1.1 percent in FY2015, with lower grants from development partners also affecting the bottom line. The government has successfully maintained a stance of avoiding any new non-concessional borrowing.

Economic growth has picked up in **Tuvalu** in recent years, with GDP growth estimated at 3 percent in 2016 (up from 2.6 percent in 2015) and is expected to rise further to 3.2 percent in 2017 due to continued government expenditure on capital projects. Government and donor funded investments, including outer-island school and clinic projects have also contributed to the pick-up in growth over recent years. Inflation was moderate at 2.6 percent in 2016 (down from 3.2 percent in 2015) and is expected to rise to 2.9 percent in 2017 as economic activity picks up.

The fiscal position, which improved significantly over recent years, returned to a deficit estimated at 2.6 percent of GDP in 2016—largely due to Tropical Cyclone Pam (TCP) recovery and reconstruction expenditures and one-off spending on infrastructure investments. Non-tax revenues such as fishing license fees and dot.tv internet domain leases finance the bulk of spending needs. Notably, fish license fees increased from 38.6 percent of GDP in 2014 to 53.2 percent in 2016. Supplementary to the Tuvalu Trust Fund (TTF) and its auxiliary fund—the Consolidated Investment Fund (CIF)—the government established the Tuvalu Survival Fund (TSF) in 2016 (capitalized at A$7 million in 2017) to finance ongoing climate change mitigation efforts, as well as to finance recovery and rehabilitation from climate change impacts and natural disasters.

The current account moved from a net surplus of around 7.6 percent of GDP in 2015 to a deficit of around 4 percent of GDP in 2016, owing to a widening of the trade deficit, reflecting increased imports for government and donor-funded investment projects. The labour market for Tuvalu's seafarers has collapsed in recent years (owing to increased international competition), limiting income from remittances—estimated at 0.5 percent of GDP in 2016. Record fishing license revenues in 2015 and 2016 resulted in substantially higher income flows, and continued to finance a significant portion of the goods and services deficit (estimated at 81.5 percent of GDP in 2016). Gross reserves have remained adequate, covering around just over 6 months of imports in 2016.

In 2016, economic growth for **Vanuatu** is estimated at 4 percent, driven primarily by government and donor funded reconstruction activities following TCP in 2015. GDP growth is expected to remain strong in 2017 (projected at 4.6 percent), on the back of continued reconstruction activity and the recovery of the agricultural and tourism sectors. The agricultural sector recovered in the second half of 2016, following unusually dry conditions triggered by El Niño throughout 2015 and early 2016, while tourism arrivals for the year surpassed 2015 arrivals by 19 percent. Inflation remained moderate at 2.2 percent in the last quarter of 2016, and is expected to increase to 2.5 percent in 2017. On the back of stronger-than-expected revenue performance (driven by VAT collections and excise taxes) and under-implementation of the development budget, the pre-grant fiscal balance recorded a surplus of 2.3 percent of GDP. In 2017, the government has targeted a balanced budget, with both revenue and expenditure estimates projected at 25 percent of GDP.

Overall, economic growth is estimated at 4.6 percent in 2017, driven by ongoing large infrastructure projects, the continuation of post-cyclone reconstruction and

rehabilitation activities, the gradual recovery of agricultural production, and overall growth in visitor arrivals. The current account deficit is estimated at 21 percent of GDP in 2017, reflecting the continued increase in imports associated with post-cyclone recovery efforts. Inflation for 2017 is estimated at 2.5 percent—an increase on the previous quarter—driven by transport and food prices.

In terms of the incidence of poverty in the region, none of the PICs conduct regular household income and expenditure surveys, and thus, do not produce regular statistics on poverty. Based on the most recent statistics available for each country, in the past, Vanuatu, Kiribati and the north Pacific (FSM and MHL) have had the highest incidence of poverty based on the international poverty line (US$1.9/day in 2011PPP) and lower middle-income class poverty line (US$3.2/day in 2011 PPP) (Figure 1). In recent years, poverty is likely to have increased in both Vanuatu and Tuvalu due to the impacts of TCP and El Nino weather patterns. Vanuatu is particularly susceptible to adverse weather due to the relatively high dependence on home produced food compared to regional neighbors. In Tuvalu, adverse weather conditions disproportionately impact the outer islands, where 99 percent of households depend at least partially on home production of food items, compared to 74 percent in Funafuti.

Outlook and Emerging Challenges

The outlook, particularly for **FSM**, **MHL**, **Palau** and **Tuvalu**, is subject to substantial risks due to their reliance on tourism, external grants, and commodity imports. A slowdown in key trading partners, a further U.S. dollar appreciation, and natural disasters could impact negatively on tourism activity. Higher commodity prices could make food and fuel imports costlier. Global financial sector volatility could also affect returns on the various trust funds held by these countries, and their ability to provide fiscal space for priority spending or buttress against future shocks. Structural and fiscal reforms to boost medium-term growth and revenues are essential, particularly for the Compact of Free Association countries (FSM, RMI and Palau), as the asset base of government-managed trust funds is not projected to provide sufficient returns to offset the effect of expiring U.S. grants after FY2023. Without these reforms, the fiscal surpluses in these nations are expected to turn into a deficit beyond FY2023.

The outlook for **Kiribati** remains positive. Growth is expected to gradually moderate toward its potential, around 2 to 2.5 percent per year, but if planned major donor-financed infrastructure projects and government-financed outer island infrastructure investments are implemented, the medium-term growth forecast will shift up. Maintaining fiscal sustainability remains a challenge despite large fiscal surpluses in recent years, as expenditure pressures remain and fisheries revenues come off their peak. A deficit of 0.7 percent of GDP is projected for the current year. Both revenue and expenditure are subject to large and frequent shocks. The main sources of income—fishing license fee revenue, investment income from the RERF, and foreign aid—will continue to be volatile, while disaster-related expenditure shocks—particularly from storm surges and king tides—could increase in frequency and severity with climate change. The country's large infrastructure and essential services deficit, widespread poverty, and young and growing population also require increased and more effective spending on physical and human capital. Ongoing efforts to improve the performance of state owned enterprises also need to be maintained, to continue to improve access to basic public services and reduce fiscal risk.

In **Nauru**, the economy is projected to contract in FY18, with only modest economic growth expected over the medium term. Growth remains dependent on the very uncertain outlook for the RPC, which in turn is contingent on the extent to which asylum seekers in Nauru are resettled in other countries and the potential additional donor support that Nauru may receive to compensate for revenue shortfalls. Nevertheless, the central case is for a

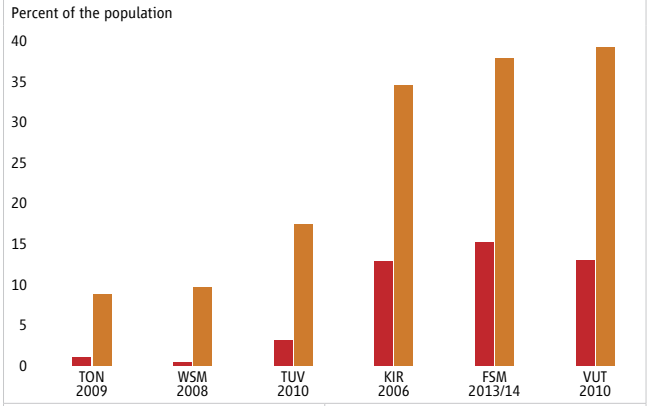
substantial decline in RPC revenue, beginning in FY18. Nauru's biggest challenge is to diversify its economy beyond reliance on the RPC and phosphate mining, neither of which is a sustainable source of income in the longer term. To ensure fiscal sustainability, it will be important for the revenue reforms now underway to be complemented with systematic efforts to contain the wage bill and recurrent spending, while preserving critical expenditures on health and education.

In **Samoa**, the exit of a major manufacturer of automotive wire harnesses in the second half of 2017 is likely to temporarily reduce growth by around 1 percentage point, with growth in FY18 projected to slow to between 1 and 2 percent. Growth is expected to return to an annual rate of around 2 percent over the medium term, supported by construction of public infrastructure and increased productive capacity in the tourism and agriculture sectors. Nevertheless, as public debt remains high, it is important that fiscal restraint is maintained, consistent with recent government efforts to increase domestic revenues, control recurrent spending (while protecting critical social expenditures), and pursue only high-priority and concessionally-funded capital investments.

In FY2018, growth in **Tonga** is projected to pick up to around 3.4 percent, driven by construction, a rebound in agriculture, and expanding remittances, as well as growth in the tourism sector. The key challenge facing Tonga in coming years is to maintain its prudent fiscal stance. This should be aided by the recent introduction of fiscal anchors which set medium-term targets for domestic revenue, the wage bill, and external debt. Management of the government wage bill should also be strengthened by the recent implementation of a new remuneration framework and performance management system. To the extent that Tonga manages its government spending prudently, it will retain the fiscal space necessary to meet pressing service delivery needs and respond quickly and effectively to the frequent shocks (particularly natural disasters) that it faces.

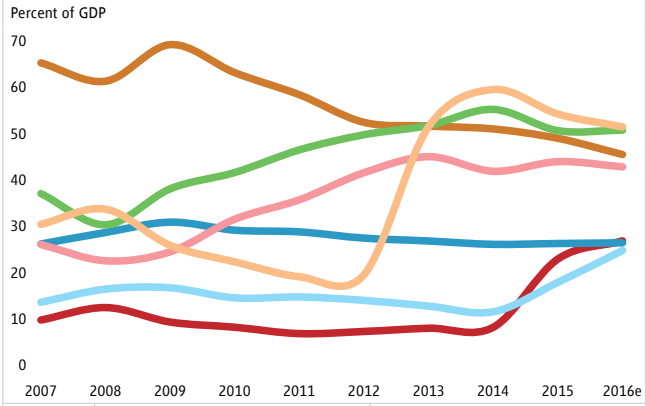
For **Vanuatu**, if current and planned public investments are undertaken efficiently, and with due regard to domestic capacity constraints, they should boost Vanuatu's potential growth rate and ensure that services are available to the poorest and most vulnerable. Given the government's conservative fiscal stance in recent years, it now has some fiscal space to take on moderate levels of concessional debt to meet its post-cyclone recovery and broader development needs. Further, throughout 2016 the government made progress in addressing deficiencies in controls on anti-money laundering and combating the financing of terrorism, which will see Vanuatu withdrawn from the Financial Action Task Force money laundering 'grey list', and may impact positively on new foreign business investment.

Figure 1. Incidence of poverty at international poverty lines (US$1.90/day and US$3.20/day)



Sources: Latest available joint World Bank and IMF DSAs.

Figure 2. Public and publicly guaranteed external debt (share of GDP)

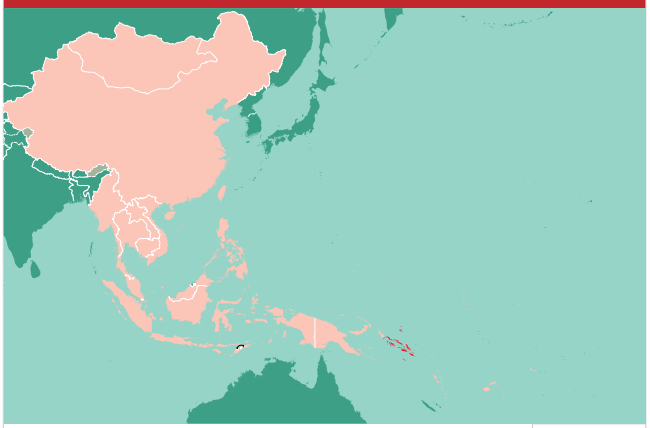


Sources: Latest available joint World Bank and IMF DSAs.

SMALL PACIFIC ISLAND COUNTRIES Selected Indicators	*2014*	*2015*	*2016e*	*2017f*
Real GDP growth, at constant market prices				
Kiribati	0.4	7.5	4.2	2.8
Marshall Islands	-1.1	0.4	1.4	1.7
Micronesia, Federated States	-2.4	3.7	3.0	2.0
Nauru	36.5	2.8	10.4	4.0
Palau	5.8	11.4	1.9	5.0
Samoa	1.2	1.6	7.1	2.5
Tonga	2.1	3.7	3.4	2.7
Tuvalu	2.2	2.6	3.0	3.2
Vanuatu	2.3	-0.8	4.0	4.5

Sources: World Bank, Macroeconomics and Fiscal Management Global Practice, and Poverty Global Practice.
Notes: Financial Years in the Small PICs are as follows: Tuvalu and Vanuatu (Jan – Dec); Nauru, Samoa and Tonga (Jul – Jun); MHL, FSM and Palau (Oct – Sept); e = estimate; f = forecast.

SOLOMON ISLANDS



	2016
Population, million	0.6
GDP, current US$ billion	1.2
GDP per capita, current US$	1,997
School enrolment, primary (% gross)[a]	113.9
Life expectancy at birth, years[a]	67.9

Source: WDI, Macro Poverty Outlook, and official data.
Note: (a) Most recent WDI value (2014).

Summary

The Solomon Islands Government prioritizes infrastructure and development in rural areas—where most of the population reside. Growth is expected to remain at trend of around 3 percent. In the medium-term, emerging challenges include a sharper than expected downturn in the Chinese economy, and ongoing uncertainties, particularly in the logging and mining sectors. Continued strong and coordinated government action coupled with greater private sector investment to promote inclusive economic growth will be necessary to ensure broad-based improvements in living standards.

Recent Developments

Solomon Islands remains dependent on foreign aid flows and natural resource extraction, and is heavily exposed to natural disasters and exogenous shocks. Following the cessation of civil strife in 2003, economic growth has depended primarily on the logging sector and a large influx of donor financing. The national basic-needs poverty rate, estimated in 2012/13, is 12.7 percent, while the gini coefficient is 37.1.

Economic growth for 2016 is estimated at 3.3 percent, driven by higher output in the logging and agricultural sectors, and investments in construction, communications and manufacturing. In 2017, the infrastructure push is continuing, but growth is forecast at 3.0 percent, with the marginal slowdown driven by continued public financial management problems which have resulted in domestic arrears and are impeding private sector activity. Agriculture, fishing, transportation and the financial sector remain important drivers of growth in 2017. Domestic economic activity, as measured by the Central Bank's production index, increased in the first five months of 2017 supported by strong log output and fish catch. Production declined in June, reflecting a month-on-month decline in log output (18 percent), fish catch (8 percent) and cocoa (35 percent). International prices for key export commodities recovered throughout 2016, and remained relatively stable in H1 2017—with the exception of palm oil, declining by 13 percent.

Since 2015, the government has pursued expansionary fiscal policy with targeted investments towards rural infrastructure and development, and the health and education sectors—potentially important and direct investments in improving the well-being of Solomon Islands' poor. The 2016 budget resulted in a deficit of 3.1 percent of GDP, financed through a draw-down of the government's cash reserves. Similarly, the 2017 budget targets a deficit of 4.3 percent of GDP, although the actual deficit could increase substantially, should optimistic revenue estimates not be met. Overall, this increase in expenditures has resulted in cash reserves declining from SI$880 million at the end of 2015 to SI$179 million at the end of 2016, significantly eroding the government's ability to absorb future exogenous shocks.

Total PPG external debt stood at 7.6 percent of GDP at end-2016. As such, Solomon Islands continues to enjoy

one of the lowest debt-to-GDP ratios in the region, and globally. The most recent debt sustainability analysis (2016) classifies Solomon Islands at a moderate risk of debt distress with the baseline scenario subject to significant risks, resulting from a lower-than-expected growth path and a shock to financing terms.

International reserves stood at US$513 million at end-2016, equivalent to 9.4 months of imports. The current account is projected to have widened from 3.0 percent of GDP in 2015 to 3.9 percent in 2016, to support imports related to large infrastructure projects.

Inflation fell throughout 2016 from 2.9 percent in January to negative 2.2 percent in December, driven by price falls in food, transport and communications.

Outlook

Economic growth is projected to average 3 percent per year over the medium-term, driven by infrastructure investments in the road transport, telecommunications and energy sectors. This baseline scenario also assumes resumed gold-mining activity, the exploitation of large nickel deposits, and sustained levels of foreign direct investment averaging 3.3 percent of GDP.

The government has targeted a budget deficit for the third consecutive year, estimated at 4.3 percent of GDP. The 2017 budget optimistically projects domestically-sourced revenues to increase by 19.4 percent against the revised 2016 budget, which could widen the planned deficit further, should this target not be met. A second supplementary appropriation bill for the year, due for passage in Q3, poses additional fiscal pressure on the deficit.

The current account deficit is expected to widen to 5.0 percent of GDP by end-2017, reflecting an increase in imports related to much needed infrastructure and energy projects, and the underlying long-run decline in logging exports; while the Honiara Consumer Price Index is expected to remain at around 3 percent over the medium term.

Risks and Challenges

With logging sources expected to be fully depleted in the long run and uncertainty around the exploitation of the country's mining potential, Solomon Islands faces the challenge of developing new sources of growth. In the near term, growth will be supported by major infrastructure projects and logging may not decline significantly. This outlook is subject to considerable risks, particularly from any contraction in log demand in China (the main export destination for logs), or delays in infrastructure projects. Thereafter, the impending decline of the logging industry is likely to significantly reduce growth and a vital source of government revenue.

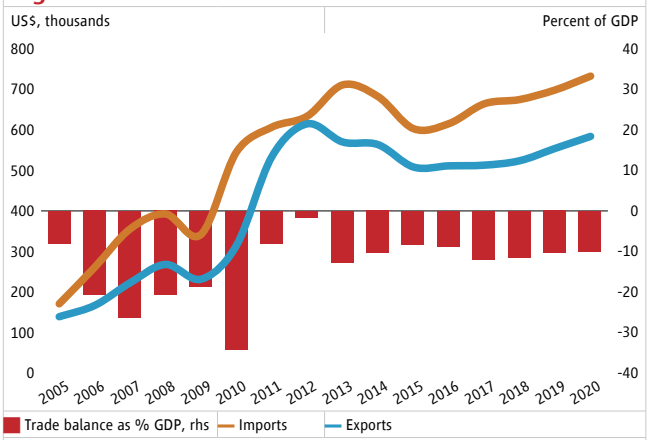
Future developments in the mining sector hinge on the development of a legal and regulatory framework conducive to mining, and on clear procedures for the acquisition of land for exploration and exploitation. Such frameworks and procedures will also ultimately impact the extent to which forthcoming benefits from mining are shared across the population.

A number of challenges remain in the fisheries sector, including licensing, monitoring, and enforcing compliance in offshore fisheries. If sustainably managed, fisheries offer the potential to contribute to growth and government export earnings over the medium term.

Tourism could also make an important contribution to broad-based, and potentially more inclusive growth in the longer-term, although at this stage it is not very developed. Challenges include limited to limited market exposure, domestic transport infrastructure and services, and access to finance for small-and-medium enterprises operating in the sector.

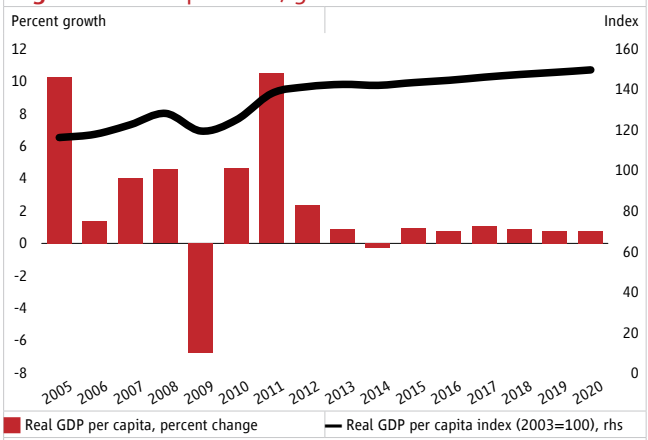
Further, should future formal employment opportunities continue to remain concentrated in Honiara and the immediate surroundings, this might exacerbate challenges associated with rapid population growth, rural-to-urban migration, and the growth of urban squatter settlements.

Figure 1. Trade and trade balance



Sources: Central Bank of the Solomon Islands, World Bank staff estimates, IMF.
Note: rhs= right-hand side.

Figure 2. Per capita GDP, growth and level of index

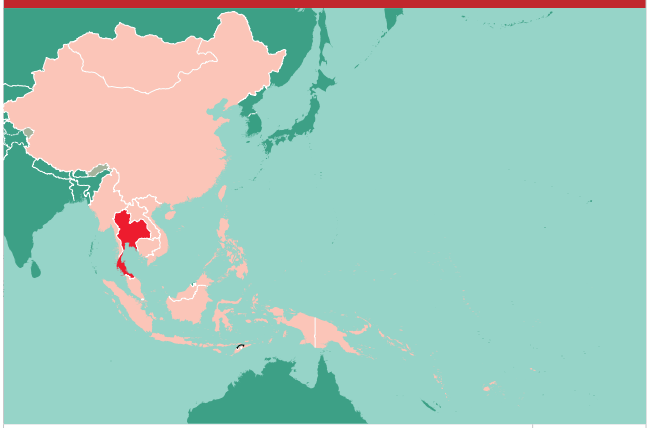


Sources: World Bank staff estimates, IMF.
Note: rhs= right-hand side.

SOLOMON ISLANDS Selected Indicators	*2015*	*2016e*	*2017e*	*2018f*	*2019f*	*2020f*
Real economy						
Real GDP	2.5	3.3	3.0	3.0	2.8	2.7
Per capita real GDP	0.3	1.0	0.8	0.8	0.6	0.5
GDP deflator	1.7	1.6	1.6	1.6	1.6	1.6
CPI (eop)	3.5	-2.2	1.9	1.8	2.9	3.4
Fiscal accounts (% of GDP)						
Expenditures	48.2	44.4	45.5	46.9	44.5	43.9
Revenues	47.9	41.3	41.3	42.2	41.5	41.0
General government balance	-0.2	-3.1	-4.3	-4.7	-3.0	-2.9
Balance of Payments (% of GDP)						
Current account balance	-3.0	-3.9	-5.0	-5.0	-5.6	-5.8
Imports (goods and services)	53.5	50.8	51.6	51.2	51.7	51.2
Exports (goods and services)	45.5	45.0	44.3	42.9	42.5	41.9
Foreign direct investment	2.4	2.9	3.9	3.6	3.6	3.7
Gross reserves (in US$ millions, eop)	519.6	513.6	519.9	542.0	561.2	594.2
In months of next year's imports	10.0	9.4	8.9	8.6	8.5	8.4
External debt	10.6	7.6	8.5	12.5	14.0	16.0
Exchange rate to US$ (average)	7.9	7.9	8.1	7.9	7.9	7.9
Nominal GDP (US$ millions)	1,158.4	1,232.9	1,272.4	1,372.2	1,456.9	1,548.0

Sources: World Bank, Macroeconomics and Fiscal Management Global Practice, and Poverty Global Practice.
Notes: e = estimate; f = forecast.

THAILAND



	2016
Population, million	68.1
GDP, current US$ billion	407.0
GDP per capita, current US$	5,973
School enrolment, primary (% gross)[a]	103.7
Life expectancy at birth, years[a]	74.4

Source: WDI, Macro Poverty Outlook, and official data.
Notes: (a) Most recent WDI value (2014).

Summary

The Thai economic recovery has continued to broaden and gain momentum, reflecting an increase in external demand and recovery from severe drought. The economy grew by 3.7 percent in 2017Q2, exceeding market expectations. Merchandise exports recorded 8.0 percent growth, due to global commodity prices and trading partner growth. The agricultural sector expanded by 15.8 percent due to rising prices and recovery from severe drought. Poverty rates are expected to fall at a slower rate in the medium term due to low agricultural prices.

Recent Developments

Domestic demand remained lackluster. Both private investment and private consumption growth remained moderate. Private investment expanded by 3.2 percent in 2017Q2 after contracting by 1.1 percent in 2017Q1, reflecting spare production capacity in manufacturing. Credit issuance remained subdued as lending standards tightened while loans to large corporates turned positive in 2017Q1 for the first time since 2015. Loans to SMEs and households continued their deceleration trend.

The recent improvement in economic performance builds on the gradual recovery of the past two years. Private consumption expanded by 3.1 percent in 2016, compared to 2.2 percent in 2015, largely driven by improved farm income and stimulus measures. Both public consumption and public investment continued to expand by 1.7 percent and 9.9 percent during the year, respectively. Services and merchandise exports grew substantially in 2016Q4 .

Agriculture showed signs of recovery from a contraction caused by a severe drought in 2015, as output expanded by 15.8 percent in 2017Q2. Higher output and commodity prices, as well as higher yields, supported farm income. In the long-run, managing the impact brought about by cycles of flood and drought through improved water management is a key priority.

Manufacturing growth decelerated to 1.0 percent in 2017Q2 and remained at relatively low levels similar to previous quarters. Growth was stronger in export-oriented industries in 2017H2 as merchandise exports increased in line with higher demand from main trading partners. However, capacity utilization remained low at 59 percent.

Thailand's external position strengthened further. Combined with a slight strengthening in the terms of trade, higher net exports contributed to an increase in the trade surplus to US$ 35.8 billion in 2016 and US$ 6.6 billion in 2017Q2. The current account surplus totaled 11.4 percent of GDP. Foreign reserves increased by 3.2 percent to US$ 197.6 billion end-2016, or 3.8 times short-term foreign debt. Total external debt remained stable at 32.5 percent of GDP.

The fiscal stance remained expansionary to support economic recovery. The fiscal deficit is expected to widen

to 3.7 percent of GDP in FY2017, up from 2.6 percent of GDP in FY2016. However, public investment contracted by 7.0 percent in 2017Q2 after significant expansion in public investment. The annual budget disbursement in 2017Q2 fell to 18.5 percent of the 2017 budget.

Despite low inflation, the Bank of Thailand has maintained the policy rate at 1.5 percent since April 2015. Headline inflation decelerated to 0.1 percent in 2017Q2 due to food prices. The Thai Baht averaged 35.3 per USD in 2016, a slight 2.9 percent depreciation compared to the previous year. However, strong fundamentals and an improved external position led to steady appreciation pressure in 2017, with the baht appreciating by 7.8 percent by end-August.

Thailand continued to make progress in reducing poverty. Based on the national poverty line, the poverty rate fell from 12 percent in 2011 to 7 percent in 2015. Poverty rates are expected to fall at a slower rate in the medium term, with poor rural households affected by cycles of drought and historically low agricultural prices. Nevertheless, farm income growth turned positive beginning in 2016H2 following recovery from drought.

Outlook

The broadening export upturn and public infrastructure plans are contributing to an improvement in Thailand's economic outlook. Economic growth is projected to reach 3.5 percent in 2017 and 3.6 percent in 2018, as inflation is expected to return gradually to the inflation target range. Continued agricultural recovery and strengthened household balance sheets will support private consumption while the export upswing will spur manufacturing and private investment. However, a broad-based recovery will hinge on domestic demand.

Ambitious public infrastructure projects will result in expansionary fiscal policy well into FY2022. The Transportation Action Plan shows public investment peaking in FY2020. However, weaknesses in the public infrastructure management framework and historical performance suggest a more prolonged expansionary fiscal stance that will extend beyond FY2022.

The implementation of public infrastructure projects in 2017 would help improve investor sentiment. The Transportation Action Plan covers 36 infrastructure projects worth 896 billion baht for investment in 2017. Five projects began construction in 2017H1. Key projects include the Chinese high-speed rail, dual tracking, and new mass transit lines in Bangkok. The first phase of the Chinese high-speed rail project has been recently approved by the cabinet.

Normalization of agricultural prices following a decline in the global commodity price cycle will limit agricultural income growth and declines in rural poverty. Rising agricultural income in the recent years mainly reflected a global commodity price cycle and not long-term productivity increases in agriculture. As agricultural prices fall back to more normal levels, growth could become less inclusive, with the rural poor negatively affected. Poverty is therefore expected to decline at a slower rate in rural areas in the medium term.

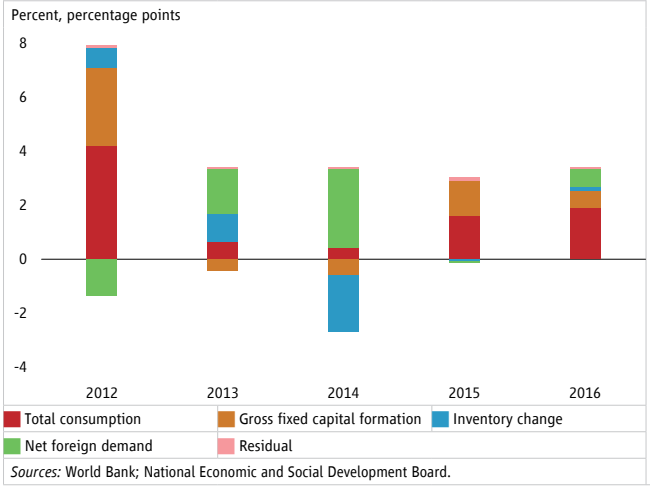
Risks and Challenges

The first risk is a deterioration in global economic prospects, particularly trade protectionism, which will weigh on Thai exports and economic recovery. Trade protectionism and the implementation of the Brexit vote reflect a significant rise in economic uncertainty, which is expected to adversely affect global growth. Such an outcome would hamper economic recovery and increase the need for more stimulus. Thailand has ample monetary and fiscal buffers but timely implementation of public infrastructure projects may prove challenging.

A second risk is a rise in Thailand's political uncertainty if ongoing political reforms fail to satisfy broad segments of society. In such a scenario, political uncertainty could

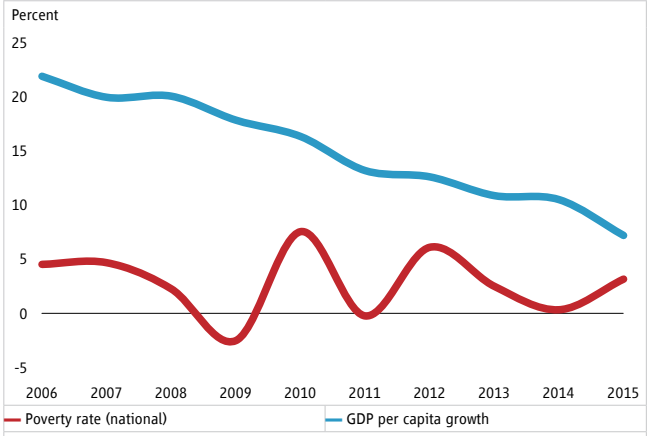
delay public spending, planned public infrastructure projects and economic reforms and weigh on investor conference. However, the accession of Crown Prince Maha Vajiralongkorn and royal approval of the new constitution help mitigate this risk.

Figure 1. Contribution to annual real GDP growth



Sources: World Bank; National Economic and Social Development Board.

Figure 2. Poverty rate and GDP per capita growth

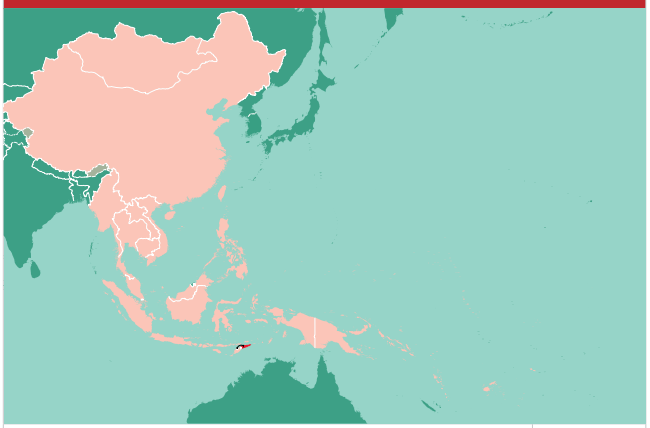


Sources: World Bank; National Economic and Social Development Board.

THAILAND Selected Indicators	*2014*	*2015*	*2016e*	*2017f*	*2018f*	*2019f*
Real GDP growth, at constant market prices	0.9	2.9	3.2	3.5	3.6	3.5
Private Consumption	0.9	2.2	3.1	3.1	3.1	3.0
Government Consumption	2.8	3.0	1.7	3.1	3.1	3.1
Gross Fixed Capital Investment	-2.2	4.4	2.8	4.0	4.2	3.7
Exports, Goods and Services	0.2	0.7	2.1	2.3	2.4	3.0
Imports, Goods and Services	-5.3	0.0	-1.4	-1.4	2.6	2.9
Real GDP growth, at constant factor prices	0.8	2.8	3.4	3.5	3.6	3.5
Agriculture	0.7	-3.8	0.6	3.0	1.3	1.3
Industry	-0.3	2.2	2.0	2.0	2.1	2.2
Services	1.6	4.1	4.7	4.6	4.8	4.5
Inflation (Consumer Price Index)	1.9	-0.9	0.2	0.7	1.6	2.0
Current Account Balance (% of GDP)	3.8	8.1	10.6	10.9	10.4	10.2
Financial and Capital Account (% of GDP)	-3.6	-7.9	-11.2	-11.5	-11.1	-10.9
Net Foreign Direct Investment (% of GDP)	-0.1	-0.1	-0.1	-0.1	-0.1	-0.1
Fiscal Balance (% of GDP)	-0.8	-1.9	-2.6	-3.6	-3.7	-3.6
Debt (% of GDP)	43.1	45.0	45.1	45.9	47.3	48.3
Primary Balance (% of GDP)	0.3	-0.8	-1.5	-2.4	-2.4	-2.3

Sources: World Bank, Macroeconomics and Fiscal Management Global Practice, and Poverty and Equity Global Practice.
Notes: e = estimate; f = forecast.

TIMOR-LESTE



	2016
Population, million	1.3
GDP, current US$ billion	1.8
GDP per capita, current US$	1,458
International poverty rate ($1.9)[a]	30.3
Basic Needs Poverty Rate[a]	41.8
School enrolment, primary (% gross)[b]	136.8
Life expectancy at birth, years[b]	68.3

Source: WDI, Macro Poverty Outlook, and official data.
Notes: (a) Most recent value (2014), 2011 PPPs. (b) Most recent WDI value (2014).

Summary

The current year has seen both Presidential and Parliamentary elections, with a hiatus in public spending growth over the course of the elections. While there are some signs of growth in the private sector, particularly in the non-tradable and tourism sectors, but it remains to be seen whether this growth can be sustained, and may depend on effectiveness of the incoming government's economic program. Growth for 2017 is forecast to be 2.4 percent, on lower government expenditure with the government in caretaker mode over the election period.

Recent Developments

Gross domestic product is expected to have grown by 5.7 percent in 2016, but slowed significantly in 2017 to date. Government spending was 20 percent higher over 2016 and government consumption is expected to have grown by 7 percent in real terms. Proxies for private consumption were strong in 2016, with car registrations 8 percent higher, international visitor arrivals 6.6 percent up and consumer imports buoyant. Private consumption is projected to have grown by 4.2 percent in 2016. Investment-related imports such as iron, steel and cement imports were 70 percent higher in 2016, and with government investment sharply higher, total investment growth is projected at 50 percent for 2016. The offshore petroleum sector, not part of GDP presented here, continues to decline with production falling by 8 percent in 2016 and 16 percent further in H1 2017 year-on-year.

While most consumption proxies continued to show strength in 2017—international visitors up 40 percent in Q1 2017 year-on-year, car registrations 12 percent higher—government expenditure has weakened which is expected to drag growth down.

The government budget position has moved from a large surplus in 2014 and previous years to a deficit of 14.7 percent in 2015 and 29.8 percent of non-oil GDP in 2016. Petroleum revenues have declined, with total government receipts falling from 190 percent of GDP in 2014 to 80 percent in 2015 and further to 72 percent in 2016. Over the three years, expenditure has remained around 100 percent of GDP. The balance of the Petroleum Fund stood at US$16.5 billion at end 2014, and by end 2015 has declined to US$16.2bn and further to US$15.8 billion by end 2016. Public debt outstanding is relatively low, at 3.9 percent of GDP, or around US$66 million, at end 2016. In 2016, domestic revenues were slightly stronger than the previous year, at 11.9 percent of non-oil GDP, but now look to have subsided again, with first half 2017 domestic revenues 4 percent lower year-on-year. Government expenditure slowed to date in 2017 and is 12 percent lower in the first half year-on-year. Overall the first-half 2017 government accounts were in surplus of around 36 percent of GDP, although this is likely to deteriorate as expenditure nearly always accelerates rapidly in the second half of the year.

Coffee exports continued to recover in 2016, with export volumes reaching 29,000 tonnes, 20 percent higher than in 2015. Petroleum tax receipts and investment returns have continued to more than offset a large deficit in goods and services trade to produce current account surpluses, although falling petroleum earnings means the surplus is declining, from US$ 1.1. billion in 2015 to a projected US$300 million in 2016.

Annual average CPI continues to be subdued with deflation of 1.3 percent in 2016, but positive inflation of 1.0 in 2017 to July. Recent inflation trends have been largely driven by prices in the tradable sector. While Timor-Leste's REER remains heightened, it depreciated just over 2 percent in 2016 and a further 2 percent in the first half of 2017. Credit to the private sector has been stagnant for the last two years, contracting by 1.8 percent in 2016, with a slight recovery of 2.8 percent Q-on-Q in the first quarter of 2017, with an absence of basic domestic financial frameworks constraining domestic credit growth.

Poverty in Timor-Leste has declined since 2007. The latest survey estimates that the basic needs poverty rate declined from about 50 percent in 2007 to nearly 42 percent in 2014. Measured using the international poverty line (US$1.9/day in 2011 PPP), poverty declined even more rapidly, from 46.8 percent in 2007 to 30.3 percent in 2014. These reductions in monetary poverty have been accompanied by other improvements in living standards, including increased electricity access, dwelling quality and asset ownership.

Outlook

Growth for 2017 is forecast to be 2.4 percent, on lower government expenditure with the government in caretaker mode over the election period. Based on first-half execution levels, it is unlikely that spending will reach the same level as 2016. Growth is then forecast to pick up, to 4.2 percent in 2018 and 5.0 percent in 2019, although there is significant uncertainty around this forecast, which will be affected by the program of the incoming government.

The outlook for private investment in the coming years looks to be gradually strengthening and there are a small number of sizeable private investment projects underway. Construction commenced in mid-2017 on a new container port, with an initial private investment of US$150m and government contribution of US$129m. Hilton recently announced a partnership with a local company to develop a new 150 room hotel in Dili, with construction already underway. Business and adventure tourism is anticipated to be a source of increased demand in the coming years and also in 2017 Citilink launched a new, price-competitive daily flight service via Bali to Jakarta.

The current account is not forecast to fall into deficit over the forecast period while there continues to be both significant overseas earnings from the Petroleum Fund and further petroleum receipts for the next three years.

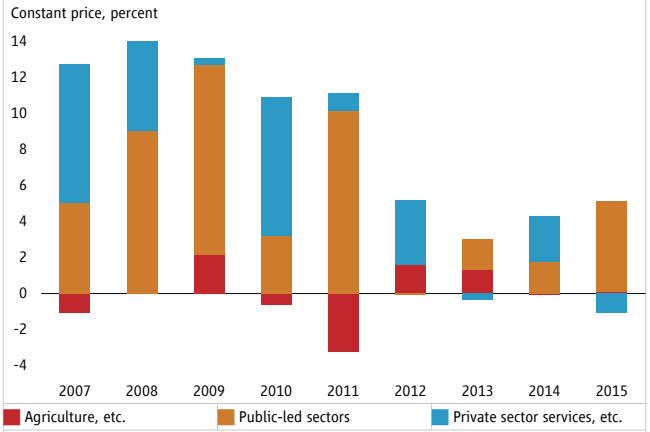
Risks and Challenges

The petroleum fields that have fueled government spending to date are fast-depleting, and the uncertain prospect of new revenues will only offer, at best, temporary respite from the difficult tasks of diversifying the economy and improving public services that are needed in order to bring down the alarmingly high levels of poverty. While some of the conditions for private sector led-growth seem to be improving, the private sector remains very small and to build on the modest gains in private sector development made so far, the government could take a leading role in addressing binding constraints in the public sphere. Major weaknesses exist in the legislative frameworks and institutional capacity in areas of economic property and commercial justice—such as contract enforcement, secure land leasing, national payments systems, and bankruptcy legislation. At the same time, the public

sector lacks the basis for domestic revenue mobilization in a post-oil environment, and would need to develop new frameworks, such as the planned value-added tax, in the near-term. It is unlikely that domestic taxation, levied at a level competitive with ASEAN peers and in an efficient manner, would be a significant deterrent to new business development when coupled with a commitment to improving the institutional and operating environment for business.

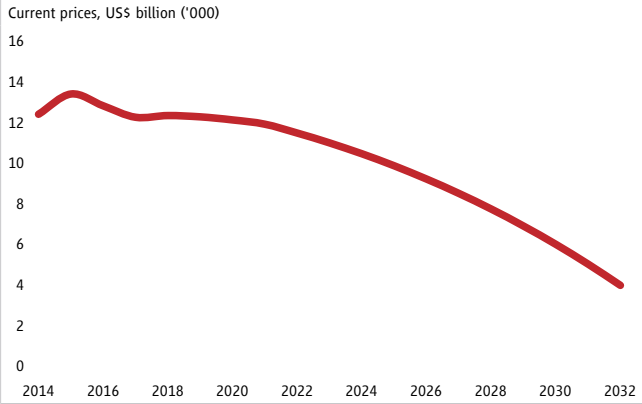
While over 2007 to 2014 there has been noticeable reduction in poverty, consumption inequality has remained largely unchanged within the same period, as presented by the Gini index of 0.28 in 2007 and 0.29 in 2014. This signifies the need for continued efforts in poverty and inequality reduction to continue apace efforts to strengthen overall economic growth.

Figure 1. Contributions to real GDP growth



Sources: Government of Timor-Leste and World Bank staff estimates.

Figure 2. Petroleum Fund wealth per capita

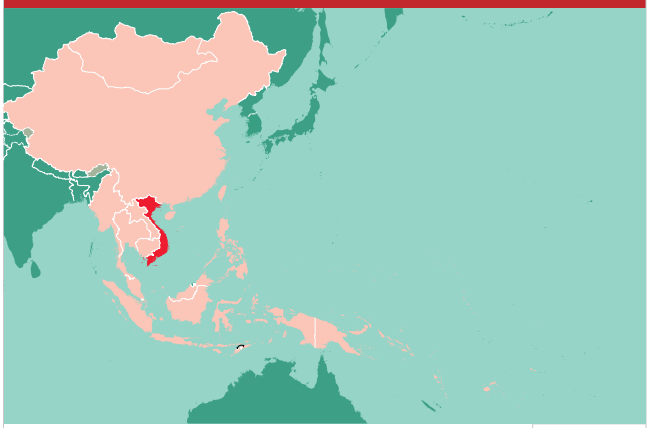


Sources: Government of Timor-Leste and World Bank staff estimates.

TIMOR-LESTE Selected Indicators	*2014*	*2015*	*2016e*	*2017f*	*2018f*	*2019f*
Real GDP growth, at constant market prices	4.2	4.0	5.7	2.4	4.2	5.0
Private Consumption	5.6	1.6	4.2	2.9	5.1	4.3
Government Consumption	12.3	3.7	7.4	-5.6	-0.1	2.9
Gross Fixed Capital Investment	6.1	-4.1	39.2	-38.6	34.4	8.8
Exports, Goods and Services	-20.1	-5.3	16.3	16.0	15.4	20.0
Imports, Goods and Services	11.5	-4.8	25.0	-29.2	18.8	5.9
Real GDP growth, at constant factor prices	4.4	6.0	5.3	2.2	4.2	5.0
Agriculture	-0.5	0.3	0.0	0.5	0.6	0.8
Industry	-9.9	24.4	14.8	-6.6	4.5	3.0
Services	10.3	3.1	4.0	5.6	5.0	6.6
Inflation (Consumer Price Index)	0.7	0.6	-1.3	0.8	1.5	2.5
Current Account Balance (% of GDP)	137.7	67.7	12.8	44.5	35.6	21.4
Fiscal Balance (% of GDP)	78.1	-14.7	-29.9	-12.1	-20.7	-23.3
Debt (% of GDP)	2.0	4.6	5.7	7.5	9.6	12.8
Primary Balance (% of GDP)	78.1	-14.7	-29.9	-12.1	-20.7	-23.3

Sources: World Bank, Macroeconomics and Fiscal Management Global Practice, and Poverty Global Practice.
Notes: e = estimate, f = forecast.

VIETNAM



	2016
Population, million	92.7
GDP, current US$ billion	203.8
GDP per capita, current US$	2,199
International poverty rate ($1.9)[a]	2.8
Lower middle-income poverty rate ($3.2)[a]	11.6
Upper middle-income poverty rate ($5.5)[a]	36.3
Gini coefficient[a]	34.8
School enrollment, primary (% gross)[b]	109.4
Life expectancy at birth, years[b]	75.6

Source: WDI, Macro Poverty Outlook, and official data.
Notes: (a) Most recent value (2014), 2011 PPPs. (b) Most recent WDI value (2014).

Summary

Growth is projected to remain resilient at 6.3 percent this year driven by export-oriented manufacturing and robust domestic demand. Broad macroeconomic stability is being maintained, but delays in fiscal consolidation and elevated credit growth may exacerbate risks to long-term stability. Acceleration of structural reforms would help raise potential growth. Externally, strong trade linkages expose Vietnam to a potential weakening of external demand in case the ongoing global recovery loses momentum.

Recent Developments

Despite some moderation in economic activity, especially during the first quarter of 2017, Vietnam's economy continues to show fundamental strength. Real GDP expanded by 5.7 percent (y/y) during the first half 2017 (about the same pace the first half of 2016). Mining output contracted by 8.2 percent y/y), largely reflecting increasingly constrained marginal production capacity of Vietnam's aging oil fields. This was offset by strong momentum of Vietnam's fundamental growth drivers—domestic demand and export-oriented manufacturing. The service sector accelerated to 6.9 percent, driven by buoyant retail trade growth, which benefited from sustained strength of domestic consumption. Industrial production outside of the mining sector also remains robust with manufacturing output accelerating to 10.5 percent in the first of half of 2017, driven in large part by the export oriented FDI sector. Growth has also gradually recovered to 2.7 percent in agriculture from last year's drought, though the recovery is still fragile.

Labor market conditions consequently improved, with more than 270,000 wage jobs created in the first quarter of 2017. Most of these were created in the FDI sector, particularly in rural based manufacturing firms. Real wages increased by 4.5 percent in that quarter and by more than 20 percent y/y -a pattern seen across sectors and especially benefited rural low skilled workers. Poverty is expected to have significantly reduced, especially in rural areas.

Monetary policy continues to balance growth and stability objectives. Inflationary pressures remain moderate. Headline inflation softened in the first months of 2017 and underlying core inflation remains well below 2 percent. Reflecting decreasing food prices and still low energy prices, the year-on-year CPI increase moderated to 2.5 percent in July, down significantly from 5.2 percent in January 2017. Amid moderate inflation, the State Bank of Vietnam (SBV) cut its key policy rates by 0.25 percentage points in July to boost economic activity to help achieve the official GDP growth target of 6.7 percent. Meanwhile, credit continues to expand rapidly, at about 20 percent year-on-year during the first six months of the year—a pace more than double nominal GDP growth. While supporting investment growth, the credit intensity of growth is rising, and

sustained acceleration of credit may raise concerns over asset quality, particularly given the unsolved balance sheet risks related to past bad debts.

After a large surplus in 2016, Vietnam's external current account balance started to decline in early 2017. Robust growth in exports, tourism receipts, and private remittances led to a current account surplus of about 4 percent of GDP in 2016, marking the sixth consecutive year of a widening current account surplus. The financial account also continued to see large net inflows of foreign direct investment (about 6 percent of GDP) and long-term loans, allowing the SBV to gradually rebuild foreign reserves. The current account surplus started to decline in the first half of 2017 as import growth recovered strongly to 23.6 percent (from -0.6 percent during the same period last year). Bolstered by the strong external position, the nominal exchange rate has been relatively stable.

Fiscal consolidation is underway. The fiscal deficit (including off-budget items) is estimated to have widened to about 6.5 percent of GDP in 2016 from 6.2 percent in 2015. As a result, Vietnam's total outstanding public debt (government, government-guaranteed, and local government) was estimated at about 63 percent of GDP at the end of 2016, inching quickly toward the legally mandated ceiling of 65 percent of GDP.

Fiscal outturns in the first half of 2017 suggest stronger revenue performance (mostly of non-tax revenue) and greater spending discipline, which helped contain the budget deficit and rising public debt. But the adjustment has so far largely resorted to ad-hoc, one-off measures. For a high-quality fiscal consolidation to be sustained over the medium term, further structural measures are needed to boost revenue potential and spending efficiency while protecting growth-enhancing investments in infrastructure and human capital.

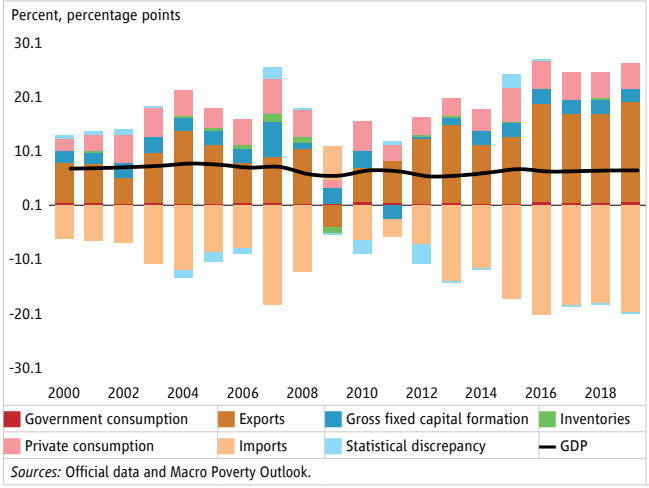
Outlook

Vietnam's medium-term outlook remains positive. Real GDP growth is projected to accelerate slightly to 6.3 percent in 2017, underpinned by buoyant domestic demand, rebounding agricultural production, and strong export-oriented manufacturing, aided by a recovery in external demand, which will be only partially offset by declining oil production. Inflationary pressures will remain moderate, reflecting stable core inflation and tapering of administrative price hikes. The current account is expected to remain in surplus, albeit at a lower level as stronger import growth resumes. Over the medium term, growth is projected to stabilize at around 6.4 percent in 2018–19, accompanied by broad macroeconomic stability. Barring extreme weather related shocks, poverty is expected to fall further.

Risks and Challenges

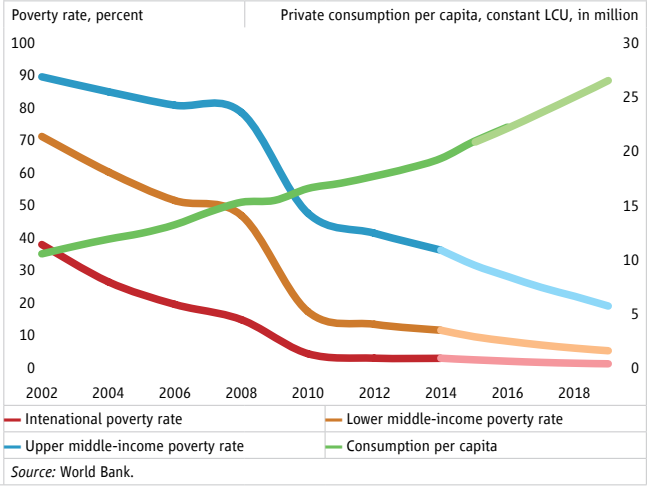
Domestic and external risks call for continued macroeconomic prudence. In view of resilient growth momentum, solidifying macroeconomic stability and rebuilding policy buffers should remain the foremost priority. Lowering the fiscal deficit will help to contain rising risks to fiscal sustainability and provide fiscal space to accommodate potential future shocks. Containing risks from rapid credit growth requires continued improvements in supervision and prudential regulation. The longer-term challenge for the Vietnam is to sustain rapid growth and poverty reduction. Considerable gains are possible from structural reforms that alleviate constraints on productivity growth, including through SOE reforms, further improvements in the business environment and more efficient factor markets for land and capital. The gender wage gap remains a concern, particularly in the urban FDI sector where the average wage for males rose even as that for females marginally declined unlike in rural areas where the increase was proportionate.

Figure 1. Real GDP growth and contribution to Real GDP growth



Sources: Official data and Macro Poverty Outlook.

Figure 2. Actual and projected poverty rates and private consumption per capita (constant LCU)



Source: World Bank.

VIETNAM Selected Indicators	*2014*	*2015*	*2016e*	*2017f*	*2018f*	*2019f*
Real GDP growth, at constant market prices	6.0	6.7	6.2	6.3	6.4	6.4
Private Consumption	6.1	9.3	7.4	7.5	7.2	7.0
Government Consumption	7.0	7.0	8.8	4.9	6.7	8.5
Gross Fixed Capital Investment	9.3	9.4	9.3	9.0	8.8	8.4
Exports, Goods and Services	11.6	12.6	17.9	14.6	13.6	13.5
Imports, Goods and Services	12.8	18.1	19.2	15.3	14.0	13.8
Real GDP growth, at constant factor prices	5.7	6.8	6.1	6.4	6.5	6.5
Agriculture	3.4	2.4	1.4	1.9	2.0	2.0
Industry	6.4	9.6	7.6	7.6	8.2	8.3
Services	6.2	6.3	6.9	7.0	6.6	6.5
Inflation (Consumer Price Index)	4.1	0.9	2.7	4.0	4.5	4.5
Current Account Balance (% of GDP)	5.0	0.1	4.0	2.5	1.8	1.5
Fiscal Balance (% of GDP)	-6.3	-6.2	-6.5	-5.7	-5.5	-5.4
Debt (% of GDP)	55.1	58.4	62.6	63.3	63.9	64.6
Primary Balance (% of GDP)	-4.6	-4.2	-4.4	-3.6	-3.5	-3.2
International poverty rate ($1.9 in 2011 PPP)[a,b]	2.8	2.2	1.8	1.4	1.1	0.9
Lower middle-income poverty rate ($3.2 in 2011 PPP)[a,b]	11.6	9.5	8.1	6.9	5.9	5.1
Upper middle-income poverty rate ($5.5 in 2011 PPP)[a,b]	36.3	31.7	28.1	24.7	22.0	19.0

Sources: World Bank, Macroeconomics and Fiscal Management Global Practice, and Poverty Global Practice.
Notes: f = forecast. (a) Calculations based on EAPPOV harmonization, using 2014-VHLSS. Actual data: 2014. Nowcast: 2015 - 2016. Forecast are from 2017 to 2019. (b) Projection using neutral distribution (2014) with pass-through = 0.87 based on private consumption per capita in constant LCU.

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