WORLD BANK **EAST ASIA AND PACIFIC ECONOMIC UPDATE** OCTOBER 2014

Enhancing Competitiveness in an Uncertain World

WORLD BANK GROUP

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LIST OF ABBREVIATIONS

ASEAN	Association of Southeast Asian Nations
BPNG	Bank of Papua New Guinea
CBSI	Central Bank of Solomon Islands
CPI	Consumer Price Index
DBM	Development Bank of Mongolia
EEZ	Exclusive Economic Zone
EGRA	Early Grade Reading Assessments
ESI	Estimated Sustainable Income
FDI	foreign direct investment
forex	foreign exchange
GDP	gross domestic product
GNI	gross national income
GST	goods and services tax
GVCs	global value chains
H1	first half
H2	second half
ICT	information and communications technology
IMF	International Monetary Fund
km^2	square kilometers
LICs	low-income countries
LMICs	lower-middle-income countries
LNG	liquefied natural gas
MFIs	microfinance institutions
MICs	middle-income countries
NPLs	nonperforming loans
OECD	Organisation for Economic Co-operation and Development
PFM	public financial management
PICs	Pacific Island Countries
PISA	Program for International Student Assessment
PNG-LNG	Papua New Guinea Liquefied Natural Gas Project
PPI	Producer Price Index
PPP	purchasing power parity
ppt	percentage points
PSL	Pledged Supplementary Lending
Q1	first quarter
Q2	second quarter
Q3	third quarter
Q4	fourth quarter
qoq	quarter-on-quarter
SAAR	seasonally adjusted annualized rate
SAR	special administrative region
SOEs	state-owned enterprises
StEP	Skills Toward Employment and Productivity
SWF	Sovereign Wealth Fund
UNESCO	United Nations Educational, Scientific and Cultural Organization
WDI	*World Development Indicators*

Regions, World Bank Classification and Country Groups

ASEAN-4	Indonesia, Malaysia, Philippines, and Thailand
ASEAN-5	Indonesia, Malaysia, the Philippines, Thailand, and Vietnam
EAP	East Asia and Pacific
ECA	Europe and Central Asia
LAC	Latin America and the Caribbean
MENA	Middle East and North Africa
PICs	Pacific Island Countries
SAS	South Asia
SSA	Sub-Saharan Africa

Countries

East Asia and Pacific countries

CHN	China
FJI	Fiji
IDN	Indonesia
KHM	Cambodia
LAO	Lao People's Democratic Republic
MMR	Myanmar
MNG	Mongolia
MYS	Malaysia
PHL	Philippines
PNG	Papua New Guinea
SLB	Solomon Islands
THA	Thailand
TMP	Timor-Leste
VNM	Vietnam

LIST OF ABBREVIATIONS (continued)

Countries (continued)

Northern Pacific Island countries

FSM	Micronesia, Federated States
MHL	Marshall Islands
PLW	Palau

Small Pacific Island countries

KIR	Kiribati
TON	Tonga
TUV	Tuvalu
VUT	Vanuatu
WSM	Samoa

All other countries

ATG	Antigua and Barbuda
AUS	Australia
BHS	Bahamas
BRB	Barbados
CAN	Canada
COM	Comoros
DEU	Germany
DMA	Dominica
GRD	Grenada
HKG	Hong Kong SAR, China
JPN	Japan
KNA	Saint Kitts and Nevis
KOR	Republic of Korea
LCA	Saint Lucia
MAC	Macao SAR, China
MDV	Maldives
MLT	Malta
NZL	New Zealand
SAU	Saudi Arabia
SGP	Singapore
STP	São Tomé and Principe
SYC	Seychelles
USA	United States
VCT	Saint Vincent and the Grenadines

Currency Units

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

PREFACE AND ACKNOWLEDGMENTS

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

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Throughout the report, geographic groupings are defined as follows.

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

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

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

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

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

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

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

This report is based on data available through September 29, inclusive.

EXECUTIVE SUMMARY

The global economy is showing signs of recovery, but at an uneven pace; global growth is expected to rise modestly to 2.6 percent in 2014, and an average 3.3 percent in 2015–17. Activity in high-income economies as a group expanded in the second quarter, but performance varied sharply across countries. In the United States, output rebounded strongly, supported by still accommodative monetary policy, easing fiscal consolidation, and rising employment, investment growth, and confidence. Growth is projected at about 2 percent in 2014, rising to 3 percent in 2015. In the Euro Area, the recovery continues to be impaired by weak domestic demand and credit growth, and subdued investment prospects. In Japan, monetary policy accommodation and reform commitments are providing ongoing support, but fiscal consolidation is expected to keep domestic demand subdued throughout 2015, with exports recovering only slowly. In both the Euro Area and Japan, growth is projected at about 1 percent in 2014, rising slowly thereafter.

The gradual strengthening of activity in high-income economies will boost demand for exports from developing East Asia and Pacific (EAP), helping the region sustain its growth performance. Growth in developing EAP will moderate gradually from 7.2 percent in 2013 to 6.9 percent in 2014–15. In the region excluding China, growth will bottom out at 4.8 percent in 2014, reflecting the slowdown in Indonesia and Thailand, before recovering to 5.3 percent in 2015–16. Developing EAP will remain the fastest-growing developing region.

In China, growth will gradually moderate to 7.4 percent in 2014 and 7.1 percent in 2016, reflecting intensified policy efforts to address financial vulnerabilities and structural constraints, and place the economy on a more sustainable growth path. Measures to contain local government debt; curb shadow banking; and tackle excess capacity, high energy demand, and high pollution will reduce investment and manufacturing output.

In the rest of the region, growth will gradually pick up, as exports firm and the impact of domestic adjustment in the large ASEAN countries eases. However, the capacity to benefit from the global recovery will vary significantly across countries, reflecting structural constraints to investment and export competitiveness, and weak export prices for commodity producers. Cambodia, Malaysia, Vietnam are well positioned to increase their exports, reflecting their deepening integration into global and regional value chains. But in Indonesia, export performance will remain fragile, as its commodity export prices continue stagnating and infrastructural bottlenecks hamper efforts at diversification.

Investment in the large ASEAN economies weakened, while private consumption remained resilient. In Indonesia, the investment slowdown reflects a poor investment climate, compounded by falling commodity export prices, increases in the cost of capital, and corrections in the real estate sector. In the Philippines and Vietnam, weak investment reflects structural factors, again reinforced by a weak real estate market. And in Thailand investment continues to suffer from political unrest and uncertainty. Conversely, private consumption remains generally robust, although underlying factors differ across countries. In Indonesia, consumption was supported by election-related spending; in Malaysia, by robust labor markets; in the Philippines, by buoyant remittances; and in Thailand, by the respite from political turmoil.

Fiscal policy in many countries has aimed at rebuilding fiscal space but these efforts need to be sustained. Revenue growth is particularly weak in Indonesia, largely reflecting stagnant commodity prices. Elevated subsidy costs, particularly for energy, constrain spending on priority areas in Indonesia, Malaysia and Thailand. Overall, fiscal deficits have generally narrowed over time. However, Mongolia and to a lesser extent

Indonesia constitute important exceptions, reflecting a broader lack of macroeconomic adjustment to declining commodity export prices.

Credit growth has slowed reflecting tighter policies and inflation generally remains low. Inflation remains generally subdued in the region. Credit growth has been dampened by monetary tightening last year in Indonesia, and this year in Malaysia and the Philippines. Macro-prudential measures directed at the housing market are helping reduce credit growth throughout the ASEAN-4 (Indonesia, Malaysia, the Philippines, and Thailand). In addition, in Thailand and Vietnam, political and structural problems constrain credit growth. Again, Mongolia represents an exception to the broad trend, as a highly expansionary monetary policy continues to fuel rapid credit growth.

Significant uncertainties remain about the strength and sustainability of the recovery in high-income economies, as well as about the timing of policy actions by central banks in these countries. A key risk to the regional outlook is that the global recovery, and the associated pickup in demand for regional exports, may be slower than anticipated. In addition, global financial conditions are likely to tighten, and financial volatility may also rise, especially if geopolitical tensions escalate; this may create debt-service challenges for some economies. Relatedly, real estate prices in some countries are likely to come under pressure.

In this uncertain global environment, there is still a window of opportunity to enact critical—and in some cases overdue—reforms; the short-term priority in several countries is to address the vulnerabilities and inefficiencies that have been created by an extended period of loose financial conditions and fiscal stimulus. In Indonesia, Malaysia, the Philippines, and Thailand, measures to bolster revenues and reduce wasteful and poorly targeted subsidies will create space for productivity-enhancing investments and poverty-reducing programs. They will also assist in gradually reestablishing fiscal buffers. Among smaller economies, Lao PDR, and above all Mongolia, need to reduce the fiscal deficit and tighten monetary policy, in order to safeguard debt sustainability and macroeconomic stability. Vietnam needs to broaden its revenue base, target social spending, and strengthen its banking system.

In China, the authorities need to strike a balance between containing the growing risks from rising leverage and meeting the indicative growth targets. A focus on structural reforms that can accelerate growth in sectors previously reserved for state enterprises and in services could offset growth-slowing measures needed to maintain stability in local government finances and the financial sector.

Over the longer term, the focus in most countries must be on implementing the structural reforms needed to enhance their export competitiveness. Such reforms will position them to benefit from the global recovery, as well as from China's continued move up the value chain to less labor-intensive exports. Key reform areas include infrastructure investment, logistics, and the liberalization of services and FDI, including in the context of regional integration.

More broadly, this report also includes a special section, focusing on two crucial medium-term issues facing developing East Asia and Pacific: education and skills development, and international migration; and an overview of the economic prospects and policy priorities for the Pacific Island Countries.

Moving from Education to Skills in East Asia and Pacific. Much of developing East Asia and Pacific has made significant progress in expanding access to education, although there are still some lagging countries. All countries now need to focus on developing labor-market skills, including cognitive and non-cognitive skills (behavioral skills, personality traits, and technical skills). A comprehensive skills development strategy ranges from early childhood development to higher education and lifelong learning, and must target particularly the most disadvantaged. Primary and secondary education systems need to focus on quality and on learning outcomes, including by strengthening autonomy and accountability. And the relevance of higher education, vocational education, and training needs to be improved by giving institutions the capacity, incentives and information to meet labor market needs, while improving their quality.

International Migration and Development in East Asia and Pacific. All labor-sending countries in the region—small and large—depend significantly on remittances to boost household incomes, finance trade deficits, and maintain macroeconomic stability. Labor-receiving countries, such as Malaysia and Singapore, depend on migrant workers to meet labor shortages and maintain competitiveness. Policy measures in sending and receiving countries could significantly increase the long-term benefits of migration. Labor-sending countries need to provide migrants with better information; regulate recruiting agencies to avoid abuse; and improve financial services to enable migrant families to use remittances more productively. Labor-receiving countries need to focus on addressing market failures that prevent their own workers from upgrading skills and engaging in more productive jobs. Such measures will ensure that their workers complement rather than compete with migrants, mitigating adverse distributional implications of migration and reducing social frictions.

Pacific Island Countries: Economic Prospects and Policy Priorities. The Pacific Island Countries (PICs) face unique challenges: their small size, remoteness from major markets, and internal dispersion combine to push up the costs of production and public administration. This narrows the feasible set of economic opportunities, and implies three priorities. First, limited public resources should be focused on activities, such as minerals, fisheries and tourism, where they can realistically be competitive in global markets. And the support should be focused on addressing market and coordination failures, including on infrastructure provision and trade facilitation. Second, public sector reforms should focus on finding innovative ways to deliver services, for instance, through regional approaches to public regulation or service provision. Public financial management reforms, in particular, are a priority given the paucity of resources. Finally, PICs and their development partners should work to increase migration options for Pacific Islanders, including through access to industries that require greater skills.

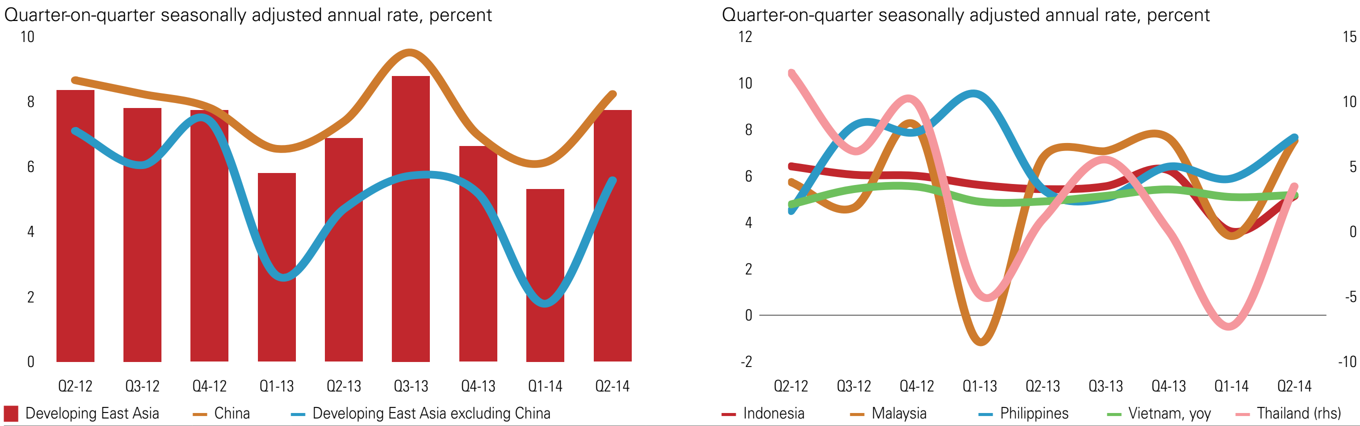
Part I. Recent Developments and Outlook

I.A. Recent Developments

Economic Growth Accelerated Sharply in the Second Quarter

Growth in developing East Asia and Pacific (EAP) rose from 5.3 percent in the first quarter of 2014 to 7.7 percent in the second quarter (Figure 1). Growth picked up in China, although preliminary indicators suggest a moderation in July and August. Growth also increased sharply in each of the ASEAN-5 countries,[1] including Thailand, which is starting to recover from a period of political turmoil. In Indonesia, however, growth remains below the post–2009 average.

Figure 1. GDP growth



Source: Staff estimates.
Note: For Vietnam, data refer to year-on-year growth rates. *rhs*=right hand scale.

The region benefited from a favorable external environment, as global demand showed signs of recovery, and financing conditions remained advantageous. Output growth and import demand in the high-income economies, and the United States in particular, firmed in the second quarter (Box 1). Accommodative monetary policy in the United States supported a continued flow of capital to developing countries.

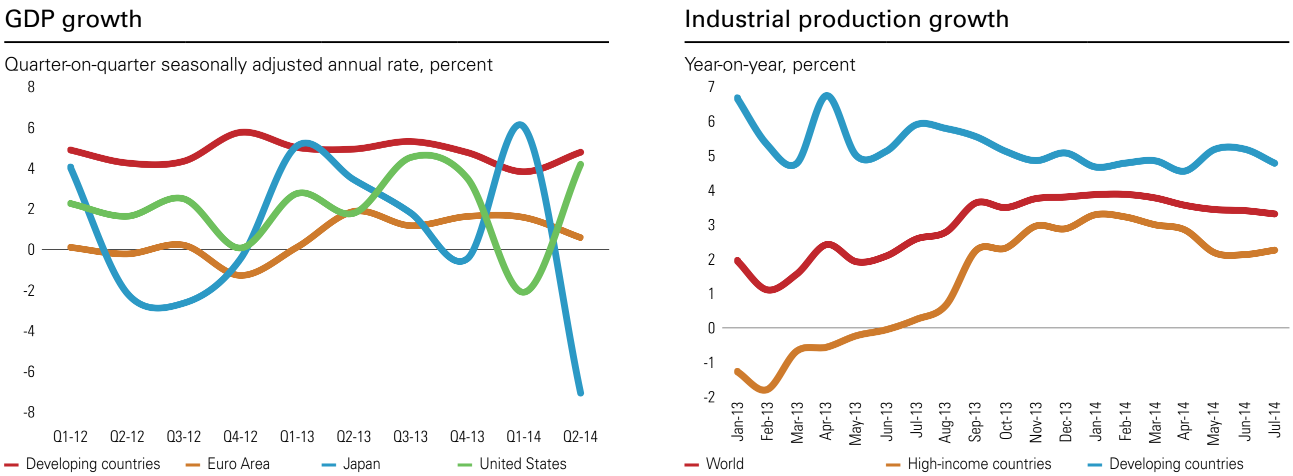
In China, growth rose from 6.1 percent in the first quarter to 8.2 percent in the second, supported by both investment stimulus measures and the global recovery; more recent weakness reflects renewed efforts to rebalance the economy. In the second quarter, increased spending on railways and other infrastructure offset weakening investment in manufacturing facilities and a downturn in residential real estate. Exports rose in line with external demand, but private consumption growth weakened across a broad range of consumer goods, including durables. In July and August, industrial activity slowed, particularly in heavy industry, mining, and power generation, reflecting both measures to reduce overinvestment, and the impact of the real estate slowdown on construction.

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

Box 1. The Global Economy Is Showing Signs of Recovery, but at an Uneven Pace

High-income economies as a group displayed early signs of a recovery, expanding by 1.7 percent in the second quarter, but growth performance varied sharply across countries. In the United States, output rebounded strongly after the weather-related decrease in the first quarter (Figure B1.1, left panel). The recovery is being supported by still accommodative monetary policy, easing fiscal consolidation, and rising employment, investment growth, and confidence. In the **Euro Area**, output was flat in the second quarter, following a small uptick in the first quarter. The recovery continues to be impaired by weak domestic demand and credit growth. In **Japan**, growth was robust in the first quarter, supported by fiscal and monetary stimulus. However, a sales tax increase in April caused a sharper second-quarter contraction than initially anticipated. Exports are still not responding to the ongoing depreciation.[2] In **Australia**, output expanded by about 3 percent during the first half of the year, although the pace of growth slowed in the second quarter. In **developing countries** as a group, growth recovered from a weak start to the year, with industrial production in July about 5 percent higher than a year before (Figure B1.1, right panel). However, activity continues to disappoint in Latin America and the Caribbean, and in Europe and Central Asia.

Figure B1.1. Growth in global GDP and industrial production



Source: Staff estimates.

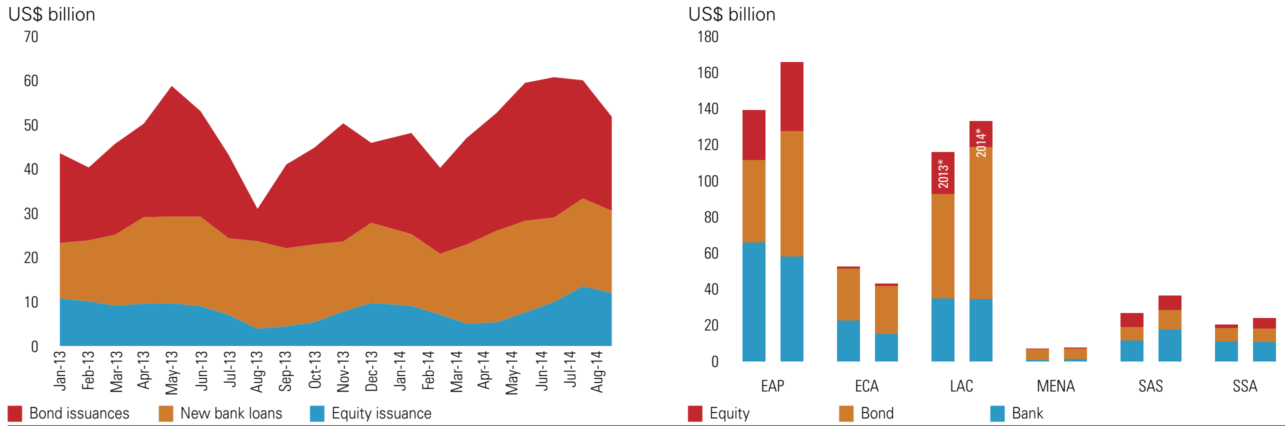
Demand for imports in high-income economies firmed in the second quarter, after a subdued start to the year. In June, import volumes in the United States were 3.7 percent higher than a year before; in the Euro Area, they were 2.8 percent higher, despite the setbacks to output. In Japan, import demand eased significantly in the second quarter, again reflecting the sales tax increase, after a sharp expansion in the first quarter.

Capital flows to developing countries have been on an upward trend since March, supported by accommodative U.S. and Euro Area monetary policy (Figure B1.2, left panel). China has accounted for an unprecedented quarter of all developing-country bond issues. More generally, capital flows have increased to all developing regions, except Europe and Central Asia, where bank flows dropped sharply as a result of the conflict in Ukraine and sanctions on Russia (Figure B1.2, right panel). Spreads on emerging market bonds declined in the second and third quarters, despite global political instability and Argentina's default. (continued)

2 The trade-weighted nominal exchange rate has depreciated by 30 percent from its peak in the fourth quarter of 2011. However, the volume of goods exports has decreased by 0.6 percent over the same period.

Figure B1.2. Gross capital flows to developing countries, and emerging market bond spreads

Aggregate flows | Flows by region



Source: Staff estimates. * for the first eight months of the year.

Commodity prices have been broadly stable during 2014. Geopolitical concerns in Ukraine and Iraq triggered only modest and temporary increases in oil prices during the second quarter. Prices eased subsequently on favorable news about oil production in Iraq, Libya, and the United States, along with weak demand data for China and Europe. Metal prices fell during the second quarter, reflecting the impact of earlier investments on supply, as well as weakening demand, especially in China; they have since recovered 5 percent. Signs of a mostly solid crop season kept agricultural prices broadly stable. Rice was a major exception, with prices up 12 percent since June, largely owing to lower inventories in India and Thailand.

Growth also accelerated in the second quarter in each of the ASEAN-5, reflecting rising exports across most of the region and diminished unrest in Thailand. In Malaysia, growth rose to 7.5 percent, as a fourth straight quarter of strong exports countered a moderation in domestic demand. Growth in the Philippines recovered to 7.8 percent, after a first-quarter slowdown stemming from an earthquake and a typhoon. Exports continued to grow, and private consumption remained robust, benefiting from continued large remittances. Thailand saw 3.5 percent growth, as domestic demand recovered after a military coup ended protracted political turmoil that had led to a collapse in investment, including foreign investment, and sharp drops in household consumption. In Vietnam, growth picked up to 5.2 percent year-to-date, as exports grew at double-digit rates.

In Indonesia, growth rose to 5.1 percent in the second quarter, but remains well below its post-2009 average, reflecting a poor investment climate and weak commodity export prices. Investment slowed, constrained by a poor business environment, protectionist policies, tighter domestic financing conditions, and corrections in the real estate sector. In stark contrast with the rest of the ASEAN-5, exports contracted, weighed down by an export ban on unprocessed minerals (beginning in January 2014) and by weak prices for key commodities. Government consumption also fell, squeezed by weak revenues.

Among the region's smaller economies, Cambodia and Myanmar are performing well. Growth held up well in Cambodia in the first half of 2014, led by garments exports which, on the back of stronger external demand, expanded 14.1 percent year-on-year by mid-2014. Construction picked up, buoyed by the return of domestic political stability, but tourism weakened, stung by political turmoil in neighboring Thailand and tensions between neighboring Vietnam and China. Growth is also robust in Myanmar, which is starting to reap the benefits of institutional reform and international re-engagement. Construction, manufacturing, and services all performed well. Investment has been rising, led by growing domestic investment and boosted further by large foreign direct investment (FDI) inflows.

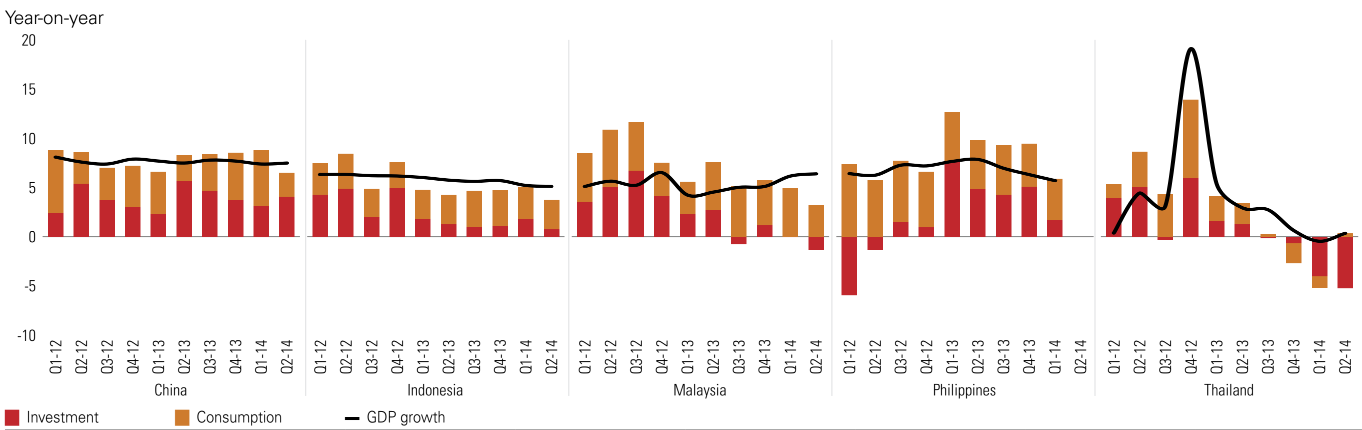
Conversely, growth is weakening in Mongolia and the Lao People's Democratic Republic. In Mongolia, growth fell sharply to 5.3 percent year-on-year in the first half of 2014, from 14 percent in the second half of 2013, despite expansionary monetary and fiscal policies that have triggered high inflation. The country is still struggling to adjust to the sharp decline in world metal prices and the resulting terms-of-trade deterioration, persistent current account deficit, falling FDI, continued depreciation, and thin international reserves. Growth is also slowing in the Lao PDR, as weak mining output and electricity exports outweigh robust construction linked to FDI in new power projects.

In the larger Pacific Island countries, other than the flood-stricken Solomon Islands, economic activity remains robust. In Fiji, rising investment and increased public expenditure have boosted economic activity ahead of the September 2014 elections. Tourist arrivals rose 3.6 percent year-on-year through May 2014, after negligible growth in 2013. In Papua New Guinea, the ramp-up in exports from the country's huge liquefied natural gas (LNG) project (an investment of 120 percent of GDP) is offsetting the tapering of LNG-related construction.[3] In Timor-Leste, buoyant public recurrent and capital spending are boosting nonoil GDP growth. In the Solomon Islands, a major flood in April 2014 caused direct losses in economic output estimated at 4.7 percent of GDP,[4] and extensive damage to physical capital, estimated at 4.5 percent of GDP.

Investment Strengthens in China, Supported by Stimulus Measures...

In China, investment recovered in the second quarter, as targeted measures supported infrastructure investment. After a weak start to the year, investment contributed 4.1 percentage points to GDP growth in the second quarter (Figure 2), although its growth slowed again in July and August. Infrastructure investment provided the needed boost, expanding 21.5 percent year-on-year (yoy) (Figure 3).

Figure 2. GDP growth: Contributions of investment and of consumption



Source: Staff estimates.

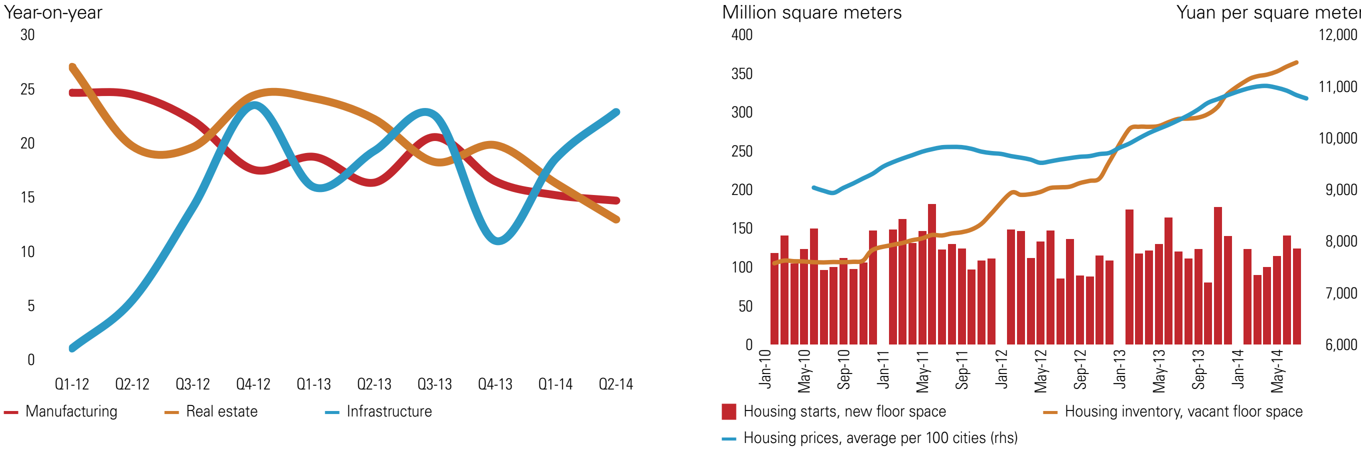
3 The first LNG shipment was delivered in June 2014 to Japan.

4 In particular, gold production though the second quarter was 74 percent lower than a year before, silver production 64 percent lower, and cocoa production 58 percent lower.

Figure 3. Fixed asset and real estate investment in China

Growth in fixed asset investment

Real estate investment: Housing starts have declined with rising inventory



Source: Haver Analytics.

In contrast, manufacturing and real estate investment decreased sharply. Investment in manufacturing facilities, which accounted for one-third of all fixed investment in the last three years, decelerated for the third straight quarter, slowed down by overcapacity in the steel, cement, ferrous metals, and plate glass industries. Real estate investment, which comprised one-quarter of all fixed investment in the previous three years, grew at its slowest pace since 2009, dragged down by housing price declines across a large and increasing swath of cities (Box 2). This is affecting a large number of related sectors, from building materials to appliances.

Box 2. The Real Estate Sector in East Asia and Pacific[5]

Real estate prices have increased rapidly in many EAP countries in recent years. Among developing countries, Malaysia and the Philippines have seen especially pronounced growth (Figure B2.1, left panel). In Malaysia, housing price increases have significantly outpaced income growth, and housing affordability has consequently worsened (Figure B2.1, right panel). Similar patterns have emerged in developed EAP economies such as Hong Kong SAR, China; Taiwan, China; and Singapore (Capital Economics 2014).

More recently, signs of weakness have emerged in the real estate sector, raising concerns about price sustainability. In China, housing starts in July and August were roughly flat compared to the same period last year; housing sales in the first eight months of the year were 11 percent lower year-on-year. Real estate prices have been decreasing since May, across a large and increasing swath of cities (as of end-August, 68 of the 70 cities monitored by the national statistics agency). In Malaysia, real prices fell by 2 percent in the fourth quarter of 2013, and in Thailand, they fell by 0.5 percent in the first quarter of 2014.

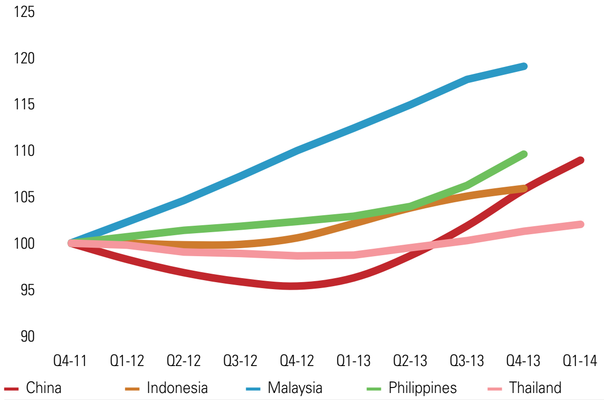
Ultimately, whether the growth in real estate prices is sustainable depends on its underlying determinants. Where price increases are driven by relatively stable fundamental factors, such as income, population, and employment, prices are more likely to prove sustainable. But where housing price growth is mainly driven by rapid credit expansion, for instance linked to loose monetary policy or easily reversed portfolio capital inflows, the economy may be more exposed to the risk of an abrupt downturn. (continued)

5 This box was prepared by Bingjie Hu, with assistance from Yi Jiang.

Figure B2.1. Real estate prices

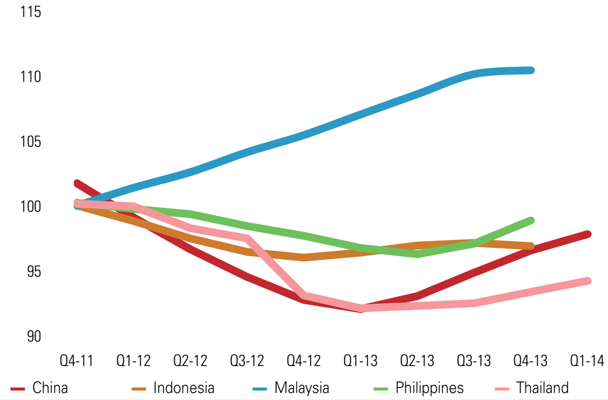
Real estate prices

2011=100, four-quarter moving average



Price to income ratio

2011=100, four-quarter moving average



Source: Bank for International Settlements and Staff estimates.

Notes: The price-to-income ratio is calculated as the ratio between real property prices and real GDP per capita. For China, the data refer to residential property prices in Beijing; for Indonesia, to 14 large cities; for the Philippines, to the Makati metro area; and for Thailand, to Bangkok.

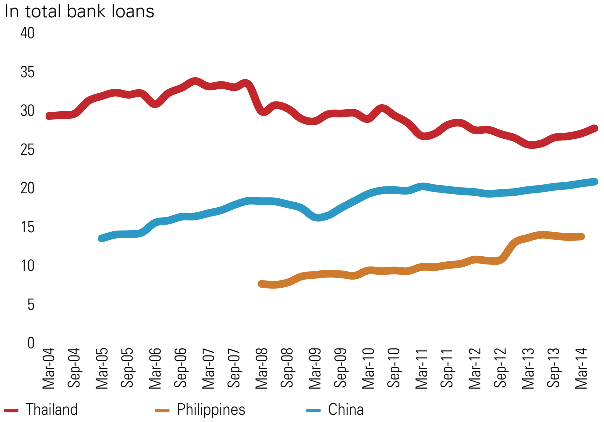
Any downward adjustment in housing prices could cause a slowdown in related industries, such as construction and building materials, with an impact on aggregate economic activity. The real estate sector accounts for a large and growing share of output in East Asia and Pacific. China's value added in the real estate and construction industries increased from 10 percent of GDP in 2000 to 13 percent of GDP in 2013. In the Philippines, the share rose from 15 percent to 18 percent during the same period. In Indonesia, the value added in the construction and building rental industries grew from 8 percent of GDP in 2000 to over 12 percent of GDP in 2013.

In addition, the exposure of banks to real estate has grown rapidly in some countries. As a result, any price decline could have a negative impact on banks' balance sheets and would likely heighten financial risks. In China, for instance, the share of bank loans to real estate developers and of mortgage loans in total loans increased from 14 percent in early 2005 to 21 percent in mid-2014 (Figure B2.2, left panel). In the Philippines, banks' real estate loans grew by an average 22 percent per year during 2009–13, twice as fast as overall loans; bank exposure to the real estate sector reached 9 percent of GDP by end-2013. In Mongolia, the share

Figure B2.2. Housing loans

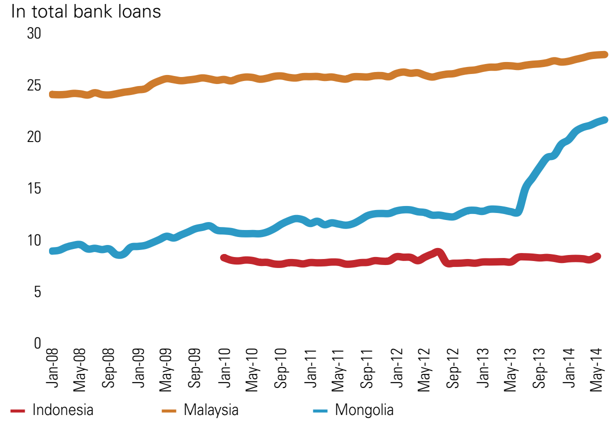
Share of real-estate-related loans

In total bank loans



Share of mortgage loans

In total bank loans



Source: CEIC.

of mortgage loans in total loans rose from 9 percent in early 2005 to 22 percent in 2014 (Figure B2.2, right panel); total mortgage loans grew more than 13 times during the last seven years, with particularly rapid increases over the last year. In Malaysia, the share of housing loans also increased, from 10 percent in 2000 to 28 percent in mid-2014. In Indonesia, the share of construction and real-estate-related loans in total loans is relatively low (12 percent as of May 2014). However, mortgage loans have been growing at a rapid 25 percent year-on-year over the last nine months. An exception to this trend is Thailand, where the share of housing loans has remained stable at about 30 percent over the last 10 years.

Authorities in some countries have responded to such concerns by trying to prevent the emergence of real estate price bubbles through both monetary tightening and macroprudential measures. In Indonesia, lower loan-to-value ratios for second homes, introduced in March 2013, and a slowdown in bank lending to the housing sector, have reduced demand for housing and commercial real estate price growth (World Bank 2014a). In Malaysia, in 2013, loan-to-value ratios were tightened, and a widely used developer incentive scheme for buyers was terminated. Previous measures included a maximum maturity of 35 years on bank loans for residential properties. In the Philippines, stricter capital requirements for real estate lending were announced in July 2014,[6] and stress tests were ordered on bank loans to the real estate sector, with an assumed 25 percent write-off on sectoral exposures (World Bank 2014b). In Thailand, lower loan-to-value ratios were introduced in 2011 and 2012 out of concerns over a possible condominium price bubble, and higher capital-adequacy risk weights were placed on mortgage loans with high loan-to-value ratios. In Hong Kong SAR, China, a series of macroprudential measures, including higher down-payment requirements and taxes to discourage foreign buyers, have led to a slowdown in real estate prices.

Other countries are instead providing policy support to mitigate incipient real estate downturns. In Vietnam, where the real estate market remains in a downturn, the government is considering legislation to allow foreign ownership of some properties. In response to a mismatch between oversupply in higher-end real estate and relatively strong demand for lower-end housing, the government has also implemented a stimulus package targeting low-income households amounting to about 0.8 percent of GDP.

In China, starting in 2010, central and local governments imposed or intensified administrative restrictions on housing purchases to curb speculative demand and prevent price bubbles. Third-home mortgages in cities with excessive housing price gains were suspended in 2010. Down-payment requirements for second homes were raised to 60 percent across the country in 2011, and to 70 percent in Beijing, Shanghai, Shenzhen, and Guangzhou in 2013.

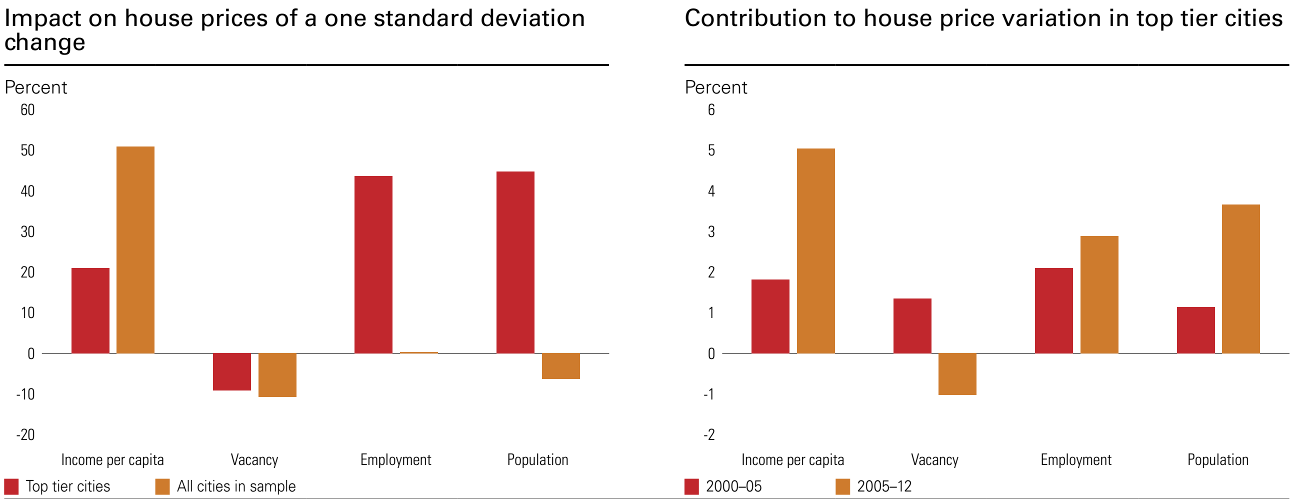
However, in response to this year's real estate slowdown, local governments are now easing restrictions on housing purchases. For instance, Hohhot city in Inner Mongolia province scrapped house purchase restrictions in June 2014, and the cities of Jinan, Hangzhou, and Nanning followed in July. Overall, 37 out of 46 cities that had imposed house purchase restrictions in recent years have since loosened or eliminated them. Other measures include tax subsidies for house buyers[7] and a relaxation of the household registration ("hukou") system to allow buyers who relocate from rural areas or other cities to access local public social services. The Ministry of Housing and Urban-Rural Development is also investigating ways for local governments to buy apartment units at significant discounts and to use them for social housing in shantytown areas. (continued)

6 Banks are required to maintain a minimum 6 percent common equity Tier 1 ratio, and 10 percent total capital ratio, on real estate lending.

7 The contract and/or business taxes related to house purchases have already been reduced or subsidized in the provinces of Hebei, Fujian, and Hunan, and in several cities including Baotou, Tongling, and Wuhu.

In China, the observed growth in property prices has to a significant degree reflected fundamentals. Analysis using a new and highly detailed dataset on residential property prices at the city level from 1995 to 2012 indicates that housing prices are significantly affected by, and their growth has largely reflected the evolution of, disposable income per capita, employment, and population, especially in major cities (Figure B2.3). This is consistent with previous studies also suggesting that income, employment, land rent, and the economic openness of cities (as measured by distance from major ports) are key determinants of housing prices (Wang, Yang, and Liu 2011).

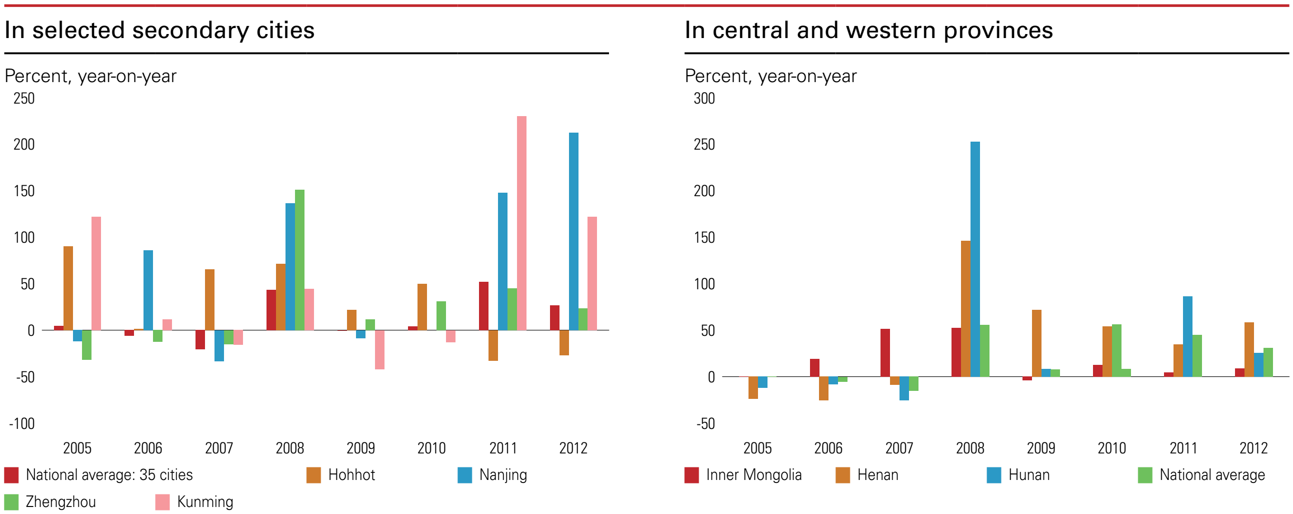
Figure B2.3. Drivers of real estate prices in China



Source: CEIC and Staff estimates.
Note: The "top tier" cities are Beijing, Guangzhou, Shanghai, Shenzhen, and Tianjin.

However, distortions in the land market, and in fiscal and financial systems, have created oversupply and speculative demand in some cities, contributing to the current weakness in the housing market. Real estate is an attractive investment tool, given the near-zero real interest rates in the formal banking sector,

Figure B2.4. Growth in vacant residential floor space in China



Source: CEIC and Staff estimates.
Note: Data for 2013 and 2014 are not available.

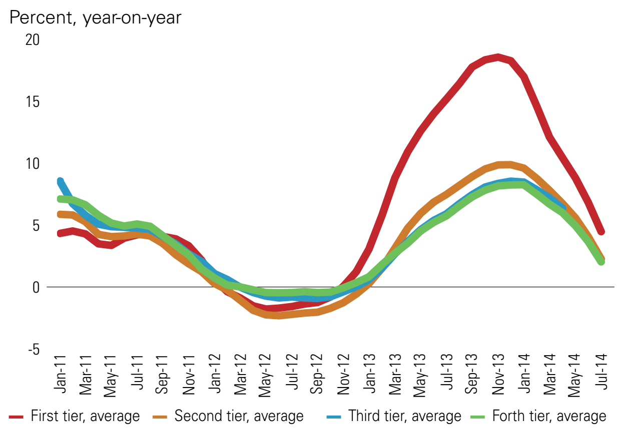
and the lack of other investment instruments for households. This renders the housing sector vulnerable to speculative demand and the potential build-up of bubbles. In addition, there is a bias toward new developments that convert farmland into residential areas, as opposed to the redevelopment of the central areas of large cities, since local governments obtain revenues from land conversion sales. All this has created excess supply in recent years in secondary cities, in suburban areas near large cities, and in the central and western regions (Figure B2.4).

Looking ahead, a major nationwide correction in real estate prices in China remains unlikely, although there may be pressure on prices in several of the less rapidly growing provinces. In top-tier cities, such as Beijing and Shanghai, and especially in their central areas, fundamentals including income, employment, and population growth remain strong. Price declines are therefore likely to be limited. However, cities in the central and western regions, where excess supply is more prevalent, may face greater pressures. Historically, oversupply has had significant effects on house prices (Figure B2.3). In particular, during previous periods of downturn in the industry, house prices declined the most in second-tier cities, where there is the most oversupply (Figure B2.5).

Elsewhere in the region, existing studies suggest that real estate prices are to a significant extent explained by persistent fundamentals. In Malaysia, income, demographics, and consumer sentiment explain much of the observed variation in house prices (Bank Negara 2012; San Ong 2013). Policy measures, including the imposition of lower loan-to-value ratios in 2010 and 2011, and the implementation of real-property-gains tax in 2010,[8] had a dampening effect on housing price growth. In Thailand, 70 percent of all housing demand is for lower-rise housing units, at the low to middle end of the market. Recent assessments indicate that such demand is nonspeculative and the likelihood of a housing price bubble low.[9]

Figure B2.5. Real estate price growth in China, by city tier

In selected secondary cities



Source: CEIC and Staff estimates.
Note: The "first tier" cities are Beijing, Guangzhou, Shanghai, Shenzhen, and Tianjin. The "second tier" includes other major provincial capitals. The "third tier" includes smaller provincial capitals, and strategically important medium-size noncapital cities. The "fourth tier" includes county-level and prefecture-level cities.

However, some countries and some market segments may be at risk of some correction, especially if foreign exchange inflows were to suddenly fall off. In Indonesia, sharp decreases in commodity-related revenues or capital inflows could affect wealth, credit growth, and hence real estate demand. In the Philippines, about 40 percent of new housing units are purchased preconstruction by overseas foreign workers. This source of demand could decrease if a slow global recovery were associated with weak remittance inflows. In addition, in Malaysia, the Philippines, and Thailand, prices in high-end markets (such as the luxury market in Manila) are relatively more likely to deviate from fundamentals, and could therefore see some adjustment even in the absence of major external shocks (Glindro et al. 2011).

8 A real property gains tax was imposed in 2010, and tax rates were increased in 2012, 2013, and 2014. See www.mia.org.my/new/downloads/circularsandresources/budget/2014/C3.pdf for details.

9 Global Property Guide, www.globalpropertyguide.com/Asia/Thailand/Price-History.

As in the last three years, investment has been affected by several policy reversals, as the authorities have attempted to attain their stated growth objectives while containing financial sector vulnerabilities. In the first quarter, the authorities tightened credit conditions for shadow banking and unprofitable projects, slowing investment growth. In contrast, the second quarter saw an infrastructure investment stimulus estimated at 2.5 percent of GDP, much of it directed at railway construction.[10] This was supplemented by monetary easing measures, including cuts in required reserves and increased loan-to-deposit ceilings on bank lending.

Recent stimulus measures focus on social housing, including direct lending from the central bank, and a targeted loosening of bank credit. Concerns about growth in general, and the real estate market in particular, are being reflected in increased expenditure on social housing.[11] Further, local governments have been responding to the real estate slowdown by easing restrictions on housing purchases previously imposed to curb speculative demand (Box 2). More recent stimulus measures include an expansion in bank credit to agriculture and small- and medium-sized enterprises,[12] and investments in clean energy, hospitals, and environmental protection.

Set against this, efforts are being made to rebalance the economy away from overreliance on investment and address related excesses. Specific measures include tighter credit to sectors with excess capacity and high energy intensity, such as steel; tighter conditions for unregulated lending, including through the shadow-banking system and off-budget local government financing vehicles; and controls on pollution, including restrictions on the production and use of low-quality coal.

…But Weakens in Large ASEAN Economies, Dragged Down by Structural Problems

In Indonesia, the impact of a poor investment climate has been compounded by weak commodity export prices, increases in the cost of capital, and corrections in the real estate sector. Investment has been a major driver of economic expansion in recent years, rising by an average 8.8 percent per year during 2004–12. But its growth has slowed since 2013, and remains sluggish at 4.5 percent in the second quarter of 2014 (Figure 4), with sharp contractions in both spending on machinery and equipment, and real estate investment. Weak commodity prices have reduced demand for machinery and equipment from the mining sector, and weighed on investable funds more broadly. The investment downturn has been compounded by a recent drift toward protectionist policies and measures, including limits on the foreign ownership of mines and banks, export bans on unprocessed minerals and other raw commodities, and food import restrictions. These have had a particular

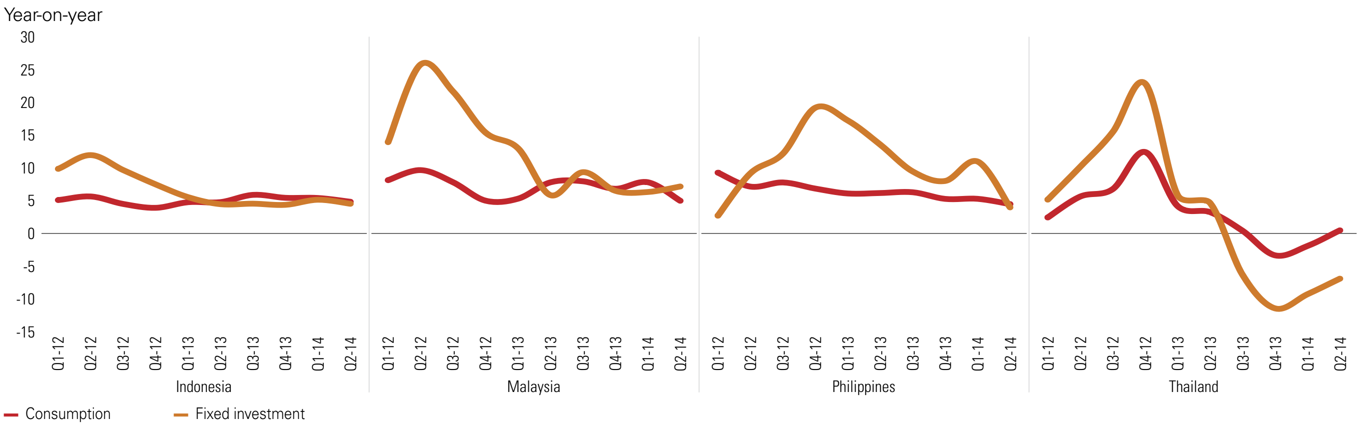
10 The fixed asset investment target for railways for 2014 was set at 1.3 percent of GDP, with the aim of having more than 7,000 kilometers of new railway lines in operation in 2014. To this end, the financing channels for railway investment were broadened to include a railway development fund, new types of railway construction bonds, guidance to banks and other financial institutions to support railway construction, and public-private partnership arrangements. In addition, the central government unveiled in June 2014 a package of infrastructure investments in railways, highways, petrochemical plants, and ports along the Yangtze River, which connects 11 of China's inland provinces to Shanghai. Provincial governments have since offered investment plans of their own: Northern Hebei province offered US$192 billion on railways, housing, and energy; Guangxi province offered US$101 billion on 166 infrastructure projects over three years; and Heilongjiang province offered US$48 billion on infrastructure and mining over two years.

11 The government set a target to start 7 million units, and to deliver 4.7 million units, of social housing in 2014. In June 2014, the China Development Bank (CDB) obtained approval to sell to other financial institutions specialized home financing bonds, which will support shantytown redevelopment and other infrastructure projects. In addition, the CDB will receive a reported 1.7 percent of GDP in financing for social housing, through a new central bank Pledged Supplementary Lending loan facility. This facility is designed to provide base money to the economy, lower funding costs for some government sponsored borrowers, and guide medium-term policy interest rates. Although details on the facility's creation and operation are unclear, its use may obviate the need for local governments and their financing vehicles to use shadow-banking credits to meet social-housing mandates.

12 Starting in July, credits to the targeted sectors faced looser restrictions on loan-to-deposit ratios; in September, liquidity was injected into the five largest banks, again backed by guidelines to support the targeted sectors.

impact on foreign investor sentiment. In addition, credit conditions have tightened markedly after five policy rate hikes in 2013, with a particular impact on business investment in the financially constrained nontradable sector, and as a result of prudential measures to reduce property-related credit growth. Public investment also remains low, and weaknesses in implementation hamper the efficient execution of infrastructure projects.

Figure 4. Fixed investment and consumption growth



Source: Staff estimates.

In the Philippines and Vietnam, the investment slowdown reflects structural factors, again compounded by corrections in the real estate sector. In the Philippines, investment growth slowed to 4 percent yoy in the second quarter, from record-high growth rates of 12 percent in 2013 and 19 percent in 2010 (Figure 4). Investment performance has always been volatile in the Philippines, which suffers from the lowest investment ratio among the large ASEAN economies (barely 20 percent of GDP on average since the Asian financial crisis of 1997–98). This year, spending on equipment, accounting for half of fixed investment, weakened in the second quarter, after private construction, comprising one-third of fixed investment, contracted in the first. Underlying weaknesses include weak implementation of public infrastructure investment, together with underdeveloped financial markets and rigid labor markets. In Vietnam, while FDI remains substantial, private domestic investment has decreased, owing to structural problems. Credit growth is weak, as the banking system continues to struggle with inadequate capital and an unfinished restructuring process. And business sentiment is poor, dragged down by the slow pace of state enterprise and business regulatory reform. The problems are compounded by a weak real estate market, with many apartments unsold, investment projects unfinished, and property inventory running as high as US$4 billion.

In Thailand, investment has contracted for four straight quarters, reflecting political unrest and uncertainty. In the second quarter of 2014, investment stood 20 percent lower than a year before. Protracted turmoil has disrupted economic activity and dampened investor confidence. The automotive industry suffered the largest investment downturn, as many foreign vehicle manufacturers held back previous plans to expand their industrial facilities.[13] The crisis also derailed the implementation of key transport infrastructure projects, including railways, and led to a contraction in private construction activity. Before this downturn, investment had been steadily rising, from 21 percent of GDP at the depth of the Asian financial crisis in 1999, to 29 percent of GDP in 2012.

13 Thailand is a major regional base for automotive production, ranking as the world's seventh largest exporter of automobiles.

In Malaysia, the investment slowdown appears temporary, and related to the timing of the public investment program. There was a temporary spike in investment by nonfinancial public enterprises in 2012. These investments have since tapered off, as many projects were completed, including the LNG regasification terminal in Malacca, and capital disbursements by the central government proved sluggish. But public investment should rebound with the approval of new projects.[14] Meanwhile, private investment, which has accounted for over half of all fixed investment in the last 10 years, remains robust. Overall, the investment ratio currently stands at an 11-year peak.

Institutional Weaknesses Remain a Significant Underlying Constraint on Investment

Adopting a broader perspective, investment in much of the region remains hampered by institutional and regulatory weaknesses. EAP as a whole enjoys relatively high overall institutional quality and a relatively favorable regulatory environment. However, there are significant failings along some critical dimensions, and significant variations across countries (Box 3). In particular, government effectiveness is on average relatively low, reflecting critical inefficiencies in policy formulation and implementation. Likewise, the regulatory environment on average presents significant challenges to starting a business and accessing credit.

Weaknesses in public investment management have had a significant impact on the provision of public goods and services, and as a result also lowered the returns to private investment. Public investment management involves technically sound project appraisal and selection, and appropriate mechanisms for project implementation, monitoring, and ex-post evaluation.[15] The available data suggest that EAP is characterized by relatively low efficiency of public investment management: only Sub-Saharan Africa performs worse, even controlling for income per capita (Figure 5, left panel).[16] Project selection and evaluation present particular challenges. At the country level, Thailand performs relatively well in all aspects of public investment management (Figure 5, right panel). In contrast, Indonesia and the Philippines face significant challenges. Lao PDR and the Solomon Islands are among the worst performers.

14 Led by the Pengerang Integrated Complex, consisting of a US$16 billion refinery and petrochemical integrated development project and US$11 billion of associated facilities in Southern Johor.

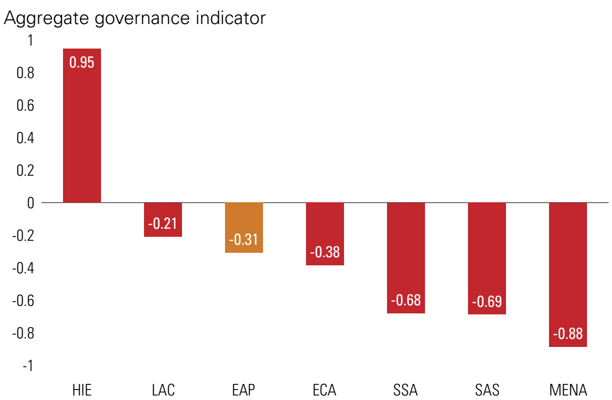
15 Dabla-Norris et al. 2011.

16 However, data are only available for seven developing EAP countries; China, among others, is excluded.

Box 3. Institutional Quality and the Regulatory Environment in East Asia and Pacific[17]

East Asia and Pacific as a whole enjoys relatively high overall institutional quality compared to other developing regions, but with significantly poorer performance along some critical dimensions. In terms of overall governance indicators, the region ranks just below Latin America and the Caribbean, and significantly above Sub-Saharan Africa, South Asia, and the Middle East and North Africa (Figure B3.1). In particular, it enjoys extremely high political stability, and above-average accountability and control of corruption. However, government effectiveness is on average low compared to other regions, reflecting the low quality of public services and of the civil service, and the low efficiency in policy formulation and implementation (Figure B3.2). A particular concern is the relatively low transparency and openness of many aspects of government, including public finances, even after controlling for income per capita (Figure B3.3). (continued)

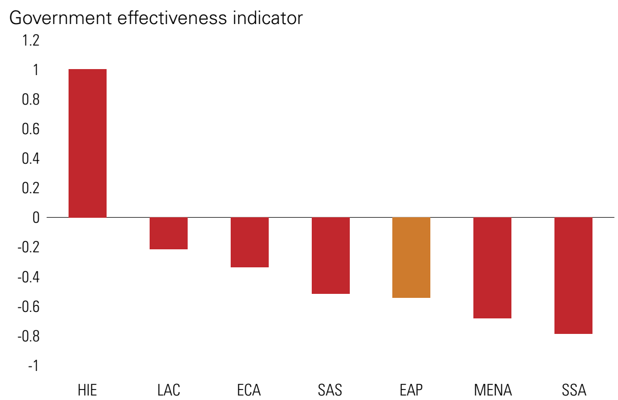
Figure B3.1. Aggregate governance across regions



Source: Worldwide Governance Indicators (2013), www.govindicators.gov.

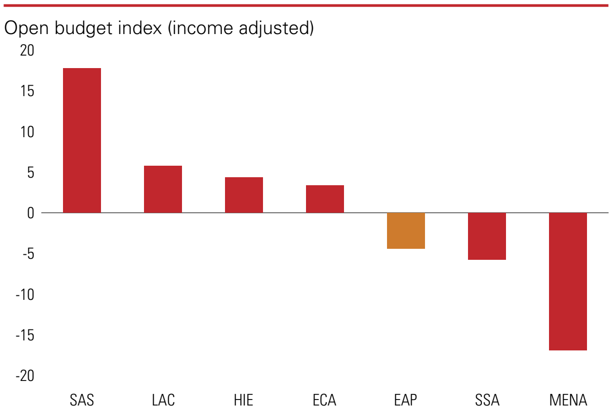
Note: The aggregate governance indicator is an equally weighted average of six subindexes, covering voice and accountability, political stability and absence of violence/terrorism, government effectiveness, regulatory quality, rule of law, and control of corruption. Each subindex ranges from -2.5 (weak governance) to 2.5 (strong governance).

Figure B3.2. Government effectiveness across regions



Source: Worldwide Governance Indicators (2013), www.govindicators.gov.

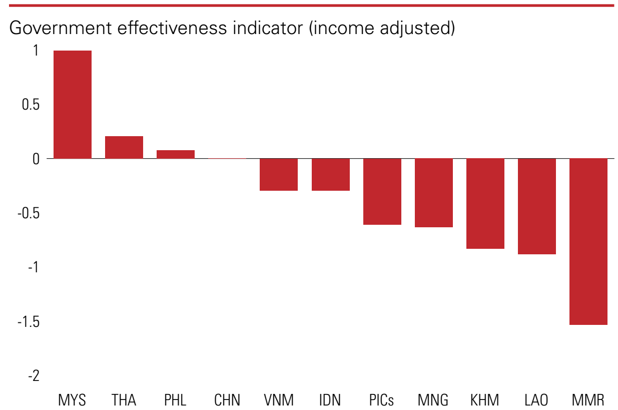
Figure B3.3. Transparency of public finances across regions



Source: Staff estimates, based on the Open Budget Survey (2012), survey. internationalbudget.org.

Note: The survey covers 100 countries. Each country is given a score between 0 and 100 for its budget transparency, defined as the amount, level of detail, and timeliness of the publicly available budget information. Values denote the residuals from a regression of the indicator on purchasing-power-parity-adjusted GDP per capita.

Figure B3.4. Government effectiveness across East Asia and Pacific



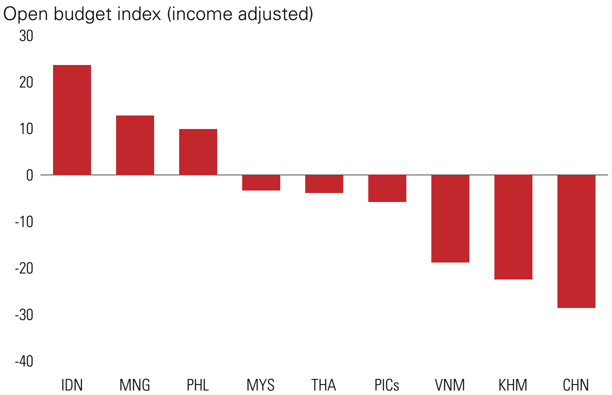
Source: Staff estimates, based on *Worldwide Governance Indicators* (2013), www.govindicators.gov.

Note: Values denote the residuals from a regression of the indicator on purchasing-power-parity-adjusted GDP per capita.

17 This box was prepared by Yan Sun.

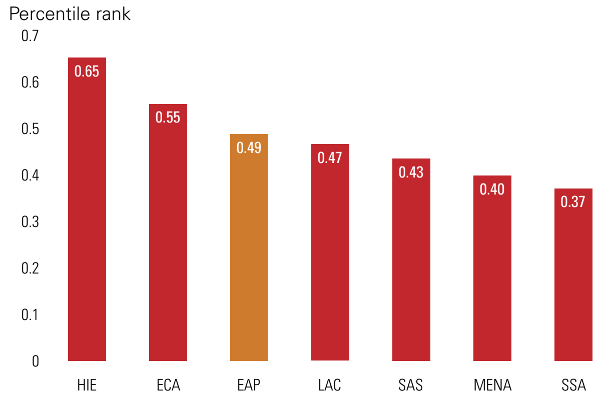
There are also significant variations in institutional quality across countries. Some of this variation is associated with differences in income per capita. But, even controlling for this, the ASEAN-4 countries rank highest in government effectiveness (Figure B3.4) and in transparency of public finances (Figure B3.5). Malaysia is a particularly strong performer, comparable, for instance, to Croatia, which has a much higher income per capita. Conversely, Myanmar, Lao PDR, Cambodia, and China face particularly significant challenges along one or both dimensions. Lao PDR, for instance, performs significantly worse than Ghana, despite their similar income per capita.

Figure B3.5. Transparency of public finances across East Asia and Pacific



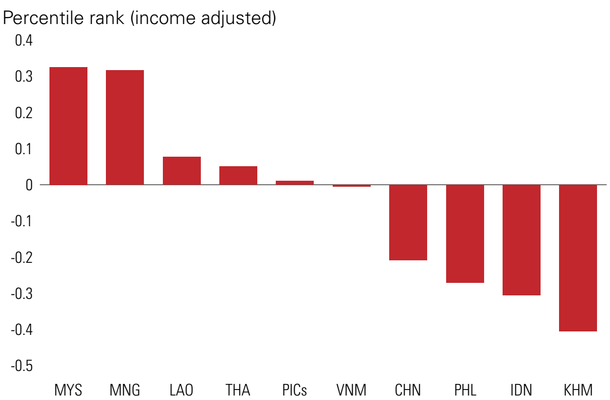
Source: Staff estimates, based on the Open Budget Survey (2012), survey. internationalbudget.org.
Note: The survey covers 100 countries. Each country is given a score between 0 and 100 for its budget transparency, defined as the amount, level of detail, and timeliness of the publicly available budget information. Values denote the residuals from a regression of the indicator on purchasing-power-parity-adjusted GDP per capita.

Figure B3.6. Ease of doing business across regions



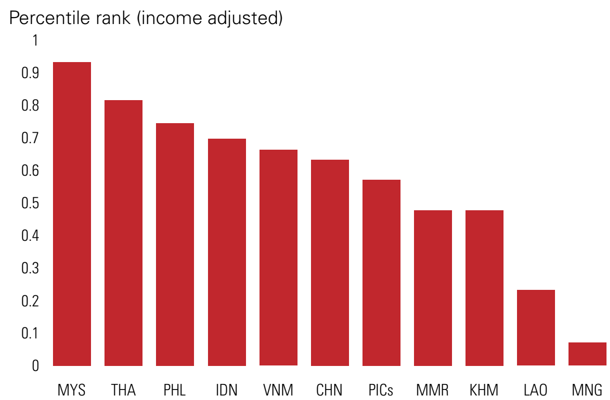
Source: Doing Business database (2014), www.doingbusiness.org.
Note: The indicator is expressed as 1—the percentile rank in the *Ease of Doing Business* rankings; greater values denote higher scores. The indicator is based on an equally weighted average of 10 topics: starting a business, dealing with construction permits, getting electricity, registering property, getting credit, protecting investors, paying taxes, trading across borders, enforcing contracts, and resolving insolvency.

Figure B3.7. Ease of starting a business across East Asia and Pacific



Source: Doing Business database (2014), www.doingbusiness.org.
Note: The indicator is expressed as 1—the percentile rank in the *Starting a Business* rankings; greater values denote higher scores. Values denote the residuals from a regression of the indicator on purchasing-power-parity-adjusted GDP per capita.

Figure B3.8. Ease of international trade across East Asia and Pacific



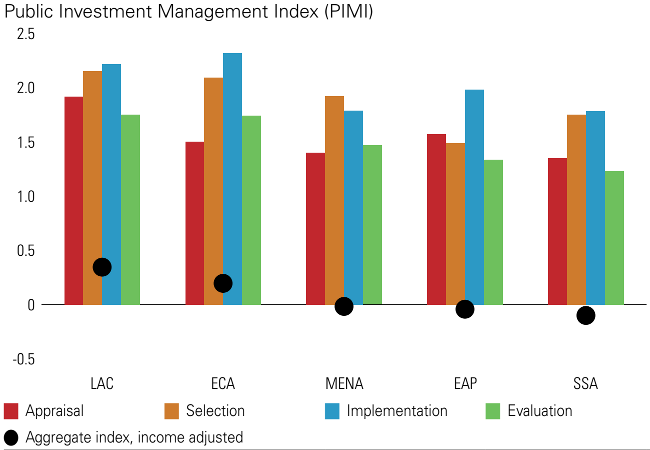
Source: Doing Business database (2014), www.doingbusiness.org.
Note: The indicator is expressed as 1—the percentile rank in the *Trading across Borders* rankings; greater values denote higher scores. Values denote the residuals from a regression of the indicator on purchasing-power-parity-adjusted GDP per capita.

EAP is also characterized by a relatively favorable overall regulatory environment among developing regions, but with some notable weaknesses. In terms of the overall *Doing Business* indicators, EAP ranks just below Europe and Central Asia, and above Latin America and the Caribbean and South Asia (Figure B3.6). However, starting a business presents significant difficulties in many countries, including Cambodia, Indonesia, and the Philippines (Figure B3.7), as does accessing credit. (continued)

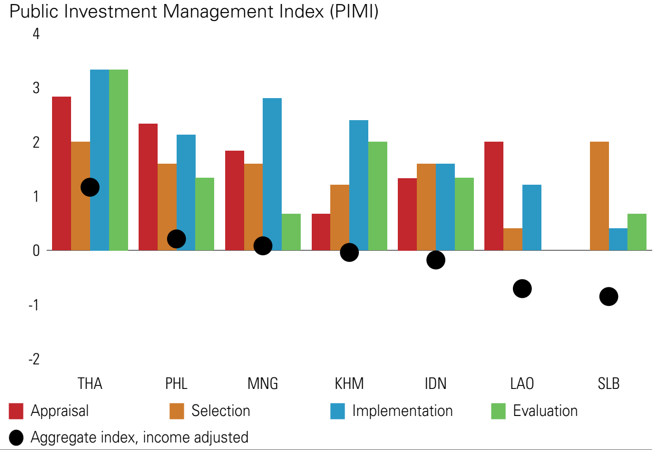
Similarly, there are significant differences across countries with respect to the ease of trading across borders. Again, the ASEAN-4, Vietnam, and China provide a particularly favorable environment. Malaysia emerges as an especially strong performer, even controlling for income per capita (Figure 3.8). In contrast, Mongolia and Lao PDR perform relatively poorly.

Figure 5. Efficiency of public investment management

Across regions



Across countries in East Asia and Pacific



Source: International Monetary Fund-World Bank Public Investment Management database, https://agidata.org/site/SourceProfile.aspx?id=14.

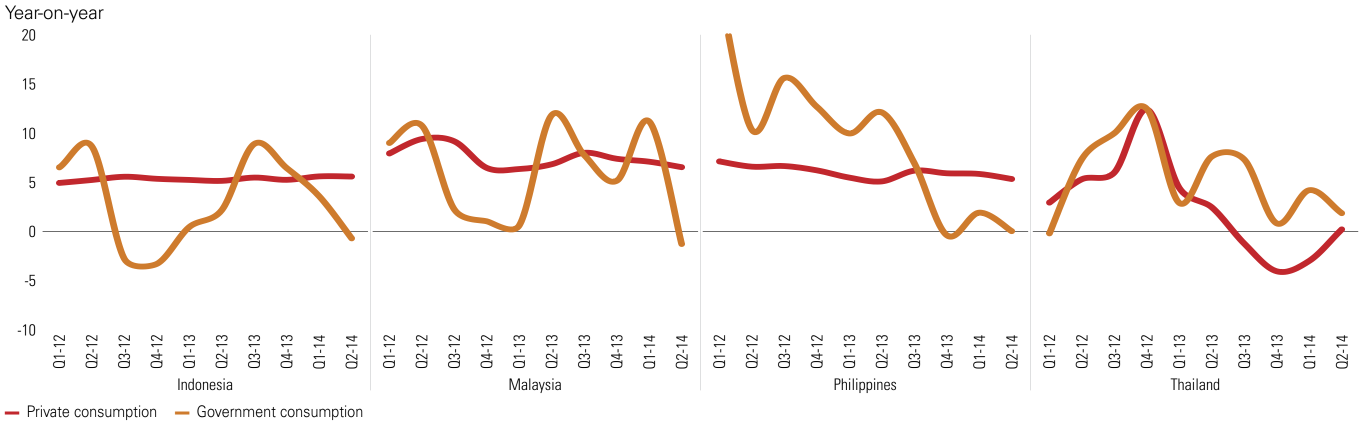
Note: The Public Investment Management Index (PIMI) is a composite index of the efficiency of the public investment management process for 71 countries during 2007–10. The lowest score is zero and the highest is 4. The index covers four major consecutive phases associated with public investment management: strategic guidance and project appraisal (Appraisal); project selection (Selection); project management and implementation (Implementation); and project evaluation and audit (Evaluation). The sample includes seven developing EAP countries: Cambodia, Indonesia, Lao PDR, Mongolia, the Philippines, the Solomon Islands, and Thailand. Values for South Asia are not shown, owing to the very limited number of countries covered (Afghanistan, Bangladesh, and Pakistan). Values for the aggregate index, but not its subcomponents, denote the residuals from a regression on purchasing-power-parity-adjusted GDP per capita.

Private Consumption Proves Resilient across Most of the Region

Private consumption remains generally robust, although underlying factors differ across countries. In Indonesia, household consumption grew 5.6 percent yoy in the first and second quarters, slightly above the annual average for the last five years (Figure 6). Election-related spending provided support, offsetting the impact of the ongoing decline in commodity prices on incomes. In Malaysia, private consumption expanded by 6.5 percent yoy in the second quarter. Labor markets are still robust, with the electrical and electronics sector adding jobs and posting higher wages in the first quarter; this offset tighter credit conditions. In the Philippines, household consumption grew 5.3 percent yoy in the second quarter, faster than the average over the last 15 years, and buoyed by remittances.

In Thailand, private consumption has bottomed out with the respite from political turmoil. Household consumption rebounded by 0.2 percent yoy in the second quarter, after shrinking 3 percent in the first quarter. Private consumption began slowing in Thailand in the first quarter of 2013, as the stimulus from previous programs designed to boost consumer spending, including a first-car rebate program, wore thin. The rice-purchase program, which paid farmers well above the market price for rice, initially spurred consumption by over a million rural households. However, the then-acting government forewent these payments in late 2013,

Figure 6. Private and government consumption growth



Source: Staff estimates.

incurring arrears amounting to 0.75 percent of annual GDP, because it lacked authority to borrow the needed funds. Household consumption then collapsed 4.1 percent yoy in the fourth quarter of 2013. A tinge of optimism has returned with the end of unrest, and with the payment of arrears to nearly 1 million rice-farming households in June 2014.

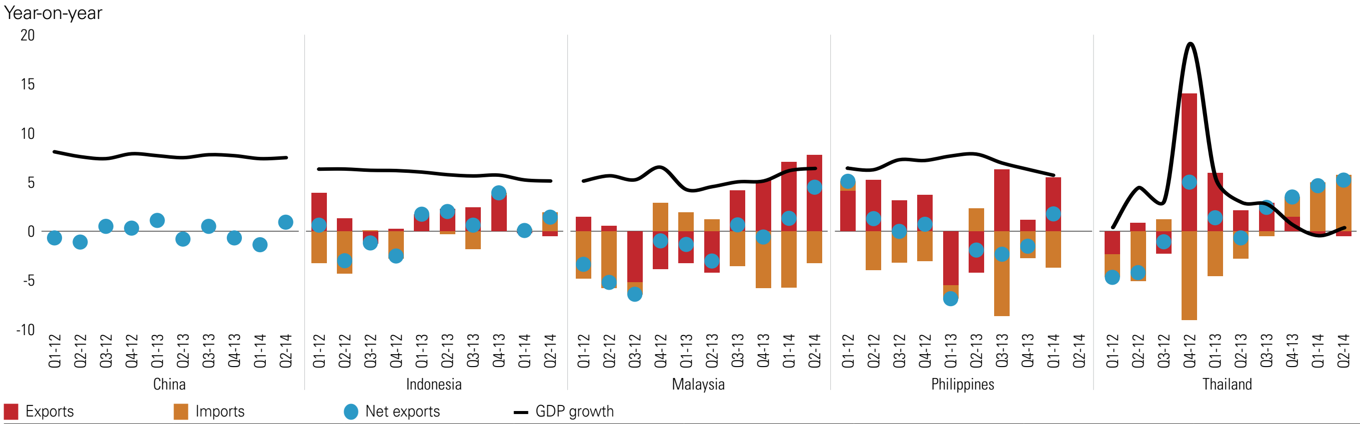
In China, the contribution of consumption to GDP growth in the second quarter was the lowest in five years (2.4 percentage points). Retail sales growth was lower in the first and second quarters than in the corresponding periods in 2013. The weakness was broad-based, affecting a broad range of consumer goods, including food, garments, footwear, household electric appliances, and hardware. As a result, domestic rebalancing efforts toward consumption have stalled, with investment once again a larger contributor to growth than consumption.

Regional Growth is Benefiting from Global Demand, but Export Performance Varies across Countries

Net exports contributed to GDP growth across the region's larger economies, but the underlying factors differed across countries. China, Malaysia, the Philippines (Figure 7) and Vietnam saw rising exports. Indonesia and Thailand were instead characterized by import compression.

Malaysia and Vietnam saw particularly sharp increases in exports. In Malaysia, net exports contributed 4.7 percentage points, or approximately two-thirds of the total, to second-quarter growth. Exports have been recovering strongly since the third quarter of 2013, propelled by a cyclical turnaround in high-tech electrical and electronics manufactures. A previous strategic move in the oil and gas industry, downstream into petrochemicals and storage services, has also started to pay off. In Vietnam, export growth accelerated in the first half of 2014, led by recent high-tech and high-value additions to the export basket, including cell phones, computers and other electronics, and automobile parts. Labor-intensive manufactures, including garments, footwear, and furniture, also grew strongly.

Figure 7. GDP growth: Contributions of exports and imports



Source: Staff estimates.

In the Philippines and China, exports have also started to contribute to growth. In the Philippines, net exports contributed 4.2 percentage points to growth in the second quarter. Total exports grew 10.3 percent yoy in real terms, including strong growth in exports of electronic products and accessories. In China, net exports contributed 0.9 percentage points to growth in the second quarter. Total exports grew 4.9 percent yoy in U.S. dollar terms. China has continued to gain global market share, including in exports of office and automatic data-processing machines; telecommunications equipment; and electrical machinery, apparatus, and appliances.

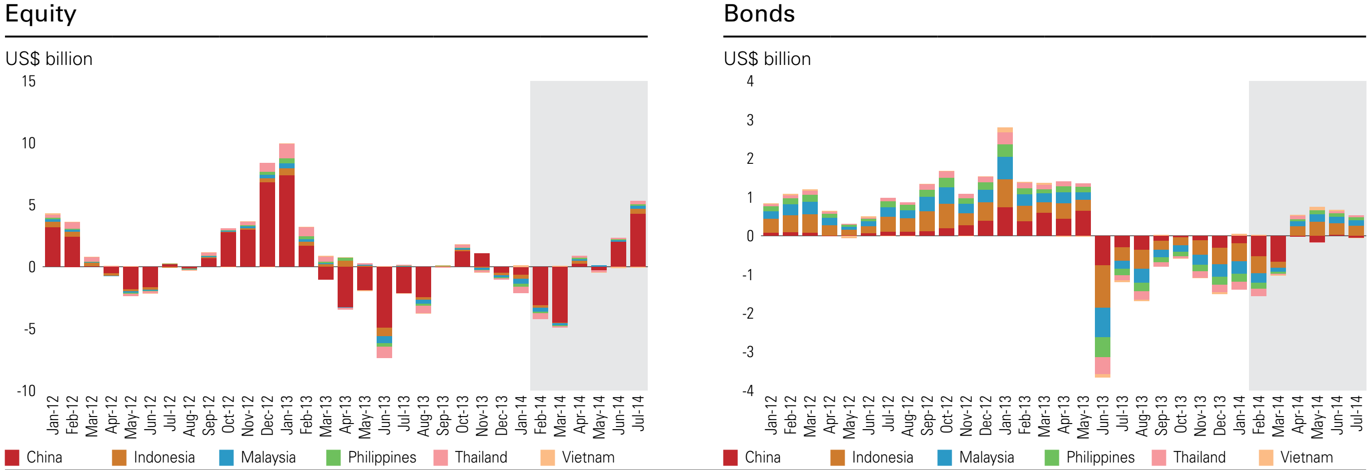
In contrast, Indonesia and Thailand were characterized by weak exports, but even sharper import declines, largely reflecting weak investment. Indonesian exports contracted in the second quarter. New regulations banning unprocessed mineral shipments cut commodity exports, and their impact was compounded by weak commodity prices. In addition, manufacturing exports are still failing to respond to the sharp real depreciation since mid-2013. But capital goods imports also declined, by 6.2 percent yoy in the first quarter and 6.5 percent in the second. In Thailand, exports in the first half of 2014 were flat yoy, with contractions in key exports such as hard disk drives and automobiles and parts. This reflected ongoing shifts in global demand and the political turmoil.[18] However, imports contracted by a far greater 13.3 percent yoy in the same period, with particularly large decreases in capital goods imports.

Rising net exports are keeping current account balances in surplus, except for Indonesia. Indonesia's current account deficit widened from 2 percent of GDP in the first quarter to 4.3 percent of GDP in the second. It has been running current account deficits continuously since the fourth quarter of 2011. The Philippines ran a current account surplus of 3.1 percent of GDP in the first quarter, as sizable remittances continue to offset large trade deficits.

The international search for yield, amid still-abundant global liquidity, has renewed foreign portfolio investment into the region. Portfolio inflows revived in the second quarter, following the "taper tantrum" of May–September 2013 and its "echo" in December 2013–January 2014. Net purchases by international mutual funds and exchange-traded funds of equity and fixed income securities amounted to almost U$5 billion in the second quarter, compared with net sales of almost U$15 billion in the first quarter. In addition, the corporate sector has experienced a surge in syndicated bank lending since March 2014.

18 In 2013, hard disk drives accounted for 97 percent of total exports of computers and accessories in Thailand, as opposed to 50 percent in Malaysia and 10 percent in China. Globally, hard disk drives are currently losing ground to solid state drives.

Figure 8. Net purchases by international mutual funds and ETFs of East Asia and Pacific equity and bonds

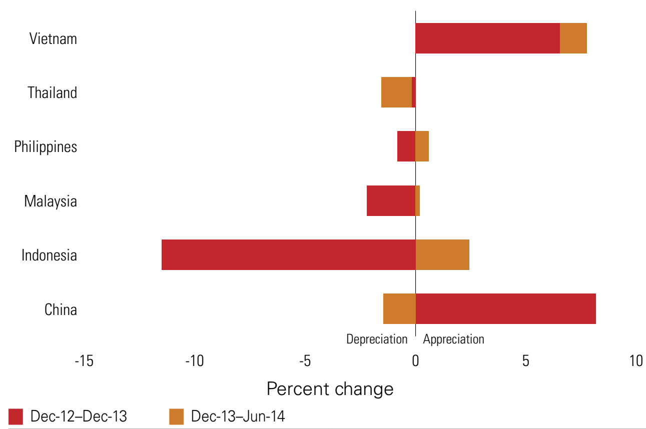


Source: EPFR Global, on Haver Analytics.

Indonesia has seen particularly large capital inflows. Portfolio investment inflows exceeded 4.2 percent of GDP in the first quarter of 2014, compared with 1.2 percent of GDP in all of 2013. In contrast, Thailand saw portfolio outflows of 3.5 percent of GDP in the first quarter, continuing last year's negative trend (Figure 8). In Vietnam, foreign direct investment remains high (accumulated commitments exceeded 140 percent of GDP by end-July 2014), supported by low wage costs, proximity to China's supply chains, and gains in macroeconomic stability.

There have been only limited movements in real exchange rates since the beginning of 2014. In Indonesia, the real exchange rate appreciated by 2.4 percent between end-December 2013 and end-June 2014, reflecting the large portfolio inflows (Figure 9); it still stands more than 10 percent below its July 2013 peak. In contrast, China has experienced a 1.5 percent real depreciation since end-December, providing a modest boost to exports.

Figure 9. Real Effective Exchange Rates



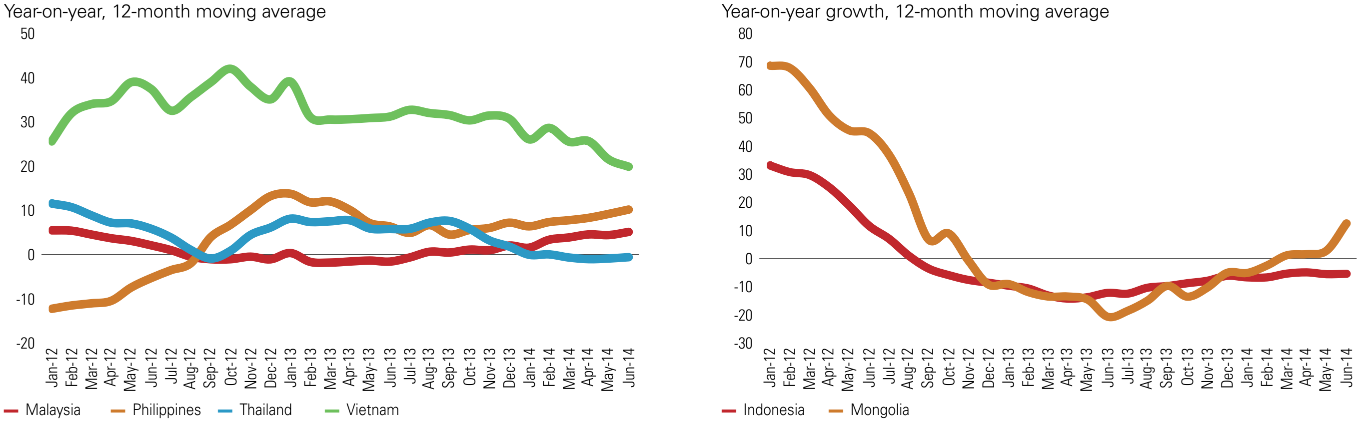
Source: IMF.

Variations in Trade Performance Reflect Differences in Export Structure, but Also Longer Run Structural Constraints

Variations across countries in their recent trade performance reflect important differences in export structure. Over the last two years, commodity exporters such as Indonesia and Mongolia have performed

Figure 10. Export growth

Manufactures exporters | Commodity exporters

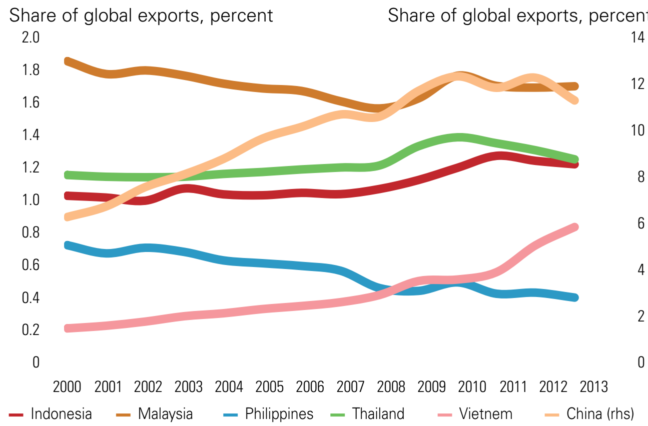


Source: UN COMTRADE.

significantly worse than manufactures exporters (Figure 10), reflecting large terms-of-trade losses,[19] including particularly sharp decreases in coal and metal prices linked to slowing demand from China.[20]

Over a longer time span, the trade competitiveness of East Asia and Pacific has generally improved, largely reflecting structural, supply-side factors; however, some countries have lagged behind. Overall, the region has enjoyed significant trade success. China raised its share of global exports from 2 percent in 1990 to 12 percent in 2013 (Figure 11). Over this same period, the other large economies also made impressive gains: Thailand increased its world market share by 0.8 percentage points, Vietnam by 0.7 percentage points, and Malaysia by 0.6 percentage points. These improvements in competitiveness have to a large extent reflected structural, supply-side factors. But in some cases, such as Indonesia, structural weaknesses have significantly constrained export growth, diversification, and quality upgrading, including by limiting countries' ability to participate in global value chains (Box 4).

Figure 11. Export market shares across East Asia and Pacific



Source: UN COMTRADE.

19 Mongolia's terms of trade have been deteriorating since the second quarter of 2010. Indonesia's terms of trade have been deteriorating since the summer of 2012, and particularly sharply since October 2013.

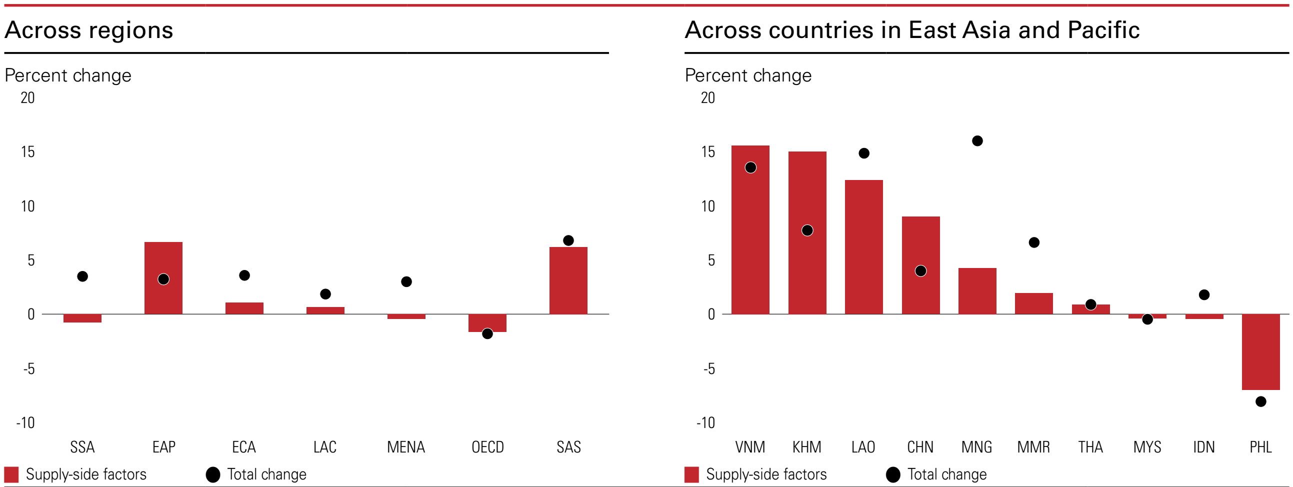
20 For instance, the prices of iron ore, copper, and aluminum fell by, respectively, 46 percent, 27 percent, and 23 percent between July 2011 and July 2014. China accounts for almost 45 percent of global demand for metals; its gradual slowdown has cut this demand. The effect have been exacerbated by excess capacity in its domestic steel and nonferrous metals industries, and by an increase in global supply, stemming from investments in base metal projects over the last few years.

Box 4. Export Competitiveness, Logistics, and Infrastructure in East Asia and Pacific[21]

Building on previous analyses of export competitiveness and trade costs, this box focuses on how logistics and infrastructure affect the ability of countries to integrate into global value chains. Previous editions of the *East Asia Pacific Economic Update* analyzed trends in competitiveness, and noted that the long-term decline in international shipping costs has helped shift attention to border and behind-the border trade costs, including logistics performance. What follows focuses on the potential impact of logistics and infrastructure on one key dimension of trade competitiveness, the ability to integrate into global value chains (GVCs).

Changes in regional competitiveness over time have to a large extent reflected structural, supply-side factors. Changes in world export market shares can be decomposed into their underlying sources, including, in particular, domestic supply-side or "push" factors, and external demand-side or "pull" factors. Domestic supply-side factors broadly reflect structural determinants, including, in particular, production technologies, the cost of inputs, and trade policy (including regulation and behind-the-border policies). External demand-side factors comprise growth in existing export destination markets, and global growth in existing export sectors.[22] During 2006–13, East Asia and Pacific was the developing region where supply-side factors made the greatest contribution to competitiveness (Figure B4.1, left panel). Their impact was especially large in Vietnam, Cambodia, Lao PDR, and China (Figure B4.1, right panel). Conversely, weak supply-side performance significantly hampered competitiveness in the Philippines. Mongolia benefited significantly from demand-side factors, including relatively high growth in its main export destination (China) and in the price of its key exports (metals).

Figure B4.1. World export market shares: Total change, and contribution of supply-side factors, 2006–13



Source: World Bank Export Competitiveness Database.

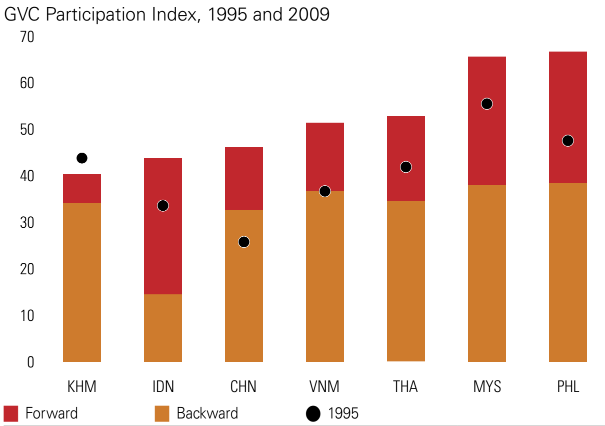
Integration into Global Value Chains: A Key Dimension of Competitiveness

Many countries, particularly in East Asia, are becoming increasingly integrated into global value chains. Global production, trade, and investment are increasingly taking place in GVCs in which firms fragment their

21 This box was prepared by Doug Addison and Frederico Gil Sander, drawing on analyses of the OECD-WTO TiVA database by Claire Hollweg, Gianluca Santoni, and Daria Taglioni.

22 See Gaulier et al. (2013) for details.

Figure B4.2. Participation in global value chains



Source: OECD-WTO TiVA database.
Note: The GVC Participation Index is calculated as a percentage of gross exports. It has two components: imported intermediate inputs, including both goods and services, embodied in exports ("backward integration"); and exported intermediate inputs embodied in other economies' exports ("forward integration"). See OECD (2013) for details. The global average value for the index is 30.

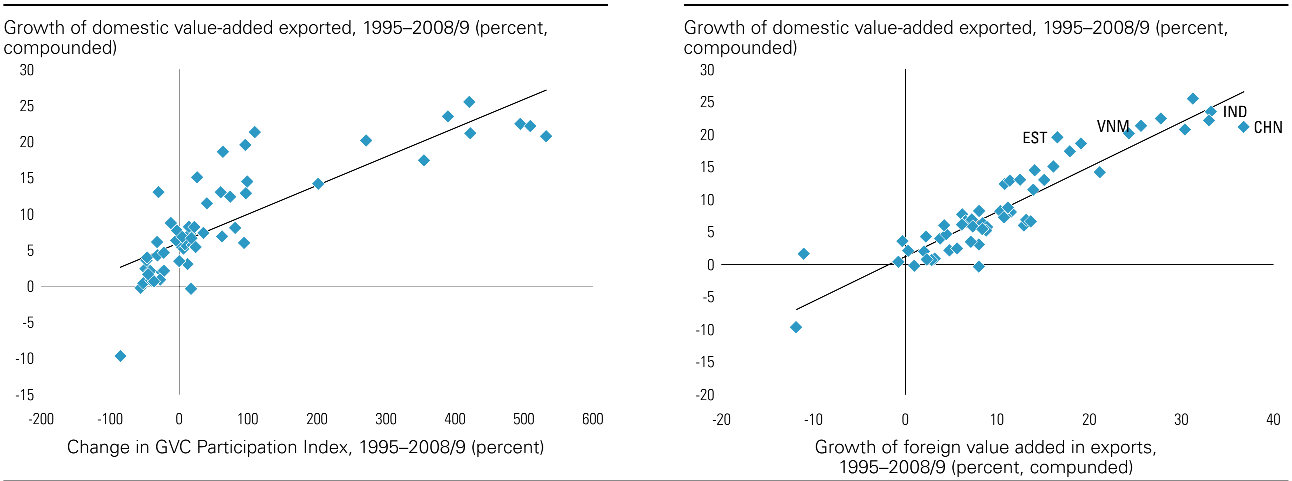
production processes, locate different production stages and tasks in different countries, operate networks of affiliates and independent suppliers, and generate multiple trades in intermediates across national boundaries (OECD 2013). These developments have been enabled by falling trade barriers and transportation costs, and advances in information and telecommunications technologies. Overall, East Asia is well integrated into GVCs. All countries for which data are available rank higher on a formal index of participation in GVCs than the global average; the Philippines ranked the highest in the region in 2009 (Figure B4.2).[23] Participation rates have increased significantly over time (except for Cambodia, which already started at a high level). Even tiny Samoa has joined an automobile parts GVC. Most countries have been particularly successful in integrating "backward," increasing their use of imported intermediates in production for export. Indonesia is the clear outlier, reflecting its continued dependency on primary and resource-based products.

Participation in global value chains is associated with faster growth in exports of domestic value added. Integration into GVCs leads to rising trade in intermediates, and a growing share of imported intermediates embodied in exports. And it is typically also associated with growing exports of domestic value added, a particularly important measure of performance. This last correlation can be seen in many industries, including, for instance, the electrical and optical equipment industry (Figure B4.3, left panel). Indeed, growth in exports

Figure B4.3. Domestic value added and participation in GVCs: The electrical and optical equipment industry

Greater integration in GVCs is associated with faster growth in domestic value added exported

Importing is (perhaps more) important than exporting for performance in GVCs



Sources: OECD-WTO TiVA database, and staff estimates.
Note: Gross exports can be decomposed into domestic and foreign value added. Foreign value added consists of imported intermediate inputs embodied in exports; domestic value added accounts for the remainder of exports. See OECD (2013) for details. Before the advent of GVCs, foreign value added in exports was relatively small.

23 Data are not available for most small countries, including Lao PDR, Mongolia, Myanmar, and all the Pacific Island Countries.

of domestic value added is also associated with growth in the foreign value added embodied in exports (Figure B4.3, right panel), suggesting that the ability to use imported intermediates is an important driver of export competitiveness.

For Vietnam and Cambodia, simply participating in a global value chain, even at the assembly stage, has generated income (Ruta and Saito 2014). Their exports generally embody little domestic value added: they import core inputs and engage in basic assembly-type operations that add limited value. Even so, exports generate a substantial and growing portion of their national income—as much as 41 percent of GDP in Vietnam and 38 percent of GDP in Cambodia.[24] Importantly, local firms may indirectly benefit from exposure to technology used by foreign firms, and from the improved business environment associated with foreign investment (Javorcik 2004).

Drivers of Competitiveness: Logistics and Infrastructure

Logistics performance strongly affects export competitiveness and, in particular, countries' ability to integrate into global value chains. International logistics and supply chain connectivity[25] are key drivers of trade costs.[26] Efficient, low-cost, reliable logistics are particularly important to integration into GVCs,[27] for three reasons. First, participation in GVCs involves a high volume of trade in parts and components, and hence high overall trade. Second, and related, firms must be able to not just export, but also import parts and components. Finally, efficiency requires the minimization of inventories through just-in-time management. Not surprisingly, both established trading nations and emerging markets view seamless logistics as a key engine of integration into GVCs, and indeed growth (Arvis et al. 2014).

Logistics performance varies widely across the region; several countries enjoy substantial unexploited opportunities for improvement. EAP, on average, scores better than any other developing region in measures of logistics performance, including trade and transport infrastructure and shipment arrangements. But there are significant differences across countries, suggesting opportunities to catch up. Myanmar, Mongolia, Lao PDR, and Cambodia are hampered by significant inefficiencies (Figure B4.4, left panel). The Pacific Island Countries face a unique set of challenges (see Part II.C, "Pacific Island Countries: Economic Prospects and Policy Priorities"). In contrast, Malaysia, China, and to a lesser degree Thailand are strong performers across all dimensions of logistics. Vietnam, Indonesia, and the Philippines occupy the middle ground. Countries with poorer logistics performance generally experience larger logistics improvements over time (Figure B4.4, right panel). However, in Papua New Guinea, Cambodia, Indonesia, and Thailand, the observed changes have fallen significantly short of what might have been expected given initial logistics quality. Conversely, the Solomon Islands, the Philippines, and China have made faster progress than expected.

In turn, logistics performance depends critically on infrastructure, whose quality again varies markedly across the region. Efficient logistics involves multiple, correlated but distinct dimensions of performance.[28] This complicates any discussion of how to effect improvements. That said, poor infrastructure is a crucial

24 Data refer to 2009, and are drawn from the *OECD-WTO TiVA* database.

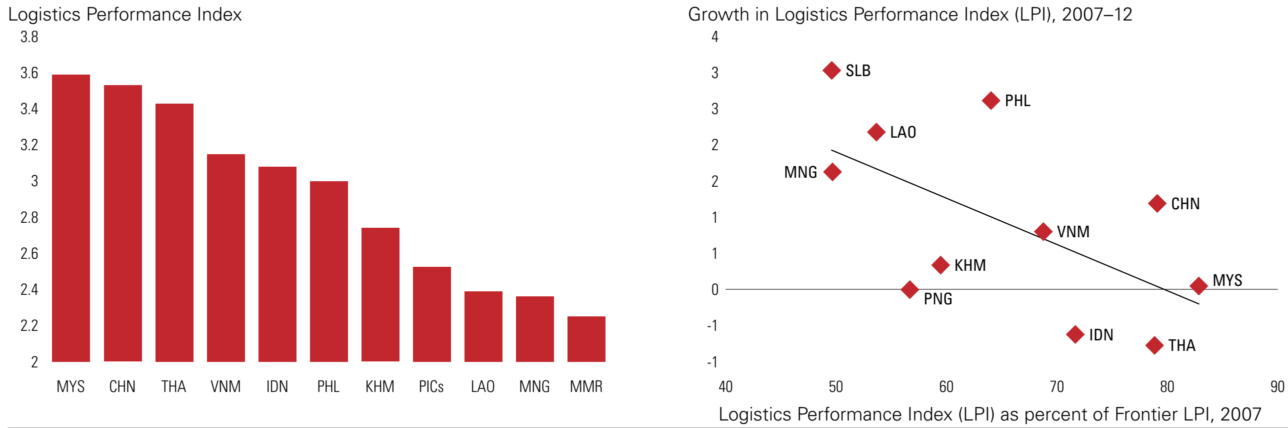
25 International logistics encompass the overall capacity to connect manufacturers and consumers with international markets, through "the process of planning, implementing, and controlling the efficient, effective flow and storage of goods, services, and related information from point of origin to point of consumption for the purpose of conforming to customer requirements" (Council of Logistics Management 1991). Connectivity refers to the ease of importing and exporting and to shipping performance, which can be facilitated by logistics in supply chain planning, implementation, and control.

26 For instance, Arvis et al. (2013) find that maritime transport connectivity and logistics performance are important determinants of bilateral trade costs, with a combined effect potentially comparable to that of geographic distance.

27 Changes in logistics performance affect trade in parts and components, a proxy for integration into GVCs, nearly 50 percent more than trade in final goods (Saslavsky and Shepherd 2013).

28 See Arvis et al. (2014), Box 1.2, footnote 4 for a discussion in the context of the World Bank's Logistics Performance Index.

Figure B4.4. Logistics performance across East Asia and Pacific



Source: Logistics Performance Index (2014), http://lpi.worldbank.org.
Note: The index is based on six dimensions of logistics: the efficiency of customs and border management clearance, the quality of trade and transport infrastructure, the ease of arranging competitively priced shipments, the competence of logistics services (trucking, forwarding, and customs brokerage), the ability to track and trace consignments, and the frequency with which shipments reach consignees within scheduled or expected delivery timeliness.

issue in all but the top-performing countries (Arvis et al. 2014). In particular, Indonesia, the Philippines, and Vietnam all suffer from inadequate infrastructure. In Thailand, infrastructure has improved over the years, but efforts to launch and complete new major projects have met a range of regulatory, legal, and political hurdles. In contrast, Malaysia and China enjoy strong infrastructure. Key points concerning the above countries are highlighted below.

In Indonesia, public infrastructure investment is low and poorly managed. It currently stands at just under 2 percent of GDP, a share that has shrunk in recent years. Moreover, project management remains inefficient. Project selection, undertaken at the local government level, is poor. Procurement, budget, and payment processes are weak. New land acquisition legislation, enacted in 2012 to remove bottlenecks holding up toll roads, has yet to make an appreciable impact on project implementation. That said, some progress is being made. The near completion of 40 new coal-fired power plants should raise electricity-generating capacity. And, going forward, investment should be facilitated by the establishment of the Indonesia Infrastructure Fund Facility to provide long-term finance, and the Indonesia Infrastructure Guarantee Fund to insure against political risk.

In the Philippines, infrastructure has been undermined by decades of underinvestment. Problems include inadequate roads, ports, and airports; and unsatisfactory water, sanitation, and waste facilities. Congestion in the port of Manila forces shippers to divert cargo delivery 130 kilometers away, and widespread blackouts are looming as energy supplies shrink. A package of 80 public-private partnership projects, valued at least US$17 billion and to be launched by end-2016, aims to address the problems. But implementation of previous initiatives had been slow; of the 10 projects put to tender in 2011, only one has been finalized.

Vietnam faces enormous infrastructure challenges, despite improvements over recent decades. There are persistent power shortages, because electricity-generating capacity has increased by only 10 percent in two decades. The length of paved roads has quadrupled in the last decade, but road networks, other than those serving industrial areas, are of poor quality. Resource allocation and project implementation are key issues. Public infrastructure projects are often carried out by decentralized local governments and state-owned enterprises, with significant delays.

In Thailand, efforts to upgrade infrastructure are beset by weak institutional capacity. Infrastructure has improved over the years, especially in the central and eastern regions that are located along trade routes.

However, significant weaknesses remain, for instance in rail, which carries less than 5 percent of freight. Projects continue to face institutional roadblocks, including regulatory inefficiency, legal difficulties, and policy uncertainty. In 2010, the upgrade of 3G telecommunications services suffered long delays following disputes between the regulator and a state-owned telecommunications firm. In 2013, a legal challenge ended plans to fund a US$62 billion investment program using off-budget resources. Recently, the new government postponed upgrades to the country's main international airport and the auction for 4G bandwidth.

In contrast, Malaysia enjoys high-quality infrastructure. The 10th economic plan envisages the creation of a world-class infrastructure. In telecommunications, the aim is to raise household broadband penetration from 67 percent in 2013 to 75 percent by 2015. In transportation, the focus will be on road and rail links to key ports and airports. An electrified double railway track system running from the north to the south aims to raise the share of freight volume carried by rail from 2 percent in 2010 to 10 percent by 2015. The capital's rapid mass transit system, started in 2011, targets an increase in ridership from 12 percent in 2013 to 50 percent by 2020.

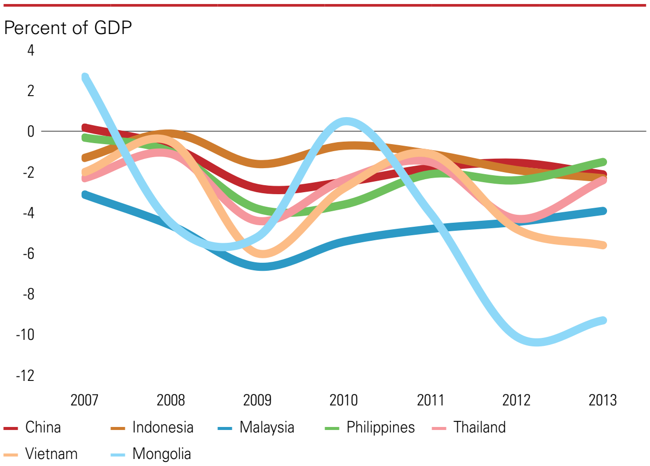
China is likewise starting from a very strong infrastructure base. Infrastructure in the wealthier south and east ranks among the most advanced in the world. Additional capital spending will further improve connections to the country's ports, roads, and airports, although connectivity will lag in the poorer regions. Over time, the focus will shift to improving transport infrastructure within cities, including urban light rail.

Many of the Large Economies Have Been Trying to Rebuild Fiscal Space, but Still Suffer from Weak Revenues or Costly Subsidies

Fiscal deficits have generally narrowed over time, but there are differences across countries in both the extent and the source of fiscal pressures. In Malaysia, the deficit fell from 6.7 percent of GDP in 2009, in the wake of the global financial crisis, to 3.9 percent of GDP in 2013 (Figure 12). Over the same period, in the Philippines, the deficit shrank from 3.7 percent of GDP to 1.4 percent of GDP. Thailand and China also saw small deficit reductions. In contrast, in Mongolia and to a lesser extent Indonesia, the deficit has been rising (in Mongolia, to over 9 percent of GDP), reflecting a broader lack of macroeconomic adjustment to declining commodity export prices. In Vietnam, the deficit has also widened, to 5.6 percent of GDP, owing to slowing revenue collections.

Public debt ratios in several cases still reflect the large deficit spending following the global financial crisis. In both Malaysia and Vietnam, debt exceeds 50 percent of GDP, after rising by more than 10 percentage points between 2007 and end-2013 (Figure 13). In Thailand, debt also increased, especially after the 2011 flood-related public support programs, but it has more recently stabilized. In China, between end-2009 and end-2013, central government debt declined slightly. But local government debt increased significantly, from

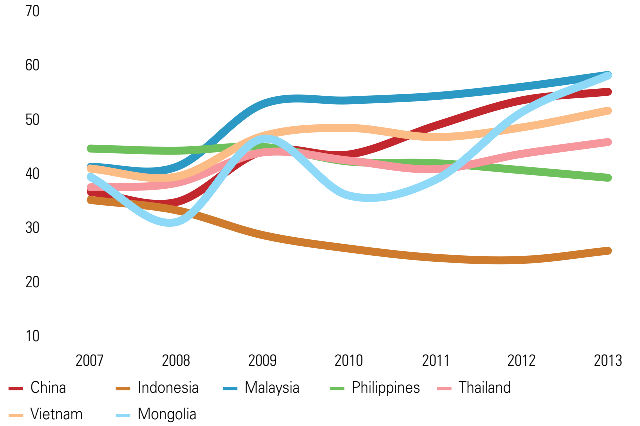
Figure 12. Fiscal balances



Source: Staff estimates.
Note: Data for China, Indonesia, Malaysia, the Philippines, and Thailand refer to the central government. Data for Mongolia and Vietnam refer to the general government, and include off-budget expenditure.

24 percent of GDP to 36 percent of GDP, as the responsibility for funding China's fiscal stimulus fell on local governments and their off-budget financing vehicles. In Mongolia, debt has been rising rapidly, to about 60 percent of GDP. Debt is also high in Lao PDR (62 percent of GDP) and the Philippines (39 percent of GDP), but it has been stable or declining during the postcrisis period.

Figure 13. Public debt



Source: Staff estimates.
Note: Data for China, Indonesia, Malaysia, and the Philippines refer to general government debt; for Mongolia, Thailand, and Vietnam, to public sector debt (for Thailand, this includes debt of nonfinancial state enterprises, the Financial Institutions Development Fund, and autonomous agencies, and special financial institutions guaranteed debt).

Revenue growth is particularly weak in Indonesia, largely reflecting stagnant commodity prices. Revenues from the oil and gas sector, accounting for approximately one-fifth of total revenues, grew by only 1.1 percent in 2013, compared to 8.5 percent in 2012,[29] and in the 2014 budget they are only being supported by nominal depreciation. Tax revenues from sources other than oil and gas have been weak owing to stagnant nonoil commodity prices. For these same reasons, they are now projected to be 4.8 percent lower in 2014, and the value-added tax 3.5 percent lower, than in the original 2014 budget.

Elevated subsidy costs constrain spending on priority areas in Indonesia, Malaysia, and Thailand. In Indonesia, fuel subsidies are both large (2.5 percent of GDP), and sensitive to increases in international oil prices or to a nominal depreciation, despite last year's reform efforts (including a 33 percent increase in subsidized fuel prices in June 2013). As a result, the government had to cut line ministry budgets for 2014 by 0.4 percent of GDP, and postpone another half percent of GDP in energy subsidy arrears payments to 2015. Similarly, in Malaysia, although fuel subsidies were already cut in September 2013, spending needs to be reined in further to meet the 2014 deficit target of 3 percent of GDP. In Thailand, the Ministry of Finance has admitted total losses of up to 3.8 percent of GDP in the rice subsidy program, and gas and diesel are significantly subsidized.

Subsidy reform is a focus of current fiscal consolidation efforts in Indonesia, Malaysia, and Thailand. Governments in the region have introduced fresh measures to rationalize subsidies. Indonesia is starting to reform electricity tariffs: those for large business and industrial groups were adjusted in May, and additional adjustments for six other customer groups began in July. The full-year cost savings are estimated at 0.3 percent of GDP. In Malaysia, the government abolished the sugar subsidy, and announced plans to further rationalize energy subsidies by reducing the volume of subsidized fuel and targeting subsidies to lower-income households. Electricity tariffs were raised in January 2014, and the 2014 budget firmed up plans to introduce a 6 percent goods and services tax beginning in April 2015. In Thailand, the rice-purchase program was discontinued in June 2014. The government currently has a rice stock of around 12.7 million metric tons, is considering monthly sales of 500,000 metric tons, and opened a tender to sell 167,000 metric tons of rice from stocks in August 2014.

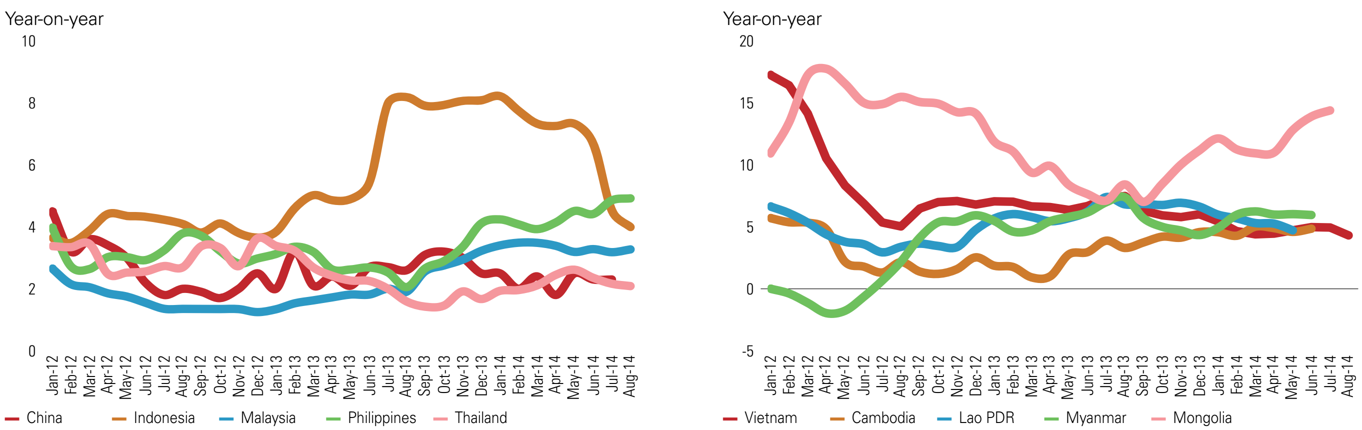
In the Philippines, fiscal reform has focused on tax administration. Tax revenues increased by 1.2 percentage points of GDP between 2010 and 2013, largely reflecting improvements in tax administration. Higher economic growth and the passage of the excise tax law in December 2012 also contributed.

29 Income taxes from the oil and gas sector, accounting for approximately 30 percent of total sectoral revenues, grew by only 6.3 percent in 2013, compared to 14 percent in 2012. The remaining oil and gas revenues, largely royalties, contracted by 1.1 percent in 2013, after growing by 6.4 percent in 2012.

With Inflation Generally Subdued, Monetary Policy Remains on Hold

Inflation remains generally subdued in the region, leading many central banks to keep monetary policy on hold. In Indonesia, headline inflation declined from 8.2 percent in August 2013 to 4 percent in August 2014 (Figure 14). This reflects the fading impact of last year's increase in subsidized fuel prices, aided by monetary tightening during 2013, when policy rates were raised five times (Figure 15), secondary reserve requirements were increased, the target ceiling for banks' loan-to-deposit ratios was lowered, and property lending requirements were toughened.[30] More recently, the tightening has paused. In Vietnam, headline inflation stabilized at 4.3 percent in August 2014, down from a peak of 23 percent in August 2011. More sustainable domestic demand, after a large stimulus in the wake of the global financial crisis, and continued external-sector strength, have helped Vietnam consolidate macroeconomic stability gains. After cutting rates 50 basis points to 6.5 percent in March 2014, policy has remained on hold. Likewise, Thailand cut rates 25 basis points to 2.5 percent in March 2014, and has since kept policy on hold.

Figure 14. CPI inflation

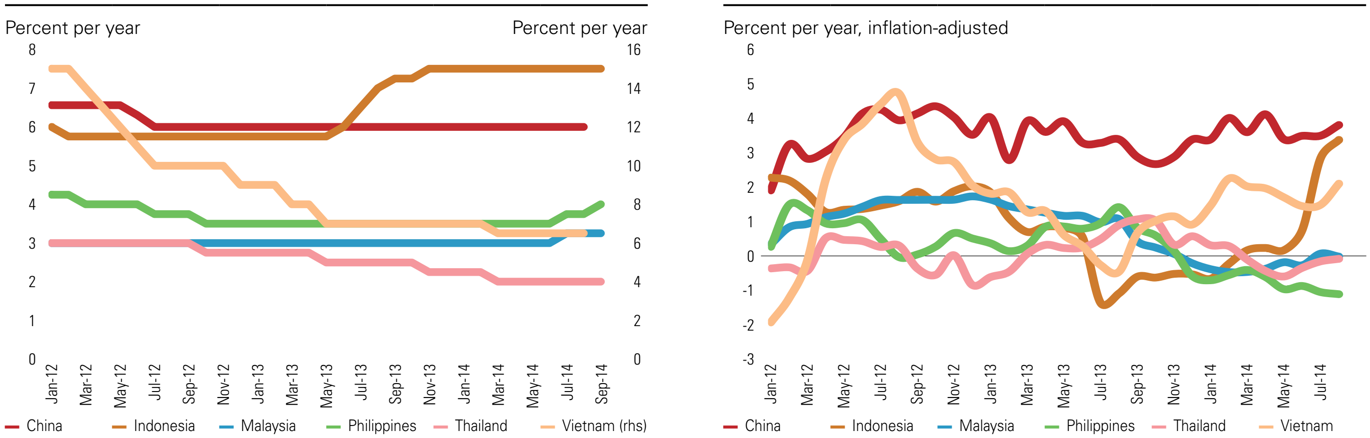


Source: Staff estimates.

Figure 15. Policy rates and real rates

Policy rates

Real rates



Source: Staff estimates.

30 Including lower loan-to-value ratios for second homes, introduced in March 2013.

However, inflationary pressures have risen in the Philippines and Malaysia. The Philippines reported headline inflation of 4.9 percent in August 2014, the highest since November 2011, and at the upper end of the central bank's inflation target of 3 to 5 percent for 2014. Rapid liquidity growth and credit expansion, particularly to the real estate sector, continue to exert upward pressure on prices. Food inflation topped 8.7 percent, up from 1.9 percent in August 2013, on higher rice prices (the result of weather-related supply interruptions). Electricity prices were also higher, similarly due to supply constraints including the simultaneous shutdown of several electricity generation plants. In Malaysia, the headline rate stood at 3.3 percent in August 2014, compared to 1.9 percent a year before. Fuel subsidy cuts in September 2013 and electricity price hikes of 15 to 17 percent beginning in January 2014 have raised energy prices.

The Philippines and Malaysia have tightened monetary policy this year, on concerns over inflation and/or growing financial imbalances. The Philippines raised the benchmark borrowing rate 25 basis points to 3.75 percent in July, for the first time since October 2012, and by another 25 basis points to 4 percent in September, to moderate price increases and anchor inflationary expectations. It also raised the benchmark lending rate by equal amounts. Malaysia raised the overnight policy rate 25 basis points to 3.25 percent in July 2014, for the first time since May 2011, on concerns over financial imbalances, including increases in household and external debt and in the prices of assets (such as real estate), and creeping inflation.

In Mongolia, inflation has accelerated sharply, reflecting a highly expansionary monetary policy. Headline inflation has accelerated since mid-2013, to 14 percent in August 2014; core inflation has reached 16 percent. Prices have been under mounting pressure from expansionary monetary and fiscal policies and from currency depreciation. In particular, the central bank's large monetary stimulus program (involving low-rate mortgage financing and liquidity injections) provided commercial banks with subsidized credit equivalent to over 20 percent of GDP by end-2013. However, the program is being gradually unwound, and the policy rate was increased in July by 150 basis points (to 12 percent).

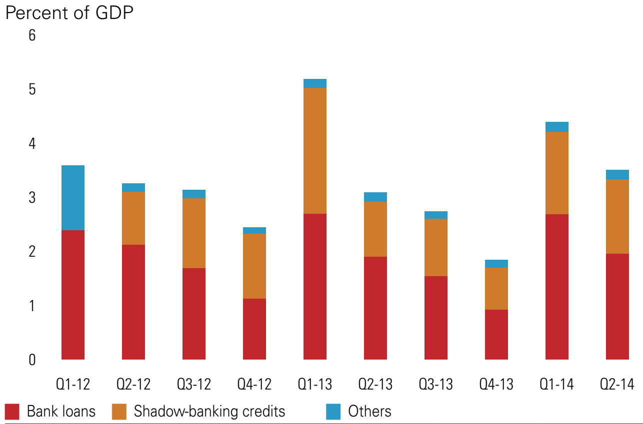
Credit Growth Has Moderated, Reflecting a Range of Policy Measures…

China has been trying to rein in credit expansion, especially from the shadow banking system. New credit amounted to 3.6 percent of GDP in the second quarter, down from 4.4 percent of GDP in the first quarter as new credit from shadow banks shrunk, although still above its value a year before (Figure 16). The central bank has kept the policy rate on hold since July 2012 and has not loosened required reserve ratios since May 2012, except for small and targeted relaxations on bank loans to agriculture and small businesses.

Last year's monetary tightening has dampened credit growth in Indonesia. Bank credit growth has moderated from an annual average 23 percent during 2010–13 to 19 percent in the first quarter of 2014 and 17 percent in the second quarter (Figure 17). Indeed, adjusting for the impact of last year's depreciation on the value of U.S.-dollar-denominated credit, bank credit growth fell to 13 percent in July.

In Thailand and Vietnam, political and structural problems constrain credit growth, despite previous loose monetary policies. In Thailand, bank lending weakened to 3.3 percent year-on-year growth in the second quarter, from 5.2 percent in the first quarter and 9.6 percent in 2013, reflecting the political turmoil. In Vietnam, bank loan growth stood at 3.5 percent in the first half of 2014, markedly lower than the government target of 12

Figure 16. China, new credit ("Total Social Financing")



Source: Staff estimates.

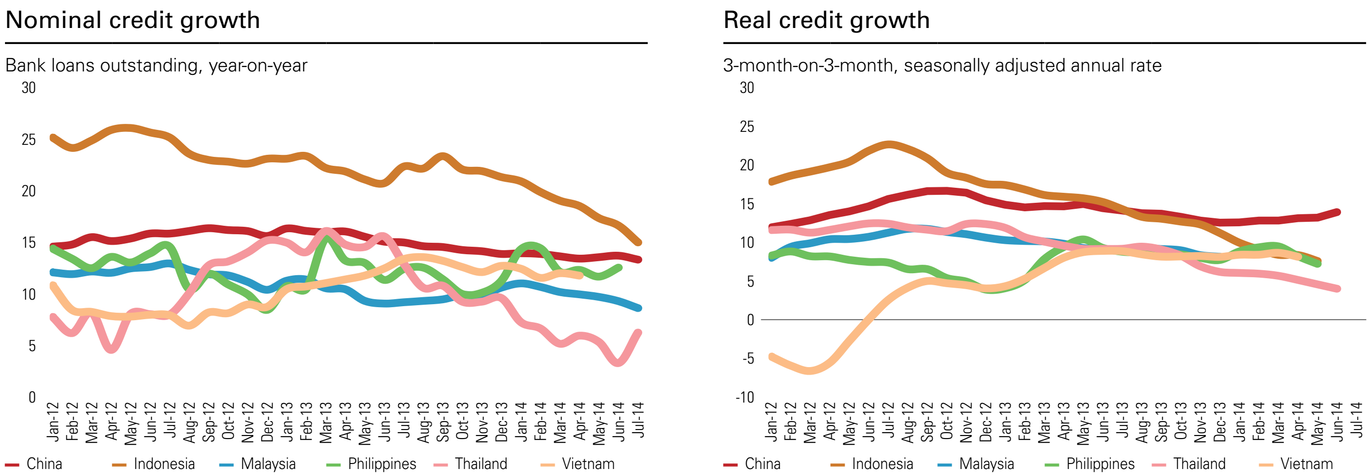
Note: "Total Social Financing" is the aggregate credit measure most frequently used in China. It differs from typical measures of credit to the private sector in that (a) it is a flow measure (although analysts routinely cumulate it into a stock measure); and (b) it includes corporate bond and stock market issuance, assets under management, and corporate-to-corporate lending (none of which is technically financial intermediation).

to 14 percent for 2014, and reflecting the structural problems in the banking system mentioned earlier.

Macroprudential measures are helping reduce credit growth in Malaysia and the Philippines. In these economies, and in Indonesia and Thailand, many recent measures have been directed at the housing market, to prevent the emergence of real estate price bubbles. Examples include lower loan-to-value ratios, stricter capital requirements for real estate lending, and increases in real estate taxes (Box 2).

In Mongolia, credit continues to grow at extremely high rates. Domestic credit growth peaked at 75 percent in November 2013, and still stood at

Figure 17. Credit growth



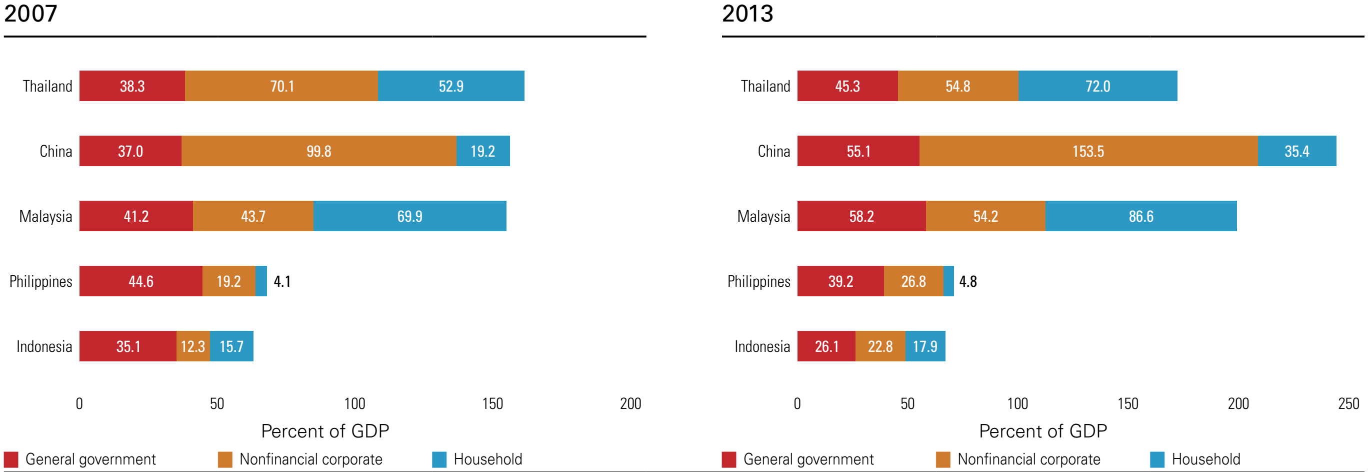
Source: Staff estimates.

38 percent in July 2014, despite the gradual phasing out of monetary stimulus. Bank loans to the construction and to the real estate sectors grew by, respectively, 43 percent and 98 percent yoy in the second quarter of 2014. Bank nonperforming and past due loans rose from 6.3 percent to 9.4 percent of loans outstanding between end-2013 and July 2014. In Lao PDR, growth in money and bank credit decelerated in March 2014 to 20 percent yoy, from the torrid pace in recent years.

...But Debt Ratios Remain Elevated

Considerable fiscal and monetary stimulus since the global financial crisis, combined with strong foreign capital inflows, led to a rapid credit expansion and debt build-up. Over this period, domestic debt expanded by 20 percentage points of GDP or more in China and Malaysia (Figure 18). These two economies are now the most leveraged in developing Asia, together with Thailand, which started with high debt levels.

Figure 18. Debt by debtor



Source: Staff estimates, and IMF Fiscal Monitor.
Note: For China, data on general government debt include local governments.

There has been a particularly rapid accumulation of nonfinancial corporate and household debt. By end-2013, this stood at 187 percent of GDP in China, of which two-thirds was corporate, and especially state-owned corporate, debt. The pace of the accumulation during 2008–13, much of it financed by nontraditional, opaque credit instruments, is rivaled only by Ireland in the years leading up the global financial crisis.[31] Household debt has reached 86 percent of GDP in Malaysia, and expanded rapidly to 72 percent of GDP in Thailand.

In several countries, including Lao PDR, Mongolia, Papua New Guinea, and Vietnam, a large part of the debt was externally financed. External debt remains high in some of the region's small economies, including Papua New Guinea (148 percent of GDP) and Lao PDR (89 percent of GDP).

31 For details, see the October 2013 *East Asia Pacific Economic Update*, Part II.A, "China's Credit Boom May Have Run its Course" (World Bank 2013a).

I.B. Outlook and Risks

Regional Growth Will Stabilize at 6.9 Percent

Growth in developing East Asia and Pacific (EAP) will moderate from 7.2 percent in 2013 to 6.9 percent in 2014–15. However, it will remain the fastest-growing developing region. In China, growth will gradually slow, as efforts to address financial vulnerabilities and structural constraints increase (Table 1). In the rest of the region, growth will gradually pick up, as exports firm and the impact of domestic adjustment in the large ASEAN countries eases.

Table 1. East Asia and Pacific: GDP growth projections

percent

			Forecast	Forecast	Forecast	Changes from April 2014 [1/] (in percentage points)		
	2012	2013	2014	2015	2016	2014	2015	2016
East Asia	6.0	6.1	6.0	6.1	6.1	-0.2	-0.2	-0.3
Developing East Asia	7.4	7.2	6.9	6.9	6.8	-0.2	-0.2	-0.3
China	7.7	7.7	7.4	7.2	7.1	-0.2	-0.3	-0.4
Indonesia	6.3	5.8	5.2	5.6	5.6	-0.1	0.0	0.0
Malaysia	5.6	4.7	5.7	4.9	5.0	0.8	-0.1	0.0
Philippines	6.8	7.2	6.4	6.7	6.5	-0.2	-0.2	0.0
Thailand	6.5	2.9	1.5	3.5	4.0	-1.5	-1.0	-0.5
Vietnam	5.2	5.4	5.4	5.5	5.8	-0.1	-0.1	0.0
Cambodia	7.3	7.4	7.2	7.5	7.2	0.0	0.5	0.2
Lao PDR	8.0	8.5	7.5	6.4	7.0	0.3	-1.5	-2.1
Myanmar	7.3	8.3	8.5	8.5	8.2	0.7	0.7	0.4
Mongolia	12.4	11.7	6.3	6.2	6.1	-5.1	-3.0	-1.5
Fiji	1.7	3.5	3.7	2.5	2.5	1.3	0.1	0.2
Papua New Guinea	8.1	5.5	5.6	20.0	4.0	-4.4	0.0	0.0
Solomon Islands	3.8	3.0	0.1	3.5	3.5	-3.4	0.0	0.0
Timor-Leste	8.3	8.1	8.0	7.7	8.6	0.0	0.0	0.0
Memo: Developing East Asia excl. China	6.2	5.2	4.8	5.3	5.3	-0.2	-0.3	-0.1
Memo: ASEAN	5.7	5.0	4.5	5.0	5.1	-0.3	-0.2	-0.1
Assumptions about the external environment: [2/]								
World	2.5	2.4	2.6	3.2	3.3	-0.4	-0.1	-0.1
High-income countries	1.5	1.3	1.8	2.3	2.4	-0.3	-0.1	0
Developing countries	4.8	4.8	4.5	5.0	5.3	-0.5	-0.4	-0.3

Source: World Bank staff estimates.
1/ World Bank, April 2014, *East Asia Pacific Economic Update: Preserving Stability and Promoting Growth.*
2/ Values for 2013 represent estimates; values for 2014–16 represent forecasts as of September 2014.

Regional exports and growth will benefit from a gradual recovery in high-income economies. In the United States, the recovery is proceeding broadly as anticipated; in other high-income economies, despite the setbacks observed this year, activity is expected to strengthen in 2015–16 (Box 5). This baseline scenario is associated with an orderly normalization of monetary policy in the United States, and a modest tightening in global financial conditions. However, a weaker-than-expected recovery in global trade, an abrupt rise in global interest rates, or increased geopolitical tensions cannot be ruled out and would pose risks to the projected regional outlook.

In China, growth will gradually moderate to 7.4 percent in 2014 and 7.1 percent in 2016, reflecting intensified policy efforts to address financial vulnerabilities and structural constraints, and place the economy on a more sustainable growth path. In the short term, recent infrastructure and social housing initiatives by both central and local governments, current monetary support measures, and rising net exports will offset much of the real estate slowdown, enabling the authorities to attain the indicative growth target. Over time, reforms and a gradual withdrawal of stimulus will reduce overinvestment and related imbalances. In particular, efforts to contain local government debt, within a framework where local government spending mandates are better aligned with their revenues, will rationalize local infrastructure investment. Similarly, measures to curb the growth in shadow-banking credit will curb excessive risk taking, including in the industrial and property sectors, and gradually moderate credit expansion to a more sustainable level. Manufacturing will be increasingly affected by measures targeting sectors characterized by excess capacity, high energy demand, and high pollution.

In the region excluding China, growth will bottom out at 4.8 percent in 2014, reflecting the slowdown in Indonesia andThailand, before recovering to 5.3 percent in 2015–16. In Indonesia, activity in the second half of 2014 is likely to be constrained by continued weakness in commodity-related income, lower-than-expected government consumption, and slower credit expansion. Growth will dip to 5.2 percent in 2014, picking up to 5.6 percent in 2015–16. In Thailand, the respite from political unrest will enable growth to resume, reaching 1.5 percent for 2014 as a whole, rising to 3.5 percent in 2015.

In Malaysia and the Philippines, growth will remain robust. In Malaysia, following strong growth driven by robust exports in the first half of the year, the growth forecast for 2014 has been raised to 5.7 percent. In 2015, monetary tightening (following a rate increase in July and a possible one later this year) and fiscal consolidation (with a second round of fuel subsidy cuts and the introduction of a goods and services tax) will reduce growth to 4.9 percent. In the Philippines, after a weak first quarter, the growth forecast has been revised downward to 6.4 percent in 2014, and 6.7 percent in 2015. Private consumption, supported by strong remittances, will account for more than half of overall growth, while higher government spending on infrastructure and social services, an acceleration of reconstruction, and progress with ongoing and newly awarded public-private partnership projects (worth 1.5 percent of GDP) will provide an additional boost to demand.

In Vietnam, economic growth will remain at 5.4 percent in 2014, rising to 5.8 percent in 2016. Although macroeconomic stability gains have solidified, the current performance remains below potential by historical standards. Further progress on restoring the health of the banking sector to improve access to credit, and leveling the playing field for private investors—especially domestic—vis-à-vis state-owned enterprises, including by easing the regulatory burden, should help the economy move forward.

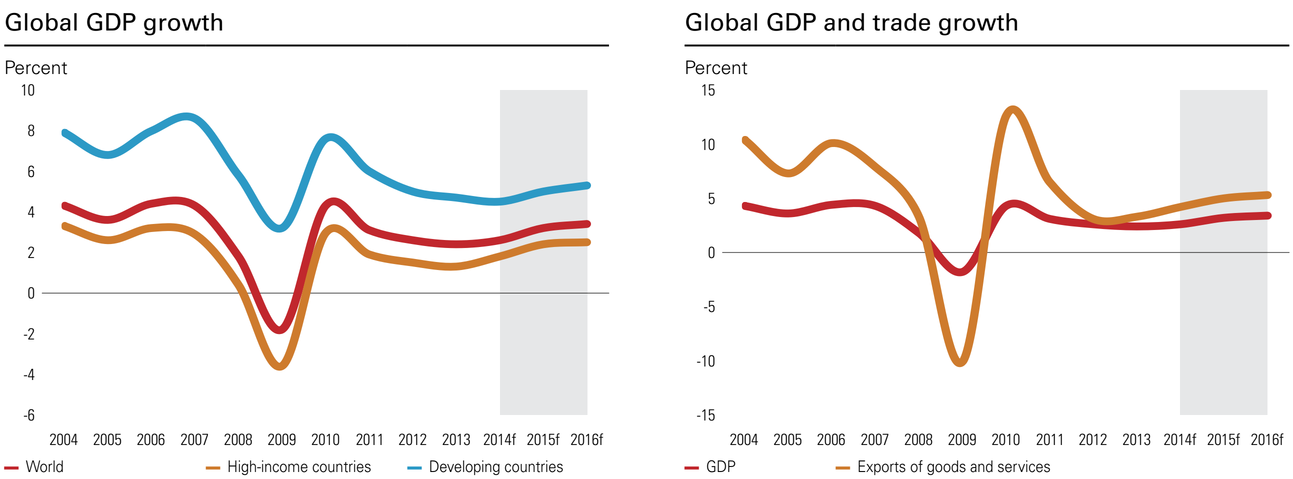
Among the smaller and lower-income economies, growth is expected to remain robust in Cambodia and Myanmar. Cambodia is forecast to grow by 7.2 percent in 2014, rising to 7.5 percent in 2015. The respite from political unrest in neighboring Thailand will boost tourism; continued domestic optimism will support construction activity, and economic recovery in the advanced economies will spur garments exports. Myanmar is expected to grow by 8.5 percent in both 2014 and 2015. Recent progress on macroeconomic stabilization, institution building, political liberalization and international reengagement will lead to a revival of investment and trade.

Box 5. Global Growth Will Gradually Strengthen, Lifting Global Trade and Raising Global Interest Rates

Global growth is expected to rise modestly in the second half of 2014, reaching 2.6 percent in 2014 and an average 3.3 percent in 2015–17 (Figure B5.1, left panel). In the **United States**, growth is projected at about 2 percent in 2014, rising to about 3 percent in 2015. Better employment prospects will support real income growth and confidence, investment will rise in line with strong profit and favorable financing conditions, and fiscal consolidation will ease. In the **Euro Area**, growth is expected to resume in the second half of 2014, reaching about 1 percent for the year as a whole. A slow improvement in credit and labor market conditions will provide some momentum, but investment prospects remain subdued and precautionary savings are still high. Exports will gradually pick up, supported by strengthening demand from the United States and a weakening euro. In **Japan**, growth is projected at about 1 percent in 2014, down from 1.5 percent in 2013. Monetary policy accommodation and reform commitments will provide ongoing support, but fiscal consolidation is expected to keep domestic demand subdued throughout 2015, with exports recovering only slowly. **Australia** is likely to grow below trend as the mining boom passes its peak. Growth in **developing economies** is projected at 4½ percent in 2014, slightly below 2013 outcomes, partly reflecting the slowdown in China. It remains below its long-run average in most regions, but will gradually firm to 5.4 percent by 2017.

The gradual recovery in high-income economies will provide some impetus in 2015–16 for developing countries, and particularly those exporting to the United States. Global trade growth will accelerate modestly from about 3 percent in 2012–13 to just over 4 percent in 2014, and firm further to over 5 percent in 2016–17 (Figure B5.1, right panel). A continuing recovery of investment, consumer sentiment, and consumer credit, particularly in the United States, will be associated with an increase in imports of capital goods and consumer durables.

Figure B5.1. Global GDP growth and trade growth



Source: Staff estimates.

A key downside risk is a slower-than-expected recovery in high-income economies. In the Euro Area, there is a risk of deflation and anemic growth. Falling inflation has raised real interest rates, potentially slowing the recovery, and downward adjustments in inflationary expectations could unleash a pernicious debt-deflation cycle. It remains unclear to what extent the European Central Bank's announced easing measures will boost activity. In Japan, investment and export growth remain tentative. Medium-term prospects will depend on the success of structural reforms (the so-called "third arrow"), including in labor markets, domestic services, and corporate governance. In the United States, the challenge is to tighten monetary policy cautiously, manage pockets of financial-market overvaluation, and set medium-term goals for fiscal policy.

Financial markets in developing countries face risks from monetary policy tightening in the United States and geopolitical tensions in a number of regions. Monetary policy is expected to diverge across high-income economies. The baseline scenario assumes a smooth transition, with interest rate increases starting in the first quarter of 2015 in the United Kingdom, and in the second quarter in the United States; policy rates in both countries will increase gradually toward 2.5 percent by end-2017. In contrast, monetary policy in the Euro Area and Japan is expected to remain accommodative, with policy rates close to zero until at least late 2016. Developing countries will be vulnerable to bouts of financial market disruptions as a result of these changes. In addition, investor sentiment could weaken should geopolitical tensions (for instance, in Russia or the Middle East) escalate.

Key commodity prices are expected to remain stable or decline marginally. Energy prices are expected to soften slightly, reflecting increased U.S. supplies and rising energy efficiency. However, an escalation of geopolitical tensions could have severe repercussions. Major disruptions in the production or transportation of oil and natural gas could add as much as $50 per barrel to oil prices; the precise impact would depend on factors including OPEC's reaction, decisions whether to tap emergency reserves, and demand curtailment. Agricultural prices will moderate further in 2014, assuming that current crop conditions persist. Grain prices will decrease by 14 percent, with particularly large decreases for maize. Prices of edible oils, protein meal, and other food items will change little in the aggregate; coconut oil will see a moderate increase. Fertilizer prices will decline 15 percent, in response to capacity expansion in the United States. Metal prices will decrease more than 6 percent, on top of last year's 5.5 percent drop, as new supplies are coupled with weaker demand by China. Precious metal prices will decline 12 percent, as institutional investors come to view them as less attractive "safe haven" investment vehicles, and demand by China decreases. Among raw materials, sharp declines in the price of natural rubber will be balanced by moderate increases for wood products.[32]

In contrast, the economies of Mongolia and Lao PDR will slow down. In Mongolia, accumulated macroeconomic imbalances will depress growth to approximately 6¼ percent through 2016. We assume continued gradual monetary and fiscal tightening to contain high inflation and address balance-of-payments pressures. Longer-term prospects remain promising, owing to the country's vast mineral resources. In Lao PDR, growth will fall to 6.4 percent in 2015, as corrective fiscal measures aim to stabilize the deficit, credit expansion slows, and a temporary surge in wood exports subsides. Partially offsetting this, investment remains robust, and electricity exports from new power projects will increase.

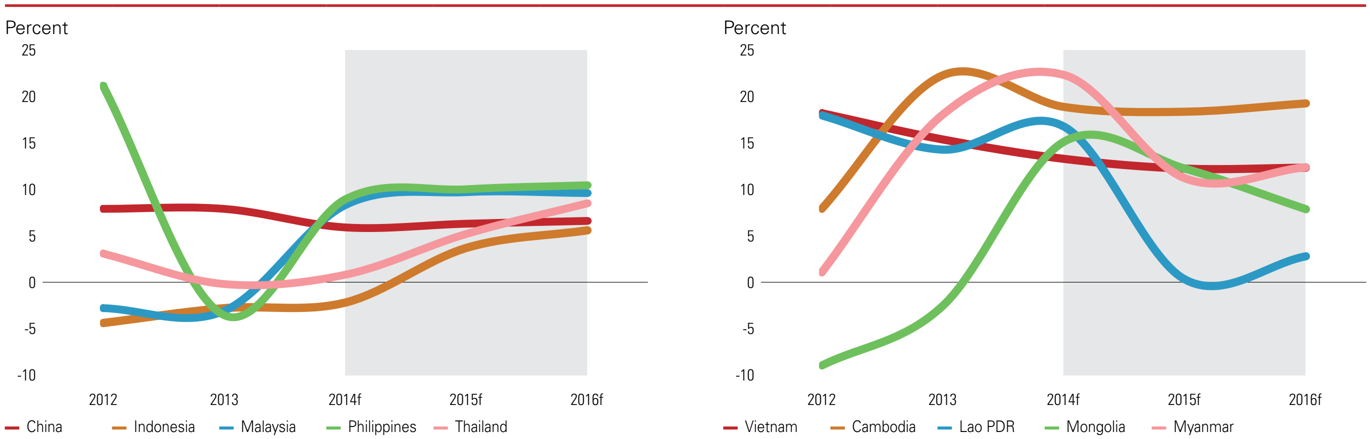
Among the larger Pacific Island countries, Papua New Guinea will benefit from a boom in LNG exports, while growth in Fiji will strengthen on election-related fiscal spending. In Papua New Guinea, growth will remain at 5.5 percent this year but top 20 percent in 2015, as the ramping up of LNG exports more than offsets the end of LNG-related construction, declines in copper exports, and weak cocoa and coffee production. The construction of the 2015 Pacific Games facilities and the upgrading of roads will provide additional boosts. Fiji is expected to grow by approximately 3.75 percent in 2014, supported by fiscal stimulus ahead of the September 2014 elections. More important, investment has been rising owing to renewed private sector confidence, and a return to democracy should result in increased access to development funding.

32 Estimates drawn from the July 2014 World Bank *Commodity Markets Outlook*.

Reconstruction activity will lift growth in the Solomon Islands, but fiscal consolidation will slow growth in Timor-Leste. In the Solomon Islands, reconstruction activity following the April 2014 flooding should drive growth to 3.5 percent in 2015–16. The medium-term challenge is to develop new sources of growth amid a forecast decline in logging activity and uncertainty around the exploitation of mining resources. In Timor-Leste, growth in nonoil GDP (the country's preferred measure of economic activity) will reach 8 percent in 2014. Activity is driven by fiscal spending, and a 13 percent cut in the 2015 budget, a necessary step toward fiscal sustainability, will slow growth to 7.7 percent in 2015.

The region as a whole will benefit disproportionately from the recovery in high-income economies, but within the region, structural constraints and stagnant commodity prices will lead to significant differences across countries in export performance. China, Malaysia, Vietnam, and Cambodia are well positioned to increase their exports, reflecting their deepening integration into the global and regional value chains which have driven the rapid expansion of international trade over the last two decades (Figure 19). Thailand is also expected to benefit from the global recovery, reflecting its strong integration into global value chains. The respite from political unrest and strengthening investor confidence should encourage FDI and production for export, following a temporary relocation to neighboring countries during the months of political instability. But in Indonesia, still predominantly a commodity exporter, export performance will remain fragile, as the terms of trade continue stagnating, and infrastructural bottlenecks hamper efforts at diversification.[33]

Figure 19. Export growth projections



Source: Staff estimates.
Note: Data refer to growth in U.S. dollar values of exports of goods.

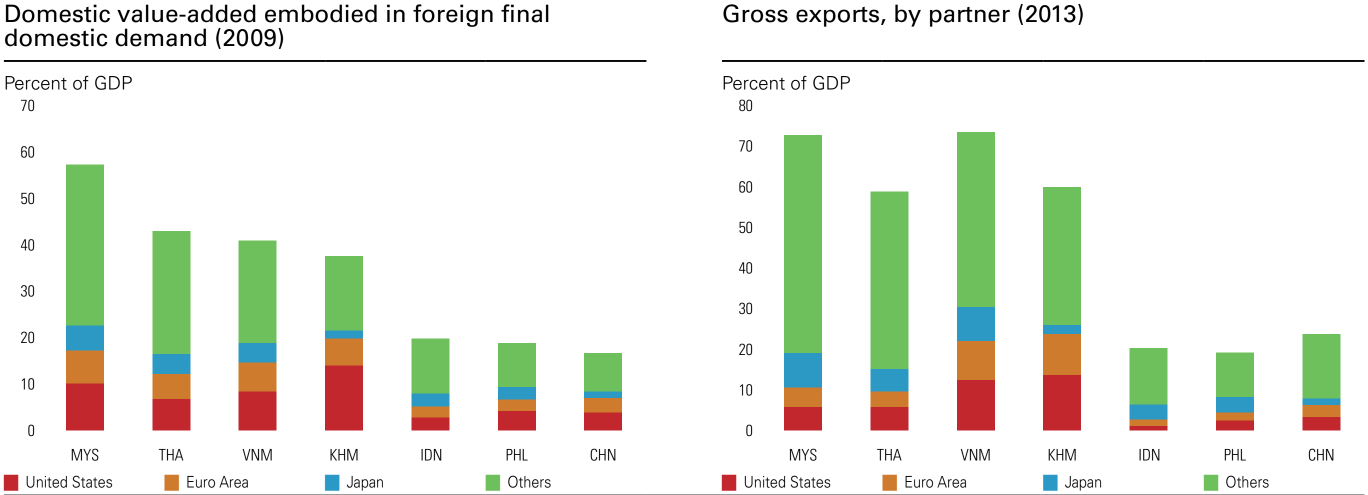
The Regional Outlook Assumes a Global Recovery, but this Could Falter

A key risk is that global demand may recover more slowly than anticipated, with a negative impact on regional exports and growth. The near-term outlook for high-income economies is subject to downside risks, particularly in the Euro Area and Japan (Box 5). If the global recovery faltered, the impact would vary across EAP, and would depend on the precise source of the shock. Overall, Cambodia, Malaysia, Vietnam, and Thailand

33 Among more positive factors, mineral exports are expected to recover starting in the second half of 2014. In particular, copper exports will resume following a reduction in the tax rates on some unprocessed mineral exports, contingent on companies' commitments to building smelters, and pursuant to new MOUs with the two largest mining corporations.

appear particularly exposed, given their greater openness (Figure 20). The Euro Area and Japan account on average for about half of total exposure.

Figure 20. Domestic value-added embodied in foreign demand, and gross exports, by partner

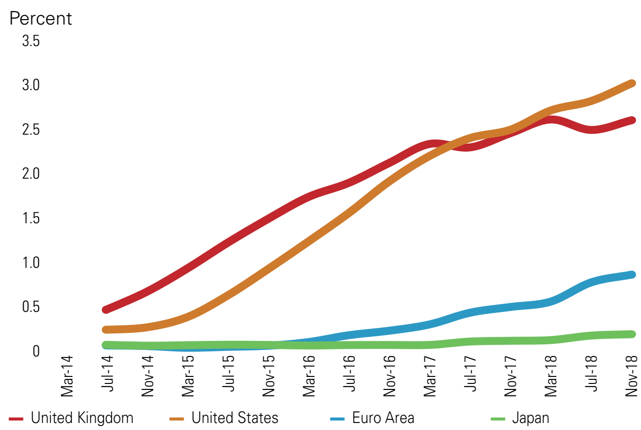


Sources: OECD-WTO TiVA database and *Direction of Trade Statistics*.
Notes: "Domestic value-added embodied in foreign final domestic demand" illustrates the full upstream impact of final demand in foreign markets on domestic output. The indicator captures how countries (and industries) export value both through direct final exports, and via indirect exports of intermediates through other countries to foreign final consumers. It reflects how upstream industries are connected to consumers in other countries, even where no direct trade relationship exists. However, the indicator is not available after 2009.

Monetary Policy Normalization Could Lead to an Abrupt Tightening of Financial Conditions...

External financial conditions facing the region are expected to tighten; an abrupt rise in interest rates cannot be discounted. Monetary policy is expected to diverge across high-income economies, with a tightening in the United Kingdom and the United States in the first half of 2015, and continued accommodation in the Euro Area and Japan (Figure 21 and Box 5). Overall, global financial conditions will tighten. In addition, the normalization process will be complex, since monetary policy in high-income economies has remained extraordinarily expansionary over an unusually extended period of time. The unwinding of large central bank interventions, in an environment of uncertainty about future policy, could be accompanied by abrupt market reactions, increased volatility, and overshooting of interest rates. Moreover, increased divergence in monetary policy among major reserve currencies raises the risk of disorderly exchange rate and interest rate movements. The adjustment to the new equilibrium could prove disruptive. The region will also be vulnerable to weakening investor sentiment should geopolitical tensions (for instance, in Russia or the Middle East) escalate.

Figure 21. Policy rate expectations



Sources: Staff estimates and Bloomberg.
Note: Expectations derived from overnight indexed swaps on: for the Euro Area, the Euro Overnight Index Average; for Japan, the Tokyo Overnight Index Average; for the United Kingdom, the Sterling Overnight Index Average; and for the United States, the Federal Funds rate.

...Exposing Some Countries in the Region to Vulnerabilities Built Up during the Long Period of Monetary Accommodation

Rising interest rates could create debt service problems for some EAP countries. In many countries, debt service ratios are now at historically elevated levels, owing to the sharp accumulation of debt since the global financial crisis. Any rapid increase in interest rates could create debt service issues for some borrowers. For instance, an increase in money market rates by 250 basis points, keeping credit-to-GDP ratios constant, would push debt service ratios in many countries across the world into "critical territory" (Table 2).

Table 2. Shock to debt-service ratio from higher interest rates (250-basis-point increase)

	Credit-to-GDP gap 1/	Debt-service ratio gap 2/	Debt-service ratio gap, if interest rates rise by 250 basis points 3/
China	23.6	9.4	12.2
Asia	19.9	2.4	4.4

Source: BIS 2014.
Note: Italics denote critical values for the above indicators; these have proved empirically robust early warning indicators of financial distress.
1/ Difference of credit-to-GDP ratio from its long-run trend. Critical if above 10.
2/ Difference of debt service ratio (share of income used to service debt) from its long-run average since 1985. Critical if above 6.
3/ Assumes a 250-basis-point increase in lending rates. Critical if above 6.

In particular, the risk of debt service problems may be significant for households and corporates, although not governments. In Malaysia and Thailand, where household debt ratios are high, abruptly rising interest rates could strain household budgets and potentially slash consumption spending. In China, where corporate debt levels have ballooned and which just recorded its first bond default in March 2014, rapidly rising interest rates could create liquidity issues, and potentially also solvency issues, among marginal corporate borrowers in troubled excess-capacity industries. That said, the risks may be moderated to the extent that rising global interest rates reflect robust performance in high-income economies and growing demand for EAP exports. Among the smaller economies, in Papua New Guinea private sector external debt has grown rapidly over the last few years, from 23 percent of GDP in 2009 to 148 percent at end-2012. The majority of the debt is owed by LNG project partners and subcontractors, and its sustainability is sensitive to the outlook for LNG prices.

Abrupt changes in market expectations could also lead to a sharper-than-expected reduction in capital inflows, exposing some countries to considerable pressures. In the baseline, private capital inflows are expected to recede by only half a percent through 2016. However, more extreme scenarios could materialize. In this case, historical evidence suggests that those economies that have been characterized over the last five years by substantial expansions in domestic credit, deteriorating current account balances, high levels of foreign and short-term debt, and overvalued exchange rates could be at particular risk.

Across the region, vulnerabilities to capital-flow reversals have broadly declined over the last year; Indonesia, however, remains relatively exposed, owing to its high short-term external financing needs. For most countries, vulnerabilities have declined since the May 2013 taper tantrum (Table 3). But in Indonesia the projected 2014 current account deficit and short-term debt together amount to a relatively large 10 percent of GDP and 77 percent of foreign exchange reserves. External financing relies heavily on portfolio inflows, which have reached record levels in 2014, but have historically proved volatile. These inflows include both foreign-currency debt and local-currency debt held by overseas investors,[34] generating significant exchange-

34 The foreign-held share of local government bonds has risen in Indonesia in recent years by 25 percentage points. Malaysia has seen a similar increase; in Thailand the increase amounted to 16 percentage points.

rate and rollover risk.[35] In Mongolia, short-term external financing needs amount to almost 20 percent of GDP and 105 percent of reserves. However, the sources of financing are much less volatile, including a bilateral swap line with China amounting to about 20 percent of GDP, as well as remittances.

Table 3. Change in vulnerabilities since May 2013

	Inflation		Credit growth/ GDP growth		Current account/ GDP		Reserves/ imports		Fiscal deficit/ GDP		Short-term external debt/ reserves		REER change since May 2013
	2013 Jul	2014 Jul	2013 Q2	2014 Q2	2013 Q2	2014 Q2	2013 Q2	2014 Q2	2013 Q2	2014 Q2	2013 Q2	2014 Q2	2014 Jun
China										…			
Indonesia													
Malaysia													
Philippines													
Thailand													
Vietnam									…	…			

Source: Staff estimates.

Note: Red denotes significant vulnerabilities, and yellow moderate vulnerabilities. *Thresholds defined as follows:*

Inflation. For countries targeting inflation: red if above inflation target, yellow if above the middle of the target band, and green otherwise. For other countries: red if above 10 percent, yellow if between 5 percent and 10 percent, and green otherwise. Indonesia targets headline inflation (3.5 to 5 percent); the Philippines, headline inflation (3 to 5 percent); Thailand, core inflation (0.5 to 3 percent). Data for Thailand refer to core inflation.

Credit growth to GDP growth. Indicator based on year-on-year growth. Red if greater than 4, yellow if between 1.5 and 4, and green otherwise.

Current account/GDP. Red if deficit exceeds 10 percent of GDP, yellow if there is a deficit smaller than 10 percent of GDP, and green if there is a surplus. Data for Vietnam refer to merchandise trade balance.

Reserves/imports. Indicator based on reserves / imports of goods and services. Red if less than three months of import cover, yellow if equal to three months of import cover, and green otherwise.

Fiscal deficit/GDP. Red if greater than the average emerging market deficit (-2.4 percent of GDP for 2013, and -2.5 percent of GDP for 2014), yellow if there is a deficit smaller than this average, and green if there is a surplus. Fiscal deficit data is not available for Vietnam on a quarterly basis.

Short-term external debt/reserves. Red if greater than 1, yellow if greater than ½, and green otherwise.

Real effective exchange rate (REER). Indicator based on cumulative change since May 2013. Green if depreciation exceeds 5 percent, yellow if between a 5 percent depreciation and a 5 percent appreciation, and red otherwise.

A sudden financial tightening could also lead to a disorderly adjustment of housing prices in the region. Following a rapid rise in recent years, real housing prices decreased in Malaysia starting in the fourth quarter of 2013, and in China and Thailand starting in the first quarter of 2014 (Box 2). Historically, episodes of monetary tightening have been strongly correlated with declines in housing prices. Monetary policy normalization in the United States and United Kingdom may therefore accelerate the real estate downturn, and the impact may prove particularly strong if interest rates rise abruptly. In turn, any rapid adjustment in housing prices may cause severe dislocation. That said, the evidence of significant bubbles in housing prices in the larger EAP economies is still weak, which limits the likely scope for significant real estate price corrections.

Other Potential Risks

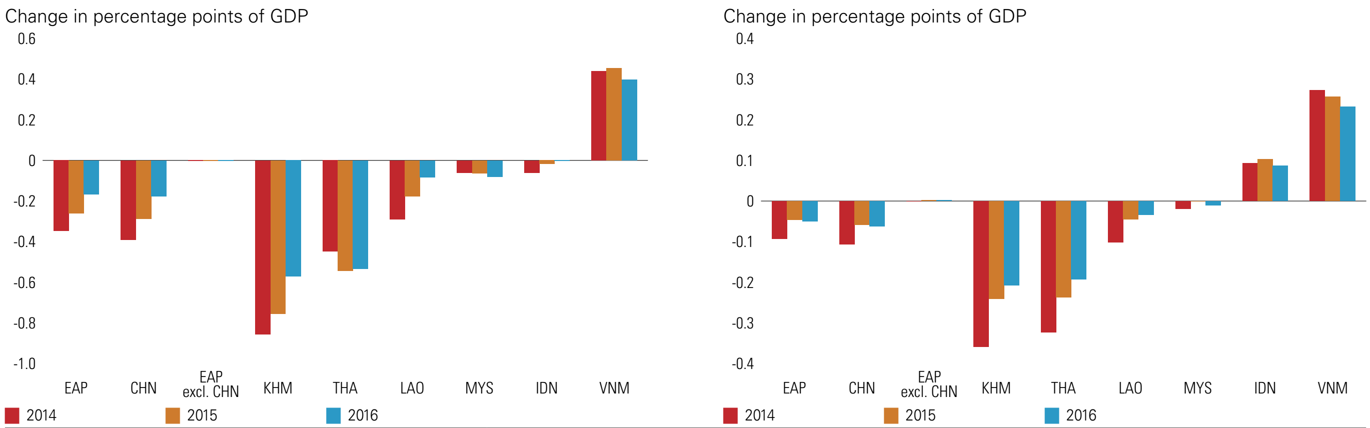
The risks posed by potential commodity price increases appear relatively small at this time, barring a sharp slowdown in China; nevertheless, the impact of any such increases would vary sharply across countries. Energy price increases would have a relatively strong negative impact on Cambodia, Lao PDR, and Thailand (petroleum importers), and a relatively strong positive impact on Indonesia and Mongolia (coal

35 For instance, estimates suggest that a 10 percent depreciation and the ensuing increase in the debt burden would create significant risks for the Indonesian corporate sector (IMF 2014). However, these estimates should be interpreted with caution, because of the lack of data on net foreign exchange exposure, and in particular on the extent of hedging of foreign exchange liabilities, as well as on the foreign currency composition of firms' assets.

exporters). Increases in food prices would most benefit Vietnam, Lao PDR, and Thailand (significant exporters of rice and other foodstuffs). Increases in metals prices would have a positive impact on Mongolia, but a negative impact on Vietnam (a significant importer of iron). In all cases, the price changes affect not only trade and current account balances, but also fiscal balances, including through changes in trade taxes, royalties and income tax on the commodity sector, and domestic price subsidies (Figure 22 through Figure 25). However, even a one-time 10 percent change in commodity prices, which is above the range judged likely in the World Bank's global commodity price outlook (unless there were a sharp slowdown in China; see below), would in almost all cases affect current accounts and fiscal balances by significantly less than 0.5 percentage points of GDP.

Figure 22. External and fiscal impact of a 10 percent increase in all commodity prices

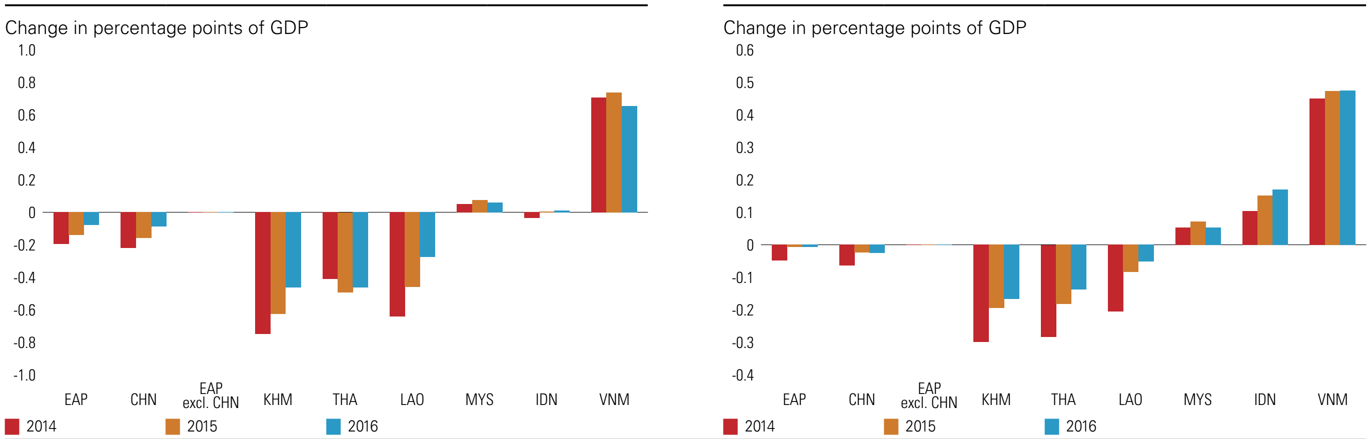
Fiscal balance | Current account balance



Source: Staff estimates.
Notes: Mongolia not included because of limited data availability.

Figure 23. External and fiscal impact of a 10 percent increase in energy prices

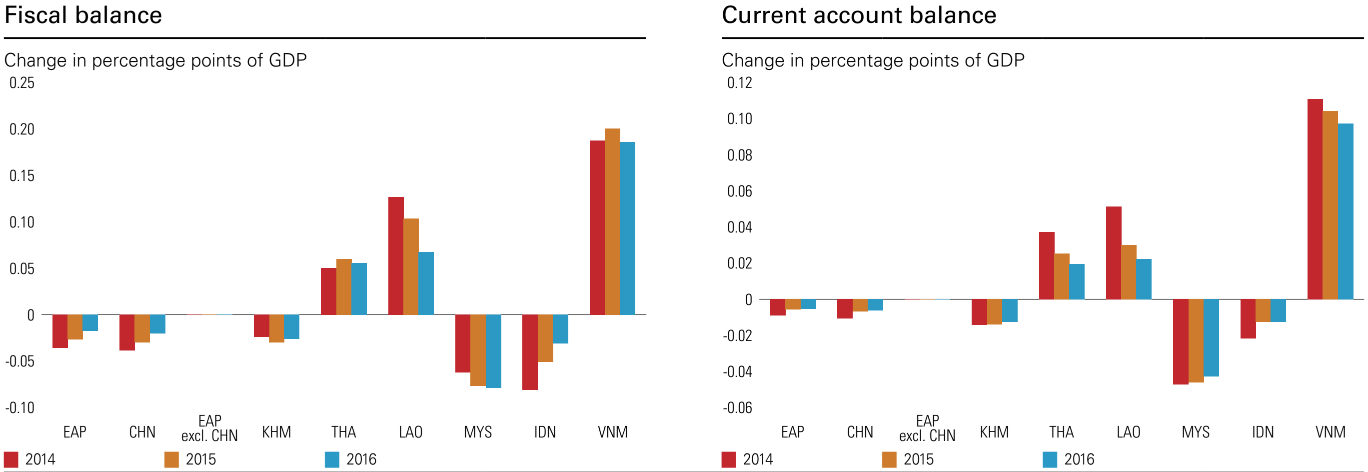
Fiscal balance | Current account balance



Source: Staff estimates.
Notes: Mongolia not included because of limited data availability.

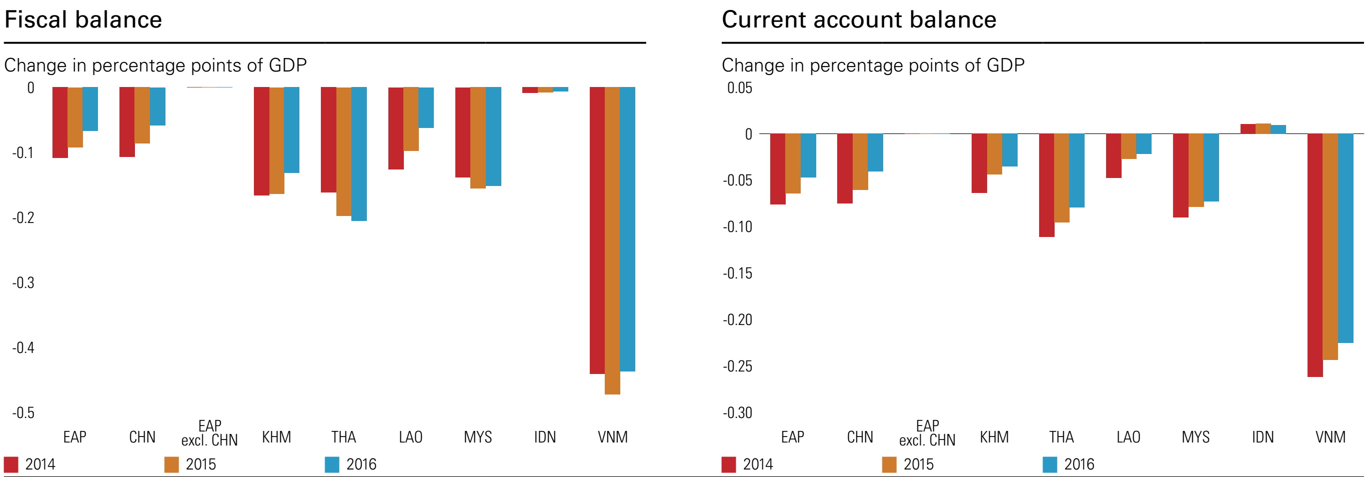
The regional outlook remains vulnerable to a sharp slowdown in China; spillovers could be especially large for commodity producers. A disorderly unwinding of local government financing in China could trigger a sharp slowdown in infrastructure investment. In addition, a steep decline in property prices could force developers and banks to deleverage quickly, and investment in real estate to contract sharply. These events

Figure 24. External and fiscal impact of a 10 percent increase in food prices



Source: Staff estimates.
Notes: Mongolia not included because of limited data availability.

Figure 25. External and fiscal impact of a 10 percent increase in metals prices



Source: Staff estimates.
Notes: Mongolia not included because of limited data availability.

would exert spillovers throughout the region, with especially large impacts on two groups of EAP countries. First, commodity exporters, including in particular metals exporters such as Mongolia, and coal exporters such as Indonesia.[36] Second, economies that are closely integrated into the regional value chain. Even holding commodity prices constant, a one-time 1 percentage point decrease in China's GDP growth relative to the baseline (reflecting a 2 percentage point decrease in investment growth) would reduce growth in the rest of the region by approximately 0.2 percentage points (Figure 26). The impact would be particularly large for Malaysia (0.29 percentage points), Thailand (0.26 percentage points), and Cambodia (0.21 percentage points).[37]

36 China accounts for almost 45 percent of global demand for metals, including copper and iron ore, whose use is linked predominantly to investment metal, and which are also used as loan collateral. It also accounts for ½ of global demand for coal, its prime source of industrial energy. In contrast, China accounts for a smaller 12 percent of global demand for oil, whose use is linked relatively more to consumption.

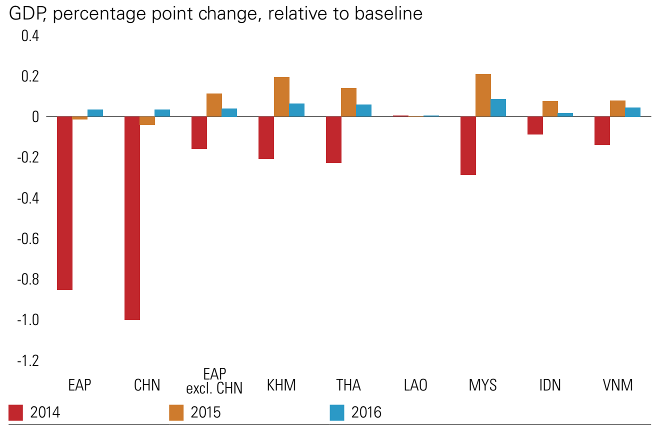
37 For broadly comparable estimates, see Ahuja and Nabar (2012), Duval et al. (2014), Gauvin and Rebillard (2013), International Monetary Fund (2013), and World Bank (2012, 2013b).

However, the likelihood of such an event remains low, given the significant room for fiscal maneuver in China. The authorities have the necessary buffers to prevent a disorderly unwinding of debt, including:

- **Fiscal buffers.** Total public debt is still moderate (55 percent of GDP). This provides sufficient fiscal space to deploy additional stimulus if growth were to slow sharply, and to bail out banks if nonperforming loans materialize.

- **Institutional buffers.** Sovereign debt is predominantly held domestically by a small group of institutions. Financial repression restricts savings instruments outside the banking system. The financial system is still predominantly state-owned. And capital controls on portfolio investment and bank lending prevent sharp outflows.

Figure 26. Regional spillovers from a 1 percentage point decrease in China's GDP growth



Source: Staff estimates.

Notes: Estimates based on the World Bank's Global Macro-Econometric Model, which provides detailed trade linkage data for 159 countries. Commodity prices are assumed constant. Mongolia not included because of limited data availability.

- **Exchange rate buffers.** Any spikes in demand for foreign currency could be met by central bank reserves, currently amounting to US$4 trillion, or 22 percent of broad money.

I.C. Policy Considerations

Bolstering Revenues and Rationalizing Expenditures Will Help Promote Priority Spending and Rebuild Buffers in the ASEAN-4

In the ASEAN-4 (Indonesia, Malaysia, the Philippines, and Thailand), measures to bolster revenues and rationalize expenditures will create space for productivity-enhancing investments and poverty-reducing programs; they will also assist in gradually reestablishing fiscal buffers. Improvements in the composition of public spending will help lift longer-term growth and development prospects. In particular, a reduction in wasteful and poorly targeted subsidies will create fiscal space for increased expenditure on priority areas, including infrastructure, human capital development, and targeted antipoverty programs. In addition, fiscal buffers were eroded by expansionary fiscal policies in response to the global financial crisis, and worsened in Indonesia by a terms-of-trade deterioration. While current fiscal deficit and public debt levels do not raise major sustainability issues, if there were an economic downturn public debt could rise rapidly, given the implicit guarantees to banking sectors. Over the longer term, gradually rebuilding fiscal buffers will therefore reduce vulnerability to shocks.

Priorities for Indonesia include bolstering revenue collection, and sustaining energy subsidy reforms while continuing to improve the targeting of safety nets and other antipoverty programs. Greater tax compliance would assist in raising tax revenues above the current, low 11.8 percent of GDP. Last year's increase in subsidized fuel prices temporarily checked the rise in energy subsidies and aided fiscal performance. However, the energy subsidy bill remains very large and sensitive to both an increase in international oil prices and a nominal depreciation. A reduction in these subsidies will open up fiscal space for critical infrastructure investment.

In Malaysia, recent steps to strengthen public finances constitute a promising beginning. Amid concerns about high federal government debt, the authorities have already taken the first steps to rationalize fuel subsidies, passed a law to introduce a goods and services tax in 2015, and continued to strengthen social safety nets. However, there is significant scope to continue enhancing the efficiency and equity of revenue and expenditure systems. Potential measures include further reducing dependence on oil revenues, and enhancing equity in the tax system, by reviewing the personal income tax and increasing contributions from property taxes; restraining public sector wage growth by introducing a medium-term expenditure framework; improving the targeting of social transfers; and monitoring and disclosing contingent fiscal liabilities, especially those arising from public-private partnerships.

Broadening the tax base is a priority in the Philippines. The authorities have set a revenue target of 16 percent of GDP for 2016, so as to support an increase in infrastructure spending to 5 percent of GDP, while maintaining the deficit at 2 percent of GDP. Tax administration reforms have yielded significant gains, but by themselves will prove insufficient to achieve this revenue target—far less the 20 percent of GDP in revenues thought necessary to finance essential public infrastructure and social programs.[38] Additional revenues will also

38 World Bank 2014b.

be needed to offset any future reduction in statutory tax rates. It is therefore critical to broaden the tax base and rationalize income tax incentives. A reorientation of spending toward more productive capital spending and toward social priorities, including primary education, universal health care, and conditional cash transfers, will help boost future productivity and greater inclusion in the growth process.

Thailand needs to pursue further fiscal reforms, following the scrapping of the rice-pledging scheme. Tax measures proposed by line ministries, which includes the revision of property income taxes, warrant serious consideration by the new government. Replacing generalized subsidies with targeted income support for vulnerable groups will reduce expenditure while enhancing equity. And greater investment in infrastructure and education will enhance growth prospects. That said, the proposed large transport and water infrastructure projects, with an estimated cost of over 20 percent of GDP (including the water projects that were proposed following the disastrous flooding in 2011), need careful scrutiny.

Fiscal Consolidation Will Help Safeguard Stability in the Smaller Economies, Including Mongolia and Lao PDR

In Mongolia, measures are urgently needed to reduce the deficit and ensure debt sustainability. A large amount of public capital spending is carried out off-budget by the Development Bank of Mongolia. Including such spending in the fiscal accounts raises the 2014 deficit to 7 percent of GDP—well above the statutory structural deficit of 2 percent of GDP. Relatedly, it is important to prioritize public investment projects, taking account of the constraints on the public sector's absorptive and implementation capacity.

In Lao PDR, fiscal consolidation is central to safeguarding debt sustainability and macroeconomic stability. Strict implementation of the announced measures will significantly improve fiscal sustainability.[39] Going forward, it is critical that a medium-term budget strategy be developed and implemented to support a more vigorous tightening and to ensure the overall deficit does not exceed 5 percent of GDP. Priorities include: continuing to increase tax collections; restraining future increases in public sector compensation, and implementing them more slowly; and carefully assessing the viability of large-scale projects. There is also significant scope to enhance public financial management capacity.

Vietnam needs a medium-term plan to reduce the fiscal deficit and public debt. In recent years, fiscal policy has been very expansionary; both the deficit and public debt are expected to increase further in 2014. Over the medium term, government revenues as a share of GDP are projected to continue declining, partly reflecting recent tax cuts. To ensure fiscal sustainability and promote inclusive growth, priorities include reducing deficits and rebuilding fiscal buffers, including through a broader revenue base and a strengthened tax administration; reorienting public expenditure toward high-quality public investment; targeting social spending, so as to increase the efficiency of the social safety nets, and continue the recent gains in poverty reduction as the country transitions further to a market economy; and raising the public resources needed to resolve banking sector nonperforming loans.

39 These measures included cutting capital and recurrent spending and stabilizing nominal wages in FY2013–14 fiscal year, and slowing civil service recruitment and limiting total spending growth in FY2014–15.

In Cambodia, further fiscal consolidation will help rebuild buffers and ensure fiscal sustainability. Improvements in revenue collection and prudent government spending have enabled continued strong fiscal performance. More measures are needed to rebuild government deposits, the only fiscal buffer in the absence of a domestic government debt market, and to ensure medium-term fiscal sustainability in light of the expected decline in grants. In particular, future public sector wage increases should be part of a broader civil service reform, and contingent liabilities related to public-private partnership projects need to be made transparent and managed carefully.

In Myanmar, it is critical to increase tax revenues. Revenues are temporarily high because of one-off receipts from the grant of telecommunications licenses. However, tax exemptions have increased, transfers to states and regions have expanded, and the government has resorted to external borrowing to finance off-budget operations. Increasing tax revenues will allow the underlying deficit to remain under 5 percent of GDP, while expanding development spending. The tax system should aim for low compliance and enforcement costs, and minimal exemptions. Reforms in tax administration are also needed. In addition, increasing the share of concessional financing will reduce interest expenditures.

Central Banks Need to Stand Ready to Tighten Monetary Policy in the ASEAN-4

In the ASEAN-4, the authorities need to stand ready to tighten monetary policy. Increases in policy rates may be required if inflationary pressures rise. Again, if the normalization of monetary policy in advanced economies proceeds faster than anticipated, or creates unexpected volatility in financial markets, the authorities may need to tighten monetary (and possibly fiscal) policy to reduce financing needs and attract additional inflows. Where adequate foreign reserves exist, these can be used to smooth the adjustment process. A loosening of restrictions on capital inflows, including FDI, would also help moderate the shock. In addition, countries with adequate policy buffers and enjoying relatively strong investor confidence may be able to engage in countercyclical macroeconomic and prudential policies where required.

In Indonesia, in particular, monetary tightening may be required if the balance of payments comes under renewed pressure. Monetary policy has already tightened significantly since last year. Nonetheless, the widening of the current account deficit in the second quarter points to continued underlying pressures. In the presence of external financing shocks, a smooth balance-of-payments adjustment will require both additional monetary tightening and continued exchange rate flexibility.

In Malaysia, the authorities need to remain attentive to inflationary pressures, while using macroprudential measures to minimize risks from elevated household debt. The monetary stance remains modestly accommodative even following a rate hike in July. The central bank's credibility should help maintain price stability. However, the incipient risks stemming from high household debt, elevated housing prices, and the bank system's significant exposure to the real estate sector may require additional adjustments to the policy rate and macroprudential measures. In Thailand, where growth remains fragile and inflation low, the focus likewise needs to be on macroprudential measures to tackle the risks posed by high household debt.

The need for accommodative monetary policy has waned in the Philippines. The central bank already raised policy rates in July, and has stirred speculation of an additional rate hike during the year. In the financial sector, where credit continues to expand in line with nominal GDP, sources of financing have become more diversified, and the authorities have accelerated the introduction of Basel III capital standards. Going forward, monetary policy needs to focus on stemming inflationary pressures and the emergence of excessive valuations for real and financial assets.

Monetary and Financial Tightening Will Reduce Risks from Excessive Credit Growth in the Smaller Economies, including Mongolia

It is critical for Mongolia to phase out its large monetary stimulus program, which is increasing inflation and distorting financial markets. The focus should instead be on strengthening the monetary policy framework, while increasing exchange rate flexibility. Pressing problems in the banking sector include a high and rising credit-to-deposit ratio, high loan concentration, high levels of dollarization, inadequate provisioning against rising nonperforming loans, and weaknesses in banking supervision. To address these, micro- and macroprudential measures are required, including strengthened bank provisioning and loan classification,[40] enforcement of existing prudential regulations (for instance, on related-party lending), and timely implementation of any required corrective actions.

Monetary tightening in Lao PDR will help support the exchange rate anchor. The commitment to a stabilized exchange rate, moving within a reasonably wide and adjustable band, has contributed to increased confidence and de-dollarization over time. However, maintaining the exchange rate anchor will require slower growth in broad money and credit. In this context, the central bank needs to raise policy rates and required reserves on local currency deposits, and accelerate the unwinding of quasi-fiscal lending. In addition, rapid credit expansion and possible currency mismatches on bank balance sheets may pose risks to financial sector stability. As a result, there is a need to raise banks' capital, increase compliance with macroprudential regulations, address supervisory weaknesses, and strengthen the financial stability framework.[41]

In Vietnam, bank restructuring is a priority, because the impaired banking sector hampers credit growth. Banks are cautious about expanding lending, despite accommodative monetary policy and growing deposits, as they continue to grapple with inadequate capital, poor asset quality, and weak governance. The Vietnam Asset Management Company has absorbed a large share of bad assets but has yet to advance a workable resolution plan, hampered by gaps in the country's corporate restructuring framework. Credit supply will remain significantly constrained without a comprehensive reform package, including in particular the financial resources and the legal cover needed to accelerate bank restructuring and the resolution of nonperforming loans.

In Cambodia, improvements in the monetary policy framework will help tackle macrofinancial risks. Vigorous, albeit decelerating, credit growth, together with the increased resort to foreign bank financing, pose substantial macrofinancial risks. These risks are heightened by the economy's high level of dollarization, which limits the effectiveness of monetary policy. The introduction of negotiable certificates of deposit is an important first step toward market-based monetary operations. Going forward, establishing an interbank and foreign

40 For instance, eliminating the preferential prudential treatment accorded to policy loans extended by the central bank.

41 The central bank has already asked commercial banks to provide foreign currency loans only to borrowers with sufficient foreign currency income.

exchange market will be needed to begin addressing dollarization, including by allowing more exchange rate flexibility.

In Myanmar, likewise, further action is needed to develop monetary policy tools. The expected introduction of Treasury bill and bond auctions in 2015 will help reduce the central bank's role in deficit financing. This will further strengthen the central bank's autonomy, and will also lay the basis for the eventual liberalization of interest rates. The proposed financial institutions law aims at comprehensive improvements in the regulatory landscape; these will be especially important in the context of the planned entry of foreign banks later this year. An increase in international reserves, while maintaining the exchange rate flexible, will help underpin macroeconomic stability.

In addition, the build-up in external debt in some of the region's small economies must be carefully monitored. In particular, in Lao PDR, defining and enforcing external borrowing ceilings for public projects will help maintain the risk of debt distress at moderate levels.

Reform of Local Government Finances and of the Financial Sector Is Vital to Address Medium-Term Risks in China

In China, the policy priority is to push ahead with structural reforms, so as to minimize medium-term risks to economic growth. In November 2013, the authorities announced a comprehensive blueprint for reform, the successful implementation of which will facilitate resource reallocation to high-return sectors and enhance the long-term sustainability of growth. The key underlying principles are to give markets a more decisive role in the economy; eliminate distortions in land, labor, and capital markets; and strengthen institutions and governance.[42] However, the blueprint lacks specifics on the reforms and on their timing and sequencing. In light of the growing economic imbalances, arising from the credit-fueled investment-led stimulus response to the global financial crisis, two reform areas stand out as candidates for early action: fiscal reforms to place local government finances on a more solid footing, and financial sector reforms to enhance the allocation of credit in the economy.

Strengthening local government finances will address risks arising from the rapid accumulation of debt by local governments, including through off-budget financing vehicles. Four reforms in particular are critical: improving local governments' revenue base; improving the intergovernmental grant system, by reducing the large number of earmarked transfers and moving to a need-based formula for general transfers; establishing an explicit framework for local government borrowing; and tightening the financial discipline of local governments. A recent pilot allowing 10 provincial and local governments to borrow directly from the market, under strengthened rules for creditworthiness and transparency, represents a step in the right direction. Mandates for local governments to adopt medium-term fiscal plans and to strengthen budget processes will improve the fiscal framework. Overall, these initiatives will better align local revenues and resources with expenditure mandates and responsibilities, and improve the management and oversight of local government borrowing.

42 See the April 2014 *East Asia Pacific Economic Update*, Part II.A, "China's Reform Roadmap" (World Bank 2014a), for details.

Financial sector reforms will help address risks arising from the rapid growth of credit, including credit from the less-well-regulated shadow banking system. These reforms are critical both to reduce financial vulnerabilities, and to support market-based investment and growth. Currently, the cap on deposit rates; the widespread implicit guarantees of savers, intermediaries, and borrowers; and the policy mandates on state banks contribute to distortions in the pricing of risk. With lending rates now liberalized, conditions are ripe for the next step, deposit rate liberalization. Relatedly, limited deposit insurance should be introduced as soon as possible. In addition, the scope of guarantees should be clarified, based on the principle that greater tolerance for defaults and bankruptcies will better foster credit discipline. Moreover, increasing the commercial orientation of state banks will promote efficient resource allocation and broaden the access of households and small enterprises to finance.

The above measures will need to be complemented with structural reforms to enhance productivity and growth. Last November's reform blueprint involves a range of measures that can meet this objective. The efficiency of China's economy would be improved by relaxing the entry of private firms into sectors previously reserved for state enterprises, improving the governance of state enterprises, and tightening their performance standards, including for financial performance. Reforming the business tax into a value-added tax (VAT), and making more land available for commercial activities, would further promote service-sector growth. The normalization of VAT export refunds would boost exports. Strengthening property rights to rural land would ensure its more efficient use, and reduce urban sprawl and the need for infrastructure investment; improving the compensation that farmers receive when their land is transferred to other uses would improve the distribution of income and wealth. And reforms in the household registration system would improve the allocation of labor across sectors and across the country, and boost consumer demand from migrants that permanently settle in cities.[43]

Structural Reforms to Enhance Export Competitiveness Will Help the Region Benefit from a Global Trade Recovery

For the other countries in the region, the priority is to increase their export competitiveness, so as to position themselves to benefit from the projected global recovery. As high-income economies pick up, their demand for imports will also increase. The extent of the gains for developing EAP countries other than China will depend on their capacity to respond, both by ramping up production, and by moving into new sectors and products. The need for export competitiveness will rise further, as the normalization of monetary policy in high-income economies results in a tightening of external financing conditions.

Moreover, over the medium term, China's continued development will place an even greater premium on other developing EAP countries enhancing their competitiveness. As productivity and wages continue increasing in China, it will move further up the value chain. This will create opportunities for lower-income countries to expand their labor-intensive manufacturing and to move into higher value-added products.

43 In preparation for these reforms, the authorities have already initiated the process of documenting farmers' land use rights, and have announced in the 2014–20 Urbanization Plan the specifics of a gradual reform of the household registration system.

Current trends suggest significant differences across countries in their ability to expand exports over time. Vietnam in particular has proved extremely successful in capturing global market share, diversifying into new sectors, and integrating into global value chains. Conversely, significant trade challenges have emerged in, for instance, Indonesia. This mixed picture underscores the need for measures aimed at enhancing the ability of the region's economies to integrate with the global economy. The remainder of this section highlights five key areas whose relative importance will vary across countries.

Institutional and structural weaknesses affect competitiveness across much of the region. Especially relevant here, in several countries a large number of inefficient border procedures (as captured by *Doing Business* indicators), and significant behind-the-border obstacles, result in regional trade costs well above those of the newly industrialized countries and of high-income economies.[44] Critically, this hampers trade in intermediate and capital inputs, restricting participation in global value chains. The barriers are especially acute, and growing in importance, in Lao PDR, the Philippines, Cambodia, and Indonesia. In contrast, Vietnam, Thailand, and Malaysia enjoy relatively low and falling costs. More broadly, much of the region is characterized by significant failings in government effectiveness, including low efficiency in policy formulation and implementation, and in regulatory quality, including the ease of starting a business and accessing credit (Box 3). Reforms in these areas raise the prospect of economy-wide gains, and may present a particular upside for exports, where the informal sector is relatively less important and regulations more binding.

Inadequate infrastructure significantly weakens logistical performance and export competitiveness in many countries. Within the ASEAN-5, the problem is particularly pressing in Indonesia, the Philippines, and Vietnam (Box 4). Elsewhere in the region, Myanmar, Mongolia, Lao PDR, and Cambodia all suffer from significant inefficiencies. As discussed, a key contributing factor is the widespread weakness in public investment management.

Restrictions on services trade and FDI hamper competitiveness, especially in the ASEAN-4. Professional services, transportation, telecommunications, and financial services are all critical inputs for other tradable sectors.[45] However, EAP imposes greater restrictions on trade in these services than most other developing regions, with particularly high barriers in professional services and transportation (Figure 27, left panel). The ASEAN-4, and in particular Indonesia and the Philippines, suffer from the greatest restrictions (Figure 27, right panel).[46] In contrast, Vietnam imposes somewhat smaller barriers, China has significantly liberalized transportation, and Mongolia and Cambodia have very low barriers in financial services and telecommunications. Relatedly, EAP and above all the ASEAN-4 impose more stringent de jure and de facto restrictions than any other developing region on FDI in services, including in particular business services, telecommunications, and transportation.[47] Removing all these restrictions would significantly reduce the price of services, with a major impact on export competitiveness.[48]

44 See the April 2014 *East Asia Pacific Economic Update*, Part II.B, "Trading Costs in East Asia" (World Bank 2014a), for details. For instance, implementation of the World Trade Organization's new *Agreement on Trade Facilitation* could conservatively expand East Asia's exports by 10 percent. In particular, improved governance and greater impartiality by border authorities could lower total trade costs by 2 percent, and the simplification of documents by a further 1.4 percent. That said, compared to other developing regions, the regulatory environment is still relatively favorable to international trade.

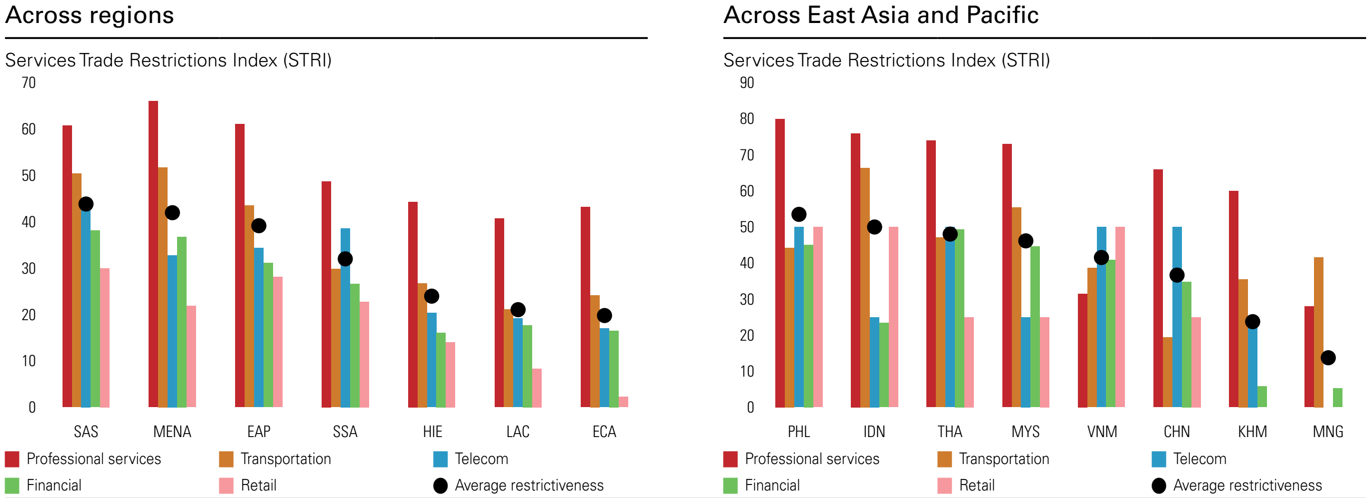
45 For instance, across ASEAN, services account for around 35 percent of the value of gross exports. Of this, around 20 percentage points reflect value added by domestic services industries, and 15 percentage points the imports of intermediate services (OECD TiVA database and World Bank staff estimates).

46 As discussed in the 2013 *ASEAN Integration Monitoring Report*, "progress in harmonizing regulations to address services trade barriers is the main pending agenda for regional integration". See also Borchert, Gootiiz, and Mattoo (2012).

47 Indeed, across a broad sample of advanced and developing countries, the Philippines and Indonesia have the greatest de facto restrictions on FDI in services, closely followed by Malaysia, China, and Thailand.

48 See the April 2014 *East Asia Pacific Economic Update*, Part II.C, "Foreign Direct Investment and Foreign Ownership Restrictions in ASEAN" (World Bank 2014a), for details.

Figure 27. Restrictions on trade in services, by sector



Source: World Bank *Services Trade Restrictions Database*: http://iresearch.worldbank.org/servicetrade.

Note: The database covers five major services sectors: (1) financial services: retail banking and insurance; (2) telecommunications: fixed line and mobile; (3) retail distribution; (4) transportation: air passenger, maritime shipping, maritime auxiliary, road trucking and railway freight; and (5) professional services: accounting, auditing, and legal services. These major sectors are subdivided into 19 subsectors. For each subsector, policy regimes are mapped into five categories and scores: completely open (0), virtually open but with minor restrictions (25), major restrictions (50), virtually closed with limited opportunities to enter and operate (75), and completely closed (100). Country-level indexes represent the mean score across all major sectors. Regional indexes represent the mean score across individual countries.

Human capital is critical to competitiveness; in this context, the region as a whole needs to shift its focus from raising access to education, where it has generally been successful, to developing more broadly the skills needed for labor market success. Upgrading workforce skills is particularly important when moving into more advanced sectors, or producing higher-quality goods. EAP has made significant progress in expanding access to education, although there are still large differences across countries. But this represents only a first step, as discussed in Part II.A, "Moving from Education to Skills in East Asia and Pacific." Countries must now focus on developing labor-market skills, including cognitive and noncognitive skills (behavioral skills, personality traits, and technical skills). Many education systems are not producing the skills demanded in the labor market, with the specific skills shortages differing by country and sector. A comprehensive skills development strategy must range from early childhood development (including early stimulation, nutrition, and health) to higher education and lifelong learning. It must also target those who are most disadvantaged. Primary and secondary education need to focus on quality and on learning outcomes, and on building effective educational systems based on autonomy and accountability. The relevance of higher education, vocational education, and training needs to be improved by giving institutions the capacity and incentives to meet labor market needs, and by increasing information about these needs and the quality of institutions.

Making effective use of migrant workers, particularly where complemented by effective skills-development strategies, can also assist in enhancing competitiveness. In labor-receiving countries in the region, such as Malaysia and Singapore, migrant workers make up a significant part of the workforce and help to meet acute labor shortages. As discussed in Part II.B, "International Migration and Development in East Asia and Pacific," the efficiency gains from migration will be maximized, and any adverse distributional implications mitigated, if labor-receiving countries focus on addressing market failures that prevent their own workers from upgrading their skills and engaging in more productive jobs. Such measures will ensure that their workers complement rather than compete with migrants, thereby also reducing social frictions. For labor-sending countries, improving the financial services available to migrant families will help enhance the long-term development impact of remittances.

For the Pacific Island Countries, Competitiveness and Better Living Standards Hinge on Enhancing the Effectiveness of the Public Sector

The Pacific Island Countries (PICs) face unique challenges, stemming from their small size, remoteness from major markets, and internal dispersion. These factors combine to push up the costs of both private production and public administration, and narrow the feasible set of economic opportunities. In this context, promoting growth and improving living standards implies three sets of priorities, as discussed in Part II.C, "Pacific Island Countries: Economic Prospects and Policy Priorities."

First, limited public sector resources should be focused on supporting those activities that have a real prospect of being competitive in global markets. In the context of the PICs, this includes minerals, fisheries and/or tourism, with agriculture and niche products playing a complementary role in some countries. The success of these sectors will depend on public action in three areas. The first is to provide the relevant infrastructure, including that required to connect firms to global markets, and the needed human capital. This needs to be complemented by facilitating business and trade, and solving coordination problems and other market failures, including by providing some public resources for industry-wide marketing and standard-setting. In addition, appropriate regulatory frameworks need to be implemented to maximize the returns from natural resources, distribute these equitably, manage their volatility, and protect against any adverse social and environmental impact of resource exploitation.

Second, the capabilities of the public sector need to be strengthened, including through long-term development assistance. These reforms should focus on finding innovative ways to perform public functions or deliver services in the unique and challenging context of PICs, including by adopting regional approaches to public regulation or service provision, and aligning regulations and sharing services with nearby large markets. Public financial management reforms that help strengthen expenditure quality and service delivery will deliver particularly high payoffs in an environment of constrained resources and capacity. That said, to fund an adequate range and quality of public services, taxation and natural resource revenues will have to be supplemented by long-term development assistance and capacity transfers from external partners.

Finally, these countries and their development partners need to work to increase migration options for Pacific Islanders. Expanded access to labor markets abroad should include greater access to industries requiring higher skill levels. To support this, it is essential to continue to invest in health and education, and to strengthen the fairness and transparency of worker selection processes.

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Part II. Medium-Term Development Agenda

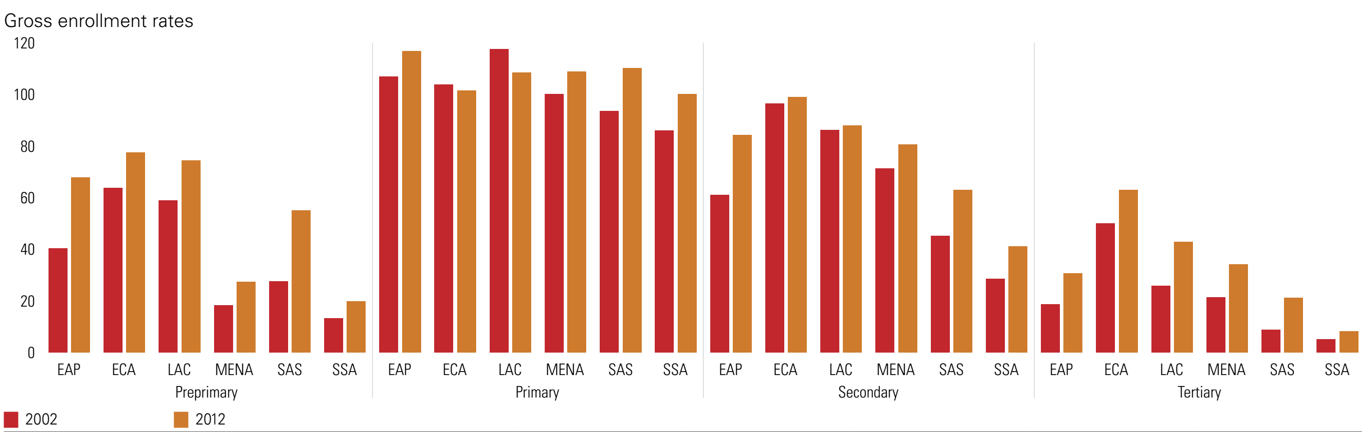
II.A. Moving from Education to Skills in East Asia and Pacific[1]

East Asia and Pacific has made significant progress in expanding access to education, although there are still large differences across countries. But this represents only a first step. Countries must now focus on developing labor market skills, including cognitive and non-cognitive skills (behavioral skills, personality traits, and technical skills). Many education systems are not producing the skills demanded in the labor market, with the specific skills shortages differing by country and sector. A comprehensive skills development strategy must range from early childhood development (including early stimulation, nutrition, and health) to higher education and lifelong learning. It must also target those who are most disadvantaged. Primary and secondary education need to focus on quality and on learning outcomes, and on building effective educational systems based on autonomy and accountability. The relevance of higher education, vocational education, and training needs to be improved by giving institutions the capacity and incentives to meet labor market needs, and by increasing information about these needs and the quality of institutions.

I. From Education to Skills: Why Skills Matter for all Countries

Access to education has expanded faster in East Asia and Pacific[2] over the last decade than in most other regions. Enrollment rates in primary education were mostly universal a decade ago and have continued to increase, especially in low- and lower-middle-income countries in the region. Enrollment rates in secondary education increased by an impressive 27 percentage points, bringing the region close to levels observed in Europe and Central Asia and Latin America, after starting from a much lower base. Although the region has

Figure 1. Gross enrollment rates by region and level of education, 2002–12



Source: Edstats.
Note: Statistics are presented for all countries in each region (including developing, newly industrialized, and high-income economies).

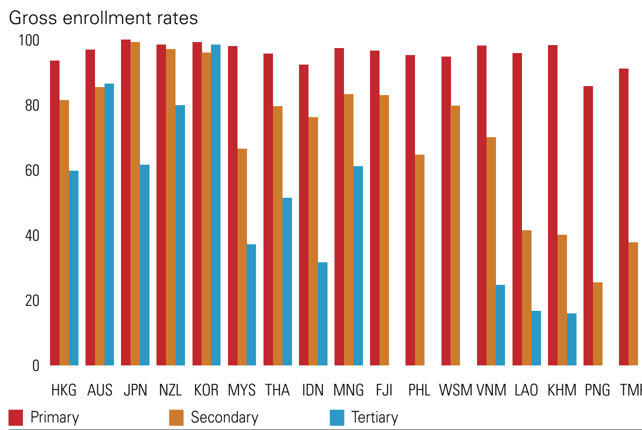
1 This note was prepared by Pedro Cerdan-Infantes, Education Economist, World Bank Education Global Practice (GEDDR).

2 Throughout this note, "East Asia and Pacific" also includes Japan, Australia, and New Zealand.

made great strides in improving access to tertiary (higher) education, and the sector continues to expand, gross enrollment rates are similar to those in the Middle East and North Africa region, but still relatively low compared to Latin America and Europe and Central Asia. Access to preprimary education is high and enrollments are rapidly increasing in the region (the net enrollment rate increased from 40 percent to almost 70 percent in 10 years) (Figure 1).

While access to education is high in the region as a whole, it varies significantly among countries. These differences map closely, but not exactly, to the differences in the level of income of countries in East Asia and Pacific (Figure 2). On the lower end of the income distribution, Myanmar and Timor-Leste are struggling with getting students to complete primary school, with net enrollment rates of around 90 percent. They are not alone, since some lower-middle-income countries (notably the Lao People's Democratic Republic, the Philippines, and Indonesia) have net primary enrollment rates that are below 95 percent. These same lower-middle-income countries also show relatively low access to secondary education. Access to tertiary education remains a challenge for most non-high-income countries in the region. High-income countries (Republic of Korea, Japan, and Australia), however, show some of the best indicators in both access to and, as we shall see, quality of education in the world.

Figure 2. Gross enrollment rates in primary, secondary, and tertiary education by country, 2012



Source: Edstats.

Notes: Countries are ordered by GDP per capita (current purchasing power parity). Data for Fiji, the Philippines, and Samoa are not available.

There are strong signals that the demand for skilled workers is high in most low- and middle-income economies in the region, and this demand will most likely continue to increase in the near future. The dynamism of the region's economies (especially middle-income economies) is creating a demand for skilled workers that is outpacing the increase in their supply (di Gropello and Sakellariou 2010). Even in countries such as Indonesia, the Philippines, and Thailand, where the number of people in the labor force with completed postprimary education (secondary and above) grew by well over 100 percent over a decade, the skill premia for postprimary education (the additional income associated with a given higher level of education[3]) remained largely constant or increased slightly (Figure 3). In other countries, such as China and Vietnam, the demand for skilled workers is so high that even with large increases in the number of educated workers, skill premia have continued to increase. In countries with slower improvements (or declines) in the educational attainment of their labor force, such as Mongolia and Cambodia, these skill premia have skyrocketed, suggesting that there is a large unmet demand for skilled workers. While country- and sector-specific trends likely differ across countries, these signs suggest that there is room for further expansion of enrollments in most low- and middle-income countries and, in many cases, strong arguments for accelerating enrollment growth.

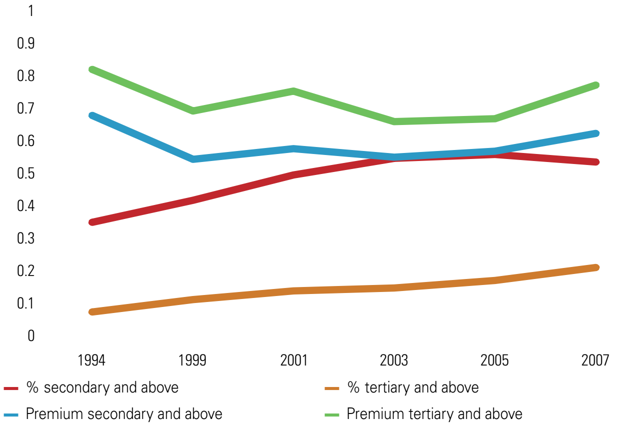
Improving enrollments in most countries means reducing early dropout. Almost all children start primary school, but many still drop out before completing primary school in low-income countries (LICs) and some lower-middle-income countries (LMICs). In 2011, there were still over 14 million school-aged children

3 The skill premium is a good measure of the demand for more educated workers. When the demand for skilled workers outpaces the supply, the skill premium tends to increase, whereas the opposite is true when demand does not keep up with supply.

Figure 3. Changes in skill composition of labor force and in skill premia, for selected countries in East Asia and Pacific

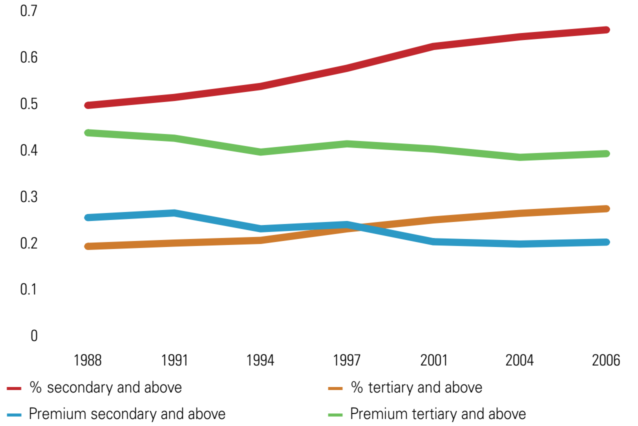
Indonesia

Skill premium and proportion of skilled workers



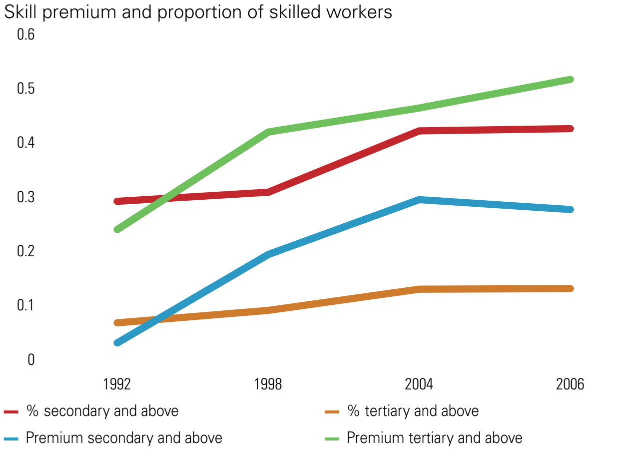
Philippines

Skill premium and proportion of skilled workers



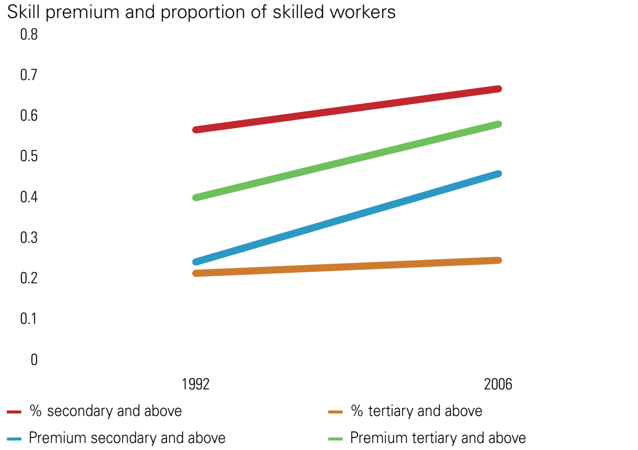
Vietnam

Skill premium and proportion of skilled workers



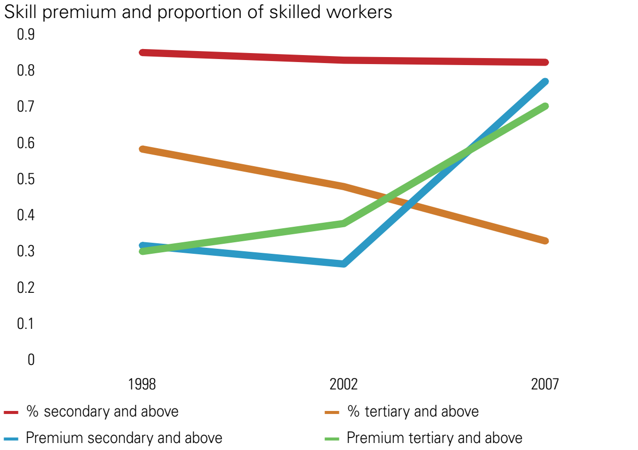
China

Skill premium and proportion of skilled workers



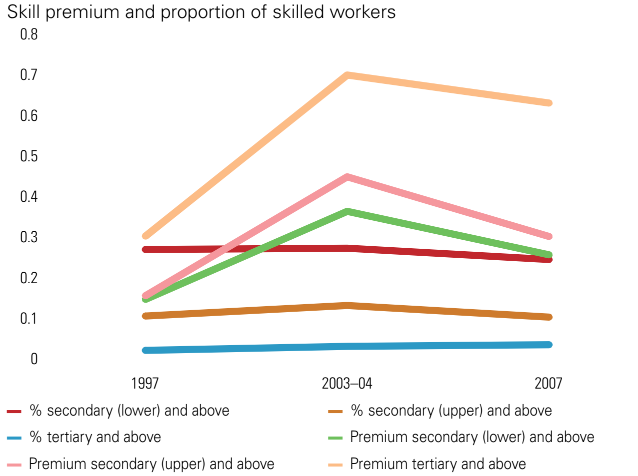
Mongolia

Skill premium and proportion of skilled workers



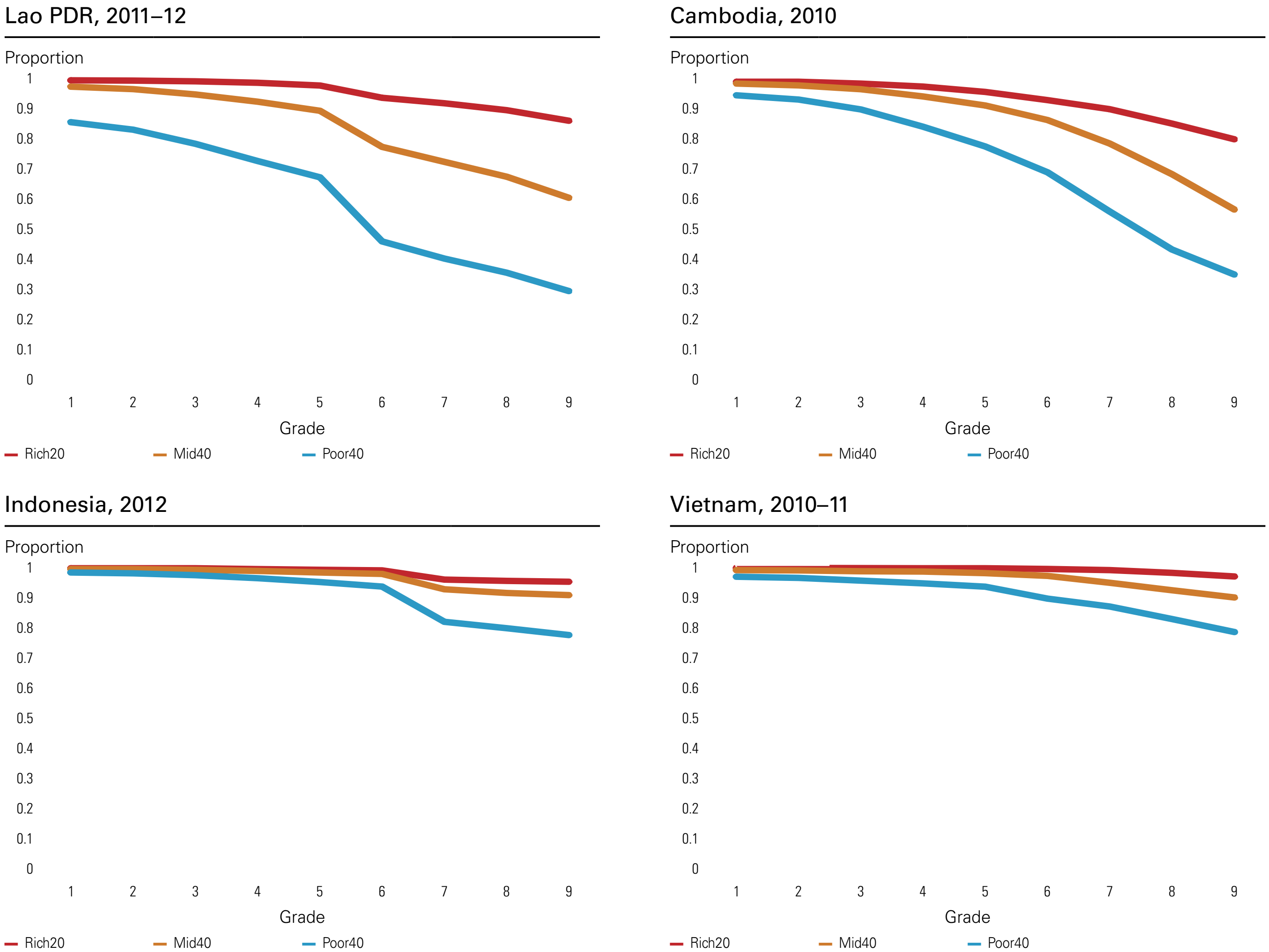
Cambodia

Skill premium and proportion of skilled workers



Source: di Gropello and Sakellariou 2010.

Figure 4. Grade survival profile in selected countries by wealth and gender, ages 10–19, 2012



Source: Enrollment profiles around the world, World Bank.

not enrolled in education[4] in the region, mostly due to early dropout (as opposed to never enrolling). Grade survival profiles, which display the probability that a student with given socioeconomic characteristics will complete a given grade, provide valuable information about when dropout happens (Figure 4). For instance, in Lao PDR, which just joined the lower-middle-income category, over 10 percent of students drop out in their first year of school, and they are virtually all from the poorest 40 percent of the population. In Cambodia, dropout is also driven by the poorest 40 percent, but it occurs later. In Indonesia and Vietnam, both lower-middle-income countries, early grade dropout is much lower, with most children completing grade 5, even if they come from the poorest 40 percent.

In middle-income countries, the challenge is generally the transition between levels of education, with the poorest significantly more likely to drop out during this transition. When looking at the grade survival profiles, it is typical to see larger drops in the probability of completing a grade in the transition between levels. For instance, in Indonesia, over 90 percent of students from the poorest 40 percent of the population complete

4 Source: Edstats. This includes primary- and lower-secondary-aged children. The age of entry and the length of primary and lower secondary differ by country, but this corresponds roughly to children aged 6 to 15.

the 6th grade, but less than 80 percent completes the 7th grade. In Vietnam, this transition is smoother, but the drop also occurs at the end of primary school. The drop is much sharper in lower-income countries, especially for the poorest. In Lao PDR and Cambodia, while virtually all students from the richest quintile complete 5th grade, only two-thirds of the poorest 40 percent complete 5th grade and less than 40 percent complete 6th grade. As a consequence, only about one-third of students from the poorest two quintiles complete 9th grade.

In some cases, the jump in cost from attending basic education to attending secondary education (or upper secondary), which tends to be more reliant on school fees, is a determinant factor of this dropout. For example, in Indonesia, the cost of schooling quintuples between basic and senior secondary school (World Bank 2012a, 2012b). However, this is not the only reason for dropping out. In a multitude of surveys and reports,[5] distance to school, the opportunity cost of attending school because of employment opportunities, the low perceived returns to education, the low quality of education, and even health issues are cited as reasons for dropping out.

In middle-income countries, the challenge continues to be tertiary education. Most middle-income countries in the region still have low enrollment rates in tertiary education. In Malaysia and Indonesia, less than 40 percent of 19-to-22-year-olds are enrolled in tertiary education. The share is higher in Thailand (50) and Mongolia (60 percent), but the rest of the countries in the region have significantly lower enrollment rates in tertiary education. While this challenge is not unique to East Asia and Pacific, higher education generally plays a major role in the transition between middle- and high-income status for countries (World Bank 2013c), so increasing access to, and improving quality and relevance of, higher education should be a priority in most middle-income countries in the region.

In summary, access to education is improving rapidly in East Asia and Pacific, but the high demand for educated workers means there is significant room for expansion. Countries at all levels of development are making important efforts to continue to expand access to education. Poorer countries are still struggling to provide universal access to primary education, mainly because of high early grade dropout, but most of these countries are implementing policies to improve retention (expanding access to early childhood development to improve school readiness, improving early grade literacy, increasing scholarships or stipends). Some middle-income countries still have low secondary school enrollment, mainly because of high dropout between levels of education. To increase secondary enrollment, countries are expanding and increasing public investment in education systems, sometimes making senior secondary education compulsory, as in the case of the Philippines and Indonesia. Increasing enrollments and retention in basic and secondary education should be a first priority in low- and lower-middle-income countries, since this is necessary to expand the tertiary education system in an equitable way. Finally, countries expanding access to tertiary education are doing so through the provision of well-targeted scholarships, and by expanding and improving the financing of tertiary education.

However, ensuring that all children enroll and remain in school represents only a first step; what they learn is even more important. The agenda on education does not end with access; ensuring that all children learn while in school is the ultimate goal.[6] Evidence is mounting on the importance of actual learning for a range of outcomes, from labor market success to economic growth, and on the importance of noncognitive (social and behavioral) skills. This evidence is starting to reshape the focus of education systems in the region away from *access for all* to *learning for all*. This is a fundamental shift for most countries, especially low-income

5 See Filmer (2004); Gomes-Neto et al. (1997); Hanushek, Lavy, and Hitomi (2006); and Jensen (2010).

6 See Pritchett (2013) for an extensive summary of existing literature on the importance of the quality of education.

and lower-middle-income countries. It requires a move from traditional policies that were designed to provide enough inputs to ensure children had access to a school with adequate teachers and materials, to policies that seek to change what happens in the school and the classroom to ensure learning. And although still in the early stages, there are reasons for this shift to go farther, to a focus on *the right skills for all*.

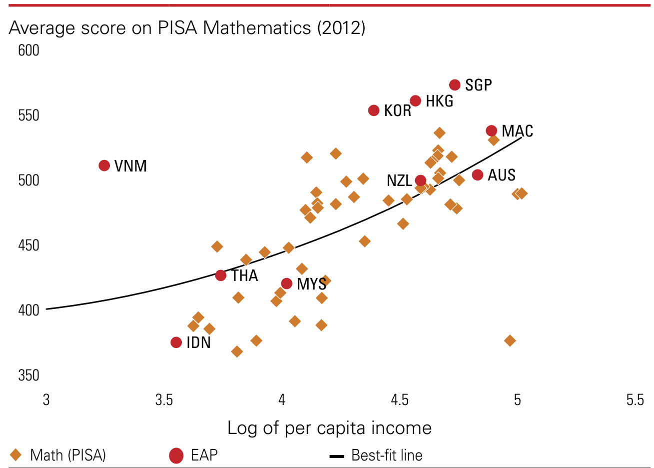
Years of Education are Not Enough; Actual Skills Matter

Learning outcomes, rather than merely the years of education completed, affect labor market success, future income, and economic growth. It is a well-established fact that completing years of education yields returns in the labor market in most economies in the world.[7] However, evidence is growing that what students actually learn, so far measured by tests focused on cognitive skills, also matters both for private returns to education and for economic growth (Hanushek and Wößmann 2008, 2012; Heckman, Stixrud, and Urzúa 2006; Urzúa 2008). Basic cognitive skills such as reading, writing, and mathematics, which are mostly acquired through the formal educational system, influence academic achievement, labor market outcomes, and other social behaviors of workers. This influence goes beyond that of years of education; workers with the same degree but a higher level of skills get compensated with higher salaries in the labor market, and these effects add up to faster growth when a significant share of workers has better skills.

East Asia and Pacific includes the best-performing countries in the world in international learning tests, but the quality of education is still generally low in most non-high-income countries. There is a dichotomy in performance within the region (Figure 5). The five highest-performing countries or territories in the Organisation for Economic Co-operation and Development's (OECD's) most recent Program for International Student Assessment (PISA) 2012 are in East Asia and Pacific (Shanghai, China; Singapore; Hong Kong SAR, China; Korea, and Macao SAR, China). Vietnam's impressive results make it the best-performing middle-income country and ahead of many OECD countries. Other middle-income countries participating in PISA, such as Thailand, Malaysia, and especially Indonesia, however, are in the lowest part of the distribution, with an average score lower than expected given their income level (Patrinos 2012).

When translating the average scores into levels of student competencies, the need to focus on improving learning outcomes becomes more evident. PISA mathematics scores can be divided into six levels of competency, and the OECD categorizes those below level 2 as functionally illiterate, meaning that students can at most do "very direct and straightforward mathematical tasks, such as reading a single value from a well-labeled chart or table," much less apply what they learn to real-life situations. When breaking down the test takers in various countries by level of proficiency, the picture is grim for middle-income countries in the region. For example, in Indonesia, the majority of 15-year-olds

Figure 5. Average mathematics score in PISA compared to GDP per capita, 2012

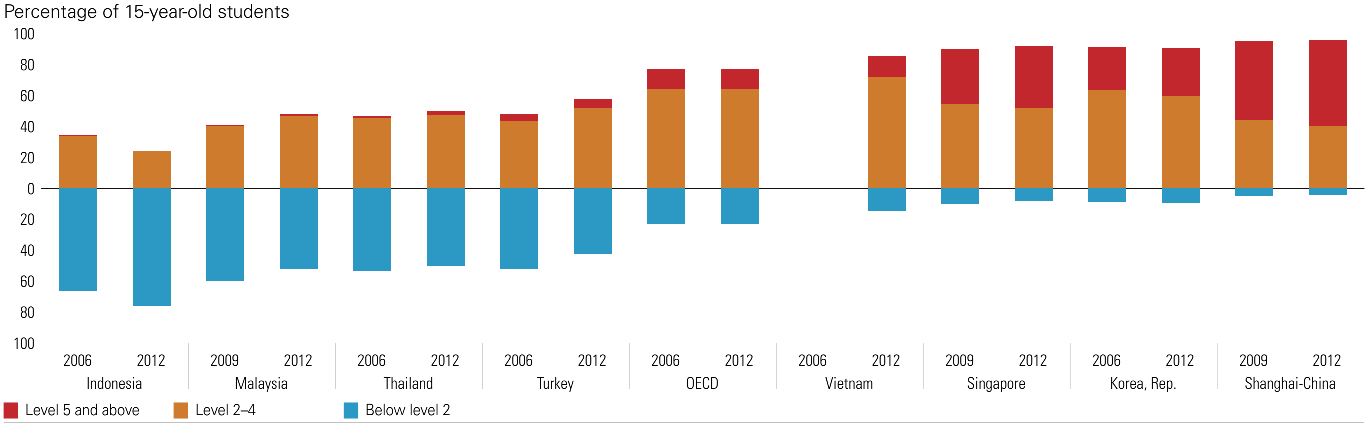


Sources: PISA, Edstats, and World Development Indicators.
Notes: Countries in East Asia and Pacific are indicated in red.

7 Montenegro and Patrinos (2013) include references to many studies, in addition to calculating updated returns to education for 131 countries.

fall below level 2 proficiency (Figure 6). Significantly, the percentage of students in the top level in Indonesia is negligible. In Thailand and Malaysia, about half of students are in the very-low-performing category, with both countries having a small (but significant) percentage of high performers. This is in clear contrast with high-income, high-performing countries in the region; in Korea and Singapore, less than 10 percent of students perform below level 2, while more than 40 percent perform at level 5 or 6.[8]

Figure 6. Share of students by level of competence in PISA, 2012

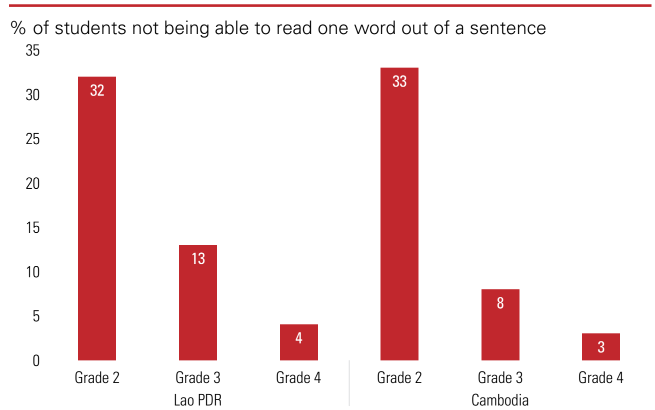


Sources: OECD, PISA 2006 and 2012. Data extracted from Edstats.
Note: Data for Vietnam for 2006 are not available.

While internationally comparable tests do not exist in most low- and lower-middle-income countries, there are indications that they are struggling with the quality of education from the early grades. The recent Early Grade Reading Assessments (EGRA) conducted in some countries in the region confirm the perception that quality of education is low. The tests, which measure a wide range of fluency and comprehension when reading and listening in the early grades, indicate that a significant share of students reach 3rd grade not being able to identify a single word. In Lao PDR (Figure 7) and Cambodia, almost a third of students at the end of 2nd grade, and from 8 to 13 percent of students at the end of 3rd grade, cannot read a single word from a passage. In addition, of those who read at least one word, a high percentage (almost 60 percent in 2nd grade) cannot correctly answer any questions about what was read. Similar assessments in Vanuatu and Tonga carried out in 2009 show low levels of reading, with about 30 percent of students not being able to read a word or, in the case of Tonga, identify letters (World Bank 2013d, 2013e).

The focus on the quality of education and what students learn is relevant to countries in all stages of development. The level of cognitive skills a country should aim for differs across stages of development, but the focus on learning is valid for

Figure 7. Share of students scoring zero in fluency and comprehension in Lao PDR, 2012



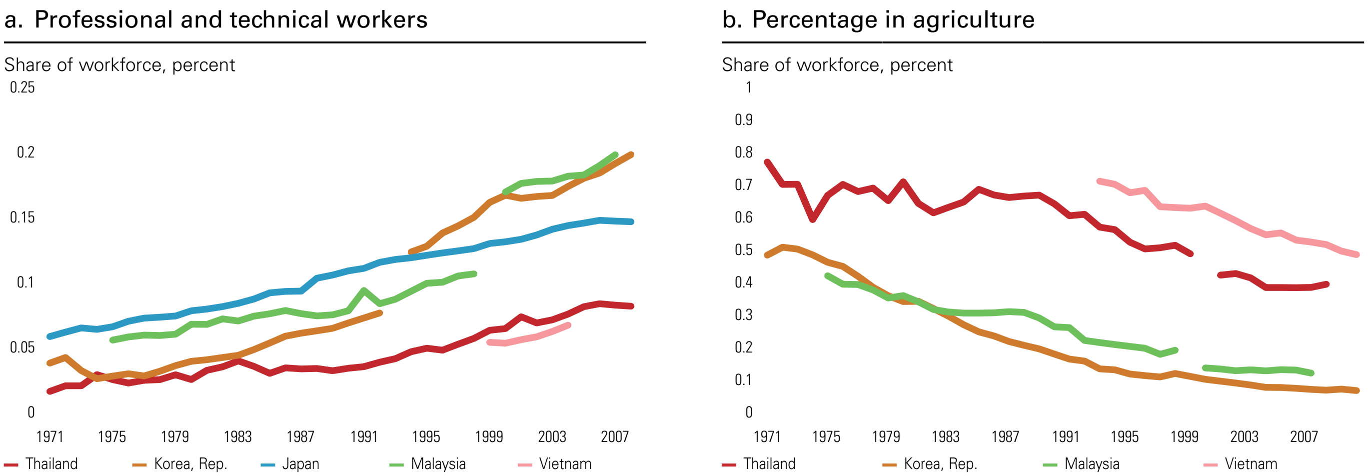
Sources: EGRA in Lao, PDR; World Bank (forthcoming); and preliminary results from EGRA in Cambodia.
Note: EGRA tests are not comparable across languages. The results for Lao PDR and Cambodia are presented in the same figure for illustrative purposes, but the percentage of students scoring zero may have different interpretations in each context.

8 Test results for science and for language follow similar patterns. This note does not discuss the recently released PISA report on "creative problem solving" (OECD 2014), since it does not cover many countries in the region, including Indonesia, New Zealand, Thailand, and Vietnam.

all countries. In largely agricultural economies, workers need strong basic skills to benefit from the growth in nonagricultural employment that is usually linked with economic growth in these countries. In both Lao PDR and the Solomon Islands, for example, the low level of basic skills in the labor force is preventing faster economic transformation and preventing the poor from benefiting from the strong growth the country is experiencing (World Bank, forthcoming). In middle-income countries, more complex cognitive skills are needed to avoid the "middle income" trap (Jimenez, Nguyen, and Patrinos 2012). In high-income countries, highly complex cognitive skills are crucial to stay at the innovation frontier. The types of jobs and the types of skills demanded in the labor market become more complex as countries develop, but strong basic cognitive skills are needed at any stage of development.

Development in the region has traditionally been accompanied by movements from agriculture into more productive sectors and activities. These shifts can happen relatively quickly if the right conditions are in place. For example, the share of the workforce employed in agriculture in Korea, Thailand, Malaysia, and Vietnam has seen a long-term decline (Figure 8, panel A), but the initial shift in Korea happened fast. While approximately 50 percent of Korea's workforce was employed in the agricultural sector in 1970, this figure had halved to 25 percent by the mid-1980s. Likewise, in Thailand the share of agricultural employment dropped from nearly 80 percent in 1970 to approximately 40 percent in 2010.

Figure 8. Structural transformation in selected East Asia and Pacific countries



Source: World Bank 2013a.
Note: In panel B, "Professional and technical occupations" include mechanical, civil, and other engineers; chemists; doctors; lawyers; technicians in IT and science; teachers; and accountants.

The sectoral transformation has been accompanied by a shift to more skill-intensive jobs. In Korea, Malaysia, and Thailand, the share of white-collar workers expanded over time (Figure 8, panel B). Similar, but less pronounced, increases were seen in the fraction of clerical ("pink-collar") workers, such as receptionists and librarians. Skilled white- and blue-collar occupations dominate the manufacturing sector employment in these more developed East Asian economies today. In Thailand in 2010, approximately 10 percent of workers in manufacturing did elementary unskilled work, while 27 percent were machinery operators and 45 percent were craftsmen.

Having a workforce ready to embrace these new types of jobs requires prioritizing the quality of education early on. Education reforms are usually complex and take a long time to show results. In addition, because of the relatively low flow of new graduates compared to the stock of workers, changing the skill composition of the labor force through education takes an even longer time.

Cognitive Skills are Not Enough

More complex jobs require, in addition to traditional cognitive skills (numeracy and literacy), a complex mix of skills, including higher-level cognitive skills (such as problem solving and creativity), as well as social, behavioral, and technical skills.[9] The skill content of jobs changes as countries develop, with the demand for analytical and interpersonal skills growing at the expense of the demand for manual skills. Jobs that are nonrepetitive or nonroutine in nature, in other words jobs that involve conducting different tasks on a regular basis, tend to expand, while those jobs that require the worker to do the same tasks or movements all the time decline. This shift brings along a shift in the *types of skills demanded* (Figure 9). Social and behavioral skills, such as conscientiousness, openness, agreeability, and technical skills become more important for success in the labor market. In employer surveys conducted with the support of the World Bank in many countries in the region,[10] employers consistently rank skills like problem solving, conscientiousness, ability to work in teams, or openness as very important when looking for an employee. The precise skill mix depends on the country, type of firm, and sector, but the importance of noncognitive skills is consistent across countries and sectors.

Figure 9. Types of skills demanded in the labor market

COGNITIVE	SOCIAL and BEHAVIORAL	TECHNICAL SKILLS
Involving the use of logical, intuitive and creative thinking	Soft skills, social skills, life-skills, personality traits	Involving manual dexterity and the use of methods, materials, tools and instruments
Raw problem solving ability vs. knowledge to solve problems	Openness to experience, conscientiousness, extraversion, agreeability, emotional stability	Technical skills developed through vocational schooling or acquired on the job
Verbal ability, numeracy, problem solving, memory (working and long-term) and mental speed	Self-regulation, perseverance, decision making, interpersonal skills	Skills related to a specific occupation (e.g., engineer, economist, IT specialist, etc.)

Source: Pierre et al. 2014.

These noncognitive skills are not only sought after by employers, but they yield returns in the labor market beyond those of education and cognitive skills, even for informal workers. In the employer surveys, job-specific technical skills are consistently ranked as one of the most important traits when looking for a new employee, but employers also value employees who are able to think critically and creatively and who are able to solve problems. As countries develop and jobs become more complex, the reported frequency of use of these higher-order cognitive skills (such as problem solving and learning new skills) increases.[11] In Vietnam, 70 percent of managers and 60 percent of professionals report using problem-solving skills at least once a month (with 30 percent using them every day), whereas less than 20 percent of service and sales workers report using them at least once a month (less than 5 percent every day). At the other end of the spectrum, in Lao PDR, even educated workers report rarely using literacy at work,[12] though numeracy skills are used more often. Although the relative importance of different social and behavioral skills varies across countries, types

9 Autor, Levy, and Murnane (2003) document the increasing role of nonroutine analytical and nonroutine interactive tasks in the U.S. labor market, requiring higher levels of cognitive skills (like problem solving to tackle nonroutine tasks) and interpersonal skills (to deal with increasing human interaction). The methodology has been used in a multitude of countries to show the same result (see, for instance, Aedo et al. 2013; Aedo and Walker 2012; and Arias et al. 2014, chapter 3).

10 With the support of the World Bank, employer skill surveys have been carried out in Indonesia (2008); the Philippines (2010); Lao PDR (2012); Vietnam (2012); and Yunnan Province, China (2012).

11 For an overview of the literature on the changing nature of skills used in the workplace and an empirical analysis of the skills used in the workplace in Vietnam, see World Bank (2013a, chapter 2).

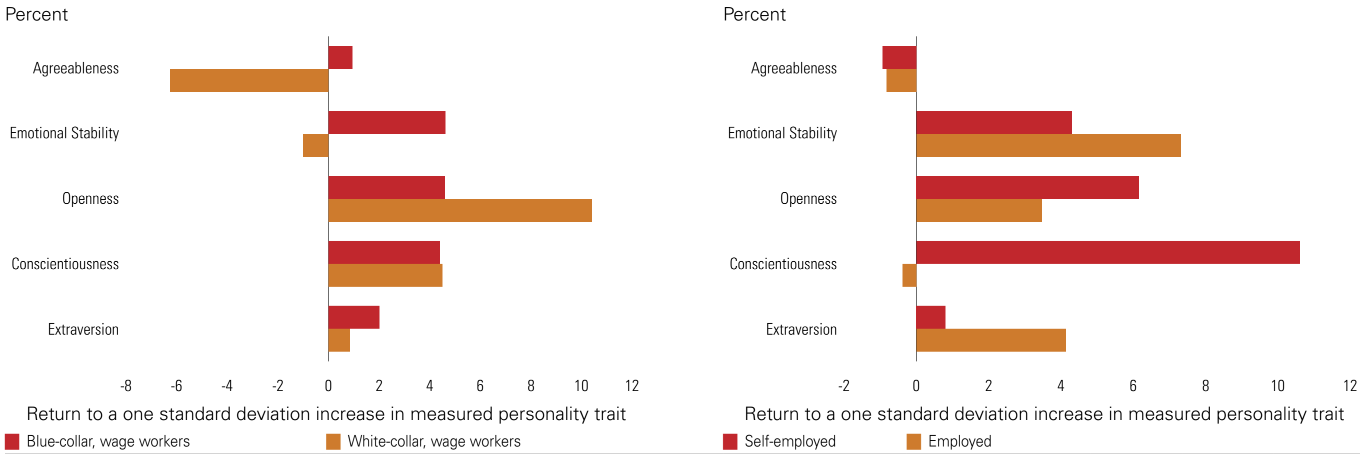
12 More than 80 percent read or wrote less than five pages in the last 12 months as part of their jobs.

of jobs, and sectors, conscientiousness is consistently the most sought after behavioral skill by employers. This quest for social and behavioral skills is evident in their returns to the labor market; conscientiousness (also known as grit) has large positive returns in the labor market in both Vietnam (Figure 10) and Lao PDR,[13] for blue-collar and white-collar workers and in the informal sector.

Figure 10. Returns to social and behavioral skills in Vietnam

a. Returns to social and behavioral skills by occupation type

b. Returns to social and behavioral skills by wage employment



Source: World Bank 2013a.

Note: World Bank staff estimates of returns to monthly incomes among highly skilled and less-skilled employed wage workers (panel A) and self-employed and employed wage workers (panel B). The reported results are from a Mincer earnings regression that controls for demographics, cognitive skills, and education. Reported standard errors are jackknifed and bootstrapped, and outliers are eliminated using a robust regression technique based on Cook's distance measure.

The region is rapidly becoming more educated, but this may not be enough if graduates are not equipped with the right skills when they graduate. This section argued that basic cognitive skills are fundamental in every context, and as jobs become more complex, a more complex mix of higher-order cognitive skills and technical and behavioral skills becomes more important. However, ascertaining the precise skills in demand and the emerging skill gaps is a challenging task, and the answers will be country specific. The next section asks whether educational systems are actually producing graduates with the right skills, after which a framework will be presented to develop comprehensive skills strategies.

II. Are Educational Systems Producing Graduates with the Right Skills?

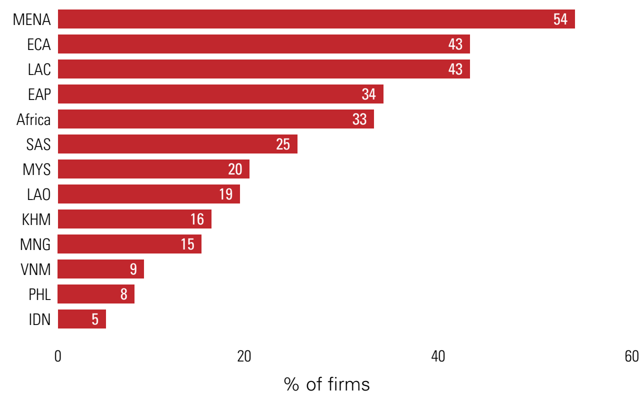
Skills shortages and mismatches have emerged as a major concern for firms in low- and middle-income countries in the region. On average, 34 percent of the firms in the region identified an inadequately educated workforce as a major constraint (Figure 11). The percentage falls below that of the Middle East and North Africa, Eastern Europe and Central Asia, and Latin America and the Caribbean. Among East Asian countries, over 15 percent of the firms in Malaysia, Lao PDR, Cambodia, and Mongolia identify the education and skills of their workforces as major constraints. Over 35 percent of the firms in Malaysia and over 15 percent of firms in Lao

13 See World Bank (2013f, section 1.3.3.1).

PDR cited an "inadequately educated workforce" as their biggest obstacle. In comparison, skills shortages are less severe a constraint for business growth in Indonesia, the Philippines, and Vietnam.

Even when employer surveys identify skills shortages, the reasons for those shortages may vary. *Occupational shortages*, where certain occupations do not have enough qualified applicants, may be the result of a dynamic economy where occupations are changing rapidly, or may stem from an unresponsive postbasic education system.[14] The responsibility for *skills gaps*, where there are enough applicants with the right level of education but who lack the specific skill mix required for the job, is, however, more likely to fall on the failure of education systems to provide these skills.

Figure 11. Percent of firms identifying an inadequately educated workforce as a major constraint



Source: International Finance Corporation Enterprise Surveys; www.enterprisesurveys.org

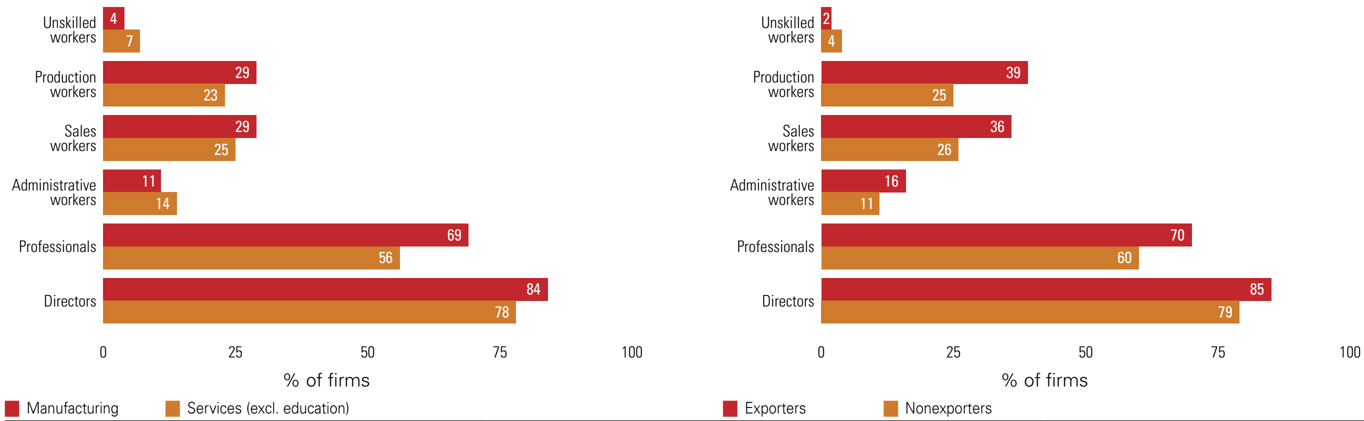
The nature of skills mismatches is country and even sector specific, and systematically measuring the *supply of skills* of the labor force and the *skills demanded* by employers is crucial to devise policies to reduce such mismatches. Several initiatives go beyond employer surveys to measure the actual skills of the labor force, but they vary in comprehensiveness and do not yet cover many countries. The OECD's *Program for the International Assessment of Adult Competencies* and UNESCO's *Literacy Assessment and Monitoring* program focus on the cognitive and technical skills of the population, whereas the World Bank's *Skills Toward Employment and Productivity* (StEP) surveys aim to provide a more comprehensive picture of the supply of and the demand for skills, including through employer surveys.[15] These initiatives serve different purposes, but they all contribute to a better understanding of the skills of the labor force. Regardless of the specific tool used, designing policies to solve skills mismatches is greatly facilitated by measuring them, so expanding the use of these tools will be important for the region.

Whatever the nature of the precise mismatches in each country, skills constraints may exacerbate as the region grows and integrates. Firms that are integrated into global markets and that adopt new technologies are more likely to perceive skills shortages and face difficulties in filling job vacancies (holding working conditions and wages constant) (Almeida, Behrman, and Robalino 2012). This is particularly true among middle-income countries. Country-specific studies in East Asia have examined the skills gaps and mismatch in depth. In the Philippines, employers are taking more weeks to fill professional positions compared to China, Malaysia, and Thailand (di Gropello, Kruse, and Tandon 2011). The service and manufacturing sectors, particularly the export sector and the chemicals, trade, and finance subsectors, are facing difficulties finding the right skills for their jobs. In Indonesia, skills gaps and mismatches have become a particularly salient issue for larger, export-oriented manufacturing firms (Figure 12). Finding director- and professional-level candidates for jobs is perceived to be difficult by the majority of employers surveyed. The widest gaps are for English and computer skills, followed

14 This seems to be the case in, for example, Indonesia. As Cerdan-Infantes and Mileiva (forthcoming) note, despite the oversupply of teachers and the undersupply of other occupations (such as engineers), the isolation of the tertiary education system from the labor market results in a continued growth of teacher training colleges and social sciences.

15 See www.oecd.org/site/piaac/; www.uis.unesco.org/literacy/Pages/lamp-literacy-assessment.aspx. See www.oecd.org/site/piaac/; www.uis.unesco.org/literacy/Pages/lamp-literacy-assessment.aspx.

Figure 12. Share of firms identifying the task of finding workers hard or very hard in Indonesia, by type of job



Source: di Gropello, Kruse, and Tandon 2011.

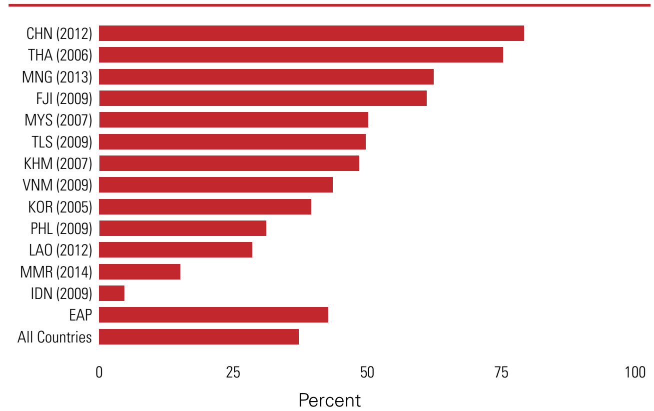
by thinking and behavioral skills. The relevance and quality of education and training are confirmed to be the main reasons for the skills gaps.

In China, as many as 28 percent of the firms surveyed listed workers' skills and education levels as the most severe constraint for growth, the second most common of all factors (Liang and Chen 2013). Even in Yunnan province, one of the least-developed provinces in the country, skills shortages and mismatches have begun to emerge. Particularly, the "lack of required skills" is a main problem encountered by firms in Yunnan in hiring for managerial and professional positions, as well as for operative skilled workers.

Some of these mismatches could be addressed through an effective nonformal vocational training system, but its use varies significantly across countries. Though evidence about the impact of such training on skills and on labor market outcomes is still scarce (Almeida et al. 2012), there are indications that these programs *can* play a role in improving wages when they have strong linkages with employers, are flexible, and permit movement between nonformal training and education institutions by mapping training and vocational education to specific qualifications and occupations, sometimes formalized in the National Qualification Frameworks (Coles 2006). However, the use of these training systems varies across countries, as reflected in the frequency of employer-led training. China and Indonesia face similar constraints according to employer surveys, but almost three-fourths of firms in China offer training to their employees, whereas less than 5 percent of Indonesian firms do (Figure 13). These differences are partly driven by the inherent difficulty of designing effective vocational training systems, which require effective coordination across public institutions (usually multiple ministries) and private institutions (employer associations and private training providers), employer leadership, and a significant investment.

Moving from education strategies to comprehensive skills strategies is a first step in responding to the challenge. Education systems are, to a large extent, not producing *all the skills* that

Figure 13. Percent of firms offering formal training opportunities to their employees



Source: Enterprise Surveys, World Bank.

are demanded in the labor market. Some skills (in particular, job-specific technical skills) may not even be the responsibility of the education sector. Other skills, including some social and behavioral skills, may reflect family influences beyond the school's control. So, to solve these skills mismatches, it is necessary to shift the focus from expanding school enrollment to promoting learning and comprehensive skill development. The next section provides a simple framework to start moving the policy dialogue from education strategies toward comprehensive skill strategies.

III. Building a More Skilled and Productive Labor Force[16]

Skills development starts at birth and is a lifelong process. It ranges from the acquisition of cognitive and behavioral skills during early childhood and general primary and secondary education, to the development of technical skills in vocational and tertiary education and during on-the-job training. Strategies to improve the skills of the workforce cannot therefore be limited to cognitive skills and the formal education sector. Formal schooling and cognitive skills are very important, but thinking more broadly can help countries address skills shortages more systematically, effectively, and comprehensively. Low literacy in the early grades may be due to inadequate school readiness, which is in many cases linked to malnutrition in the first three years of life (Naudeau et al. 2011). Similarly, employers may complain about skills of tertiary education graduates, but the skills deficits may be generated in primary school, or even earlier.

Understanding how and when skills are formed is critical to develop a coherent framework for skills development. Four features of skill formation are especially critical:

1. *The most sensitive periods for building a skill vary across behavioral, cognitive, and technical skills*. Behavioral skills start to be formed in the early years, although they evolve throughout adult life. Early stimulation and early childhood development are critical to making the most of one's abilities. Children who fall behind early have a very difficult time catching up to their peers.

2. *Skill formation benefits from previous investments and is cumulative*. For example, a child who has learned to read fluently by second grade will be able to absorb more in third grade than a child who cannot yet read fluently. This implies that earlier investments are likely to have a greater longer-term impact on skills, since it is easier and less costly to build these skills at the moments when children are most receptive to learning.

3. *Social and behavioral skills are valuable early in a child's life since they support, and benefit from, cognitive skills development*. For example, a child who displays more openness to new experiences is more likely to be imaginative, creative, and apply themselves at school.

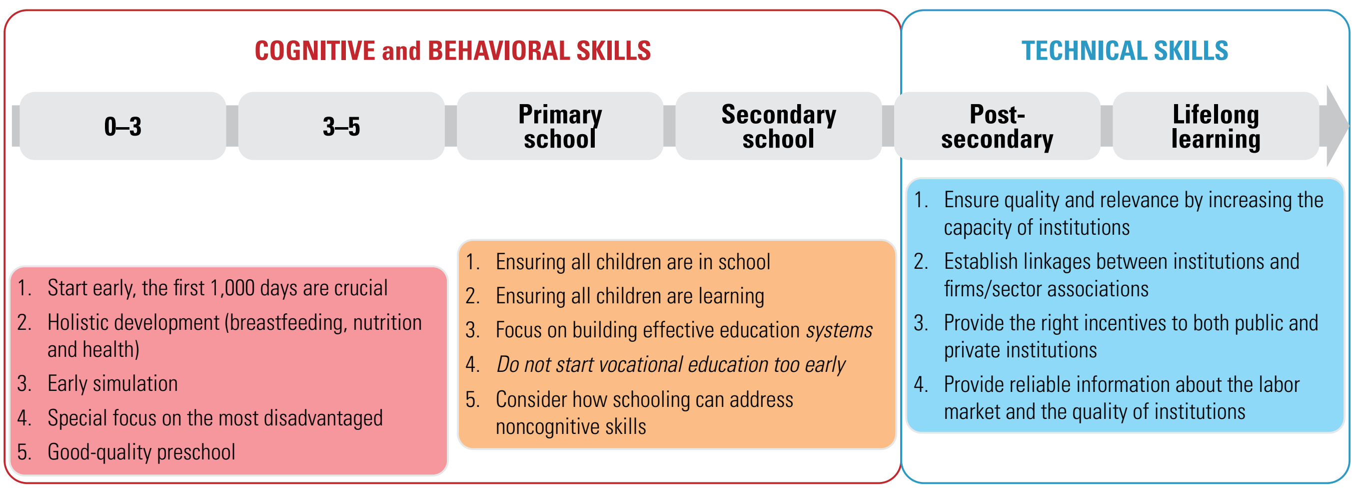
4. *The foundations of cognitive and behavioral skills are formed early and are the platform upon which later technical skills are built*. Technical and job-specific skills—often acquired last, through technical and vocational education and training, higher education, and on-the-job learning—benefit from the stronger cognitive and

16 This section draws on the summary of the literature on skill formation in World Bank (2013a). This section draws on the summary of the literature on skill formation in World Bank (2013a).

behavioral skills acquired earlier in the educational system. The skills learned in formal education help workers continuously update their technical skills during their working lives.

A skills development strategy should therefore analyze how to best equip individuals with relevant skills and knowledge through their *entire* life cycle. Such a strategy must first be based on a proper diagnostic of the skills supply and demand in the economy, and the constraints faced by employers and graduates to succeed in the labor market. With that diagnostic, and taking into account all the points at which skills are formed, a skills strategy should start with *early childhood* to ensure school readiness and the development of many noncognitive skills; continue with developing the proper cognitive and behavioral foundations during *formal primary and secondary schooling*; and include postsecondary education and lifelong learning, including on-the-job training (Figure 14).

Figure 14. The process of skills formation, a simplified model



Source: Adapted from World Bank (2013a), Figures 6 and 7.

While the specific policies differ in each country, this framework allows countries to identify policies *in each crucial area* and formulate priorities in a comprehensive way. A good example of how this framework can be used to identify specific policy actions is the recent World Bank report on *Skilling Up Vietnam* (World Bank 2013a). Starting from a diagnostic of current skills of the labor force and trends in the economy, the report uses this framework to propose specific policy actions in early childhood, primary and secondary education, and postsecondary education that would address the skills shortcomings of the current labor force.[17] There are, however, some policy directions in each area that apply more generally.

Promoting School Readiness through Early Childhood Development

Early childhood development and education for children below age 6 is the most important entry point for building their cognitive and behavioral skills and making them "ready for school." The right nutrition and stimulation before age 3 through effective parenting, and quality preschool between ages 3 and 6, contribute to children's school readiness. The concept of "school readiness" or "readiness to learn at school"

17 World Bank (2013g) and World Bank (forthcoming) use a similar logic to develop recommendations for, respectively, Malaysia and Lao PDR, but the framework is not made explicit.

represents whether a child entering primary school is able to succeed at school. School readiness is generally considered to be the product of a young child's cognitive, physical, and socioemotional development from an early age onward (Naudeau et al. 2011). In developing countries, early childhood education programs can have large impacts on child development, school readiness, and performance in primary school, in terms of both years of schooling completed and learning outcomes.[18] Early childhood education also has a positive impact on noncognitive skills such as self-confidence (Berlinski, Galiani, and Gertler 2009). In terms of long-term outcomes, recent evidence from Jamaica shows very large and significant impacts of early stimulation on labor market outcomes 20 years later (Gertler et al. 2013).

The key features of effective interventions in early childhood development are:

- *Start early*. Deficits in school readiness persist throughout life, so it is important to start addressing them as early as possible. Malnutrition during the first 1,000 days of life can have long-lasting effects, so early childhood interventions should start during that period. Parental awareness about the importance of early childhood education, the quality and type of services, and the characteristics of the targeted beneficiaries are important for outcomes. In a recent evaluation of a program in Cambodia (Bouguen et al. 2013), for example, the low takeup for community play groups and home-based programs reduced the impact of the program significantly.

- *Target efforts to disadvantaged children*. Children from poorer households often lack stimulation, which limits their development potential from an early age. The brain development of young children is highly sensitive to stimulation and interaction. The more that parents and caregivers interact with a young child, for instance by talking, singing, or reading, the better are the conditions for brain development. The greater impact of early childhood education on more disadvantaged groups (that is, those that start with a larger deficit) has been well documented in Indonesia (Hasan, Hyson, and Chang 2012).

- *Provide good-quality services*, with adequately trained teachers or caregivers, since the low quality of caregivers may also adversely affect outcomes (Rao et al. 2012).

Developing Cognitive and Behavioral Skills in Formal Education

Primary and secondary education provide the cognitive and behavioral skills base needed to absorb future technical and job-specific skills, and the skills to be adaptable to changes in the nature of jobs in the future.

In this area, some general priorities should be to:

- *Continue to increase access*, including in tertiary education, especially in low- and lower-middle-income countries.

- *Place a greater focus on early-grade reading*, (especially in poor-performing countries) to ensure all students have basic skills to absorb the future curriculum. In some cases, this may require changes in pedagogical

18 World Bank (2013g) and World Bank (forthcoming) use a similar logic to develop recommendations for, respectively, Malaysia and Lao PDR, but the framework is not made explicit.

approaches to teaching reading, and improvements in the curriculum and quality of teachers.

- *Build effective educational systems*. Spending more by itself does not automatically increase educational quality (Patrinos 2012). Isolated policy changes are also unlikely to have the transformational effects that are needed in many countries to improve quality. Instead, several aspects of education interact to produce well-performing systems.[19] The World Bank's *Systems Assessment for Better Education Results* provides a framework to diagnose the areas of the system that need improvement.

- *Delay tracking of students into vocational education*, to ensure a good broad base of cognitive and behavioral skills before acquiring technical skills.

- *Consider how education can provide the noncognitive skills so demanded in the labor market*. While there is increasing evidence of the importance of these skills, it is still unclear how educational systems can provide them. This is an important area for future research. As a first step, the supply of skills should be measured as comprehensively and rigorously as possible through tools such as StEP or the *Program for the International Assessment of Adult Competencies*, to provide decision makers with essential information.

Building Job-Relevant Technical Skills through a More Connected System

Higher education, vocational training, and on-the-job training are the key avenues for acquiring technical skills that workers need to work in their chosen profession. Higher education should provide the higher-order thinking skills needed for highly skilled jobs, while also providing technical skills relevant to the field of study. Nonuniversity tertiary degrees focus more on higher-level technical skills, while vocational secondary education and vocational training tend to focus on lower-level technical skills.

While the composition of higher education (between university and nonuniversity and technical degrees), the division between general and vocational tracks in secondary education, and the prominence of vocational training vary, notably from country to country, there are some common traits of well-performing systems that can serve as policy directions:

- *If tracking students early, vocational education should provide students with the right skills mix and allow them to continue to study for technical tertiary degrees*. Many countries still divide secondary students into general and vocational tracks. The vocational track is designed to provide technical skills that are relevant to the labor market, while the general track is designed to prepare students for further study. However, it is difficult to succeed in the labor market without a sufficiently strong base of cognitive and behavioral skills, partly because these skills have value in themselves, and partly because a weak base of cognitive skills may prevent effective acquisition of technical skills in the future. This is causing countries in general to consider delaying tracking (Jakubowski et al. 2010).

- *Making higher education more responsive to the needs of the labor market*. In the absence of the right policies, educational institutions tend to be isolated from the labor market (World Bank 2013c; Cerdan-Infantes and Mileiva, forthcoming). These disconnects are largely driven by:

19 Including early childhood interventions, teacher quality, school-based management, information systems, use of technology, and financing. For more details, see http://saber.worldbank.org.

- **Low capacity to deliver** good-quality services.
- **Lack of reliable information** about the labor market and the quality of educational institutions. Without information about labor market trends (for students, employers, and educational institutions) and about the quality of institutions (quality assurance), the choices of potential students will not be aligned with those of the labor market, and educational institutions will not have the incentives to align their offerings to the demands of employers. If employers cannot properly distinguish between good and bad educational institutions, then the rewards for their graduates will not be clear, either.
- **Inadequate incentives** to adapt to the needs of the labor market. Providing the right incentives requires autonomy and accountability, incentives for performance (especially in public institutions), and opportunities for direct links between institutions and employers (for instance, apprenticeships, staff exchanges, research collaboration). Advanced tertiary education systems go beyond these basic elements and attempt to address further disconnects—between higher educational institutions themselves, between higher educational and training institutions, and between senior secondary and tertiary education (in addition to the role of tertiary educational institutions as catalyzers of innovation) (Cerdan-Infantes and Mileiva, forthcoming).

- *Vocational and on-the-job training*. Skills beget skills, and a strong base of cognitive skills is needed to acquire higher-level skills. However, raising the level of skills of the general population through basic education necessarily takes time. Even if basic education could be perfected instantly, its impact on the workforce would only start to be felt after 20 years. It is therefore essential to find short- and medium-term solutions for the current skills constraints. Vocational training systems, as well as on-the-job training, can play that role. However, these systems are difficult to implement, because they require strong coordination among the government, institutions, and employers, with employers playing a crucial role.

While the broad policy areas above are important for all economies, the weight placed on each area will depend on the country's specific challenges, often linked to its stage of development. For most *low- and lower-middle-income countries* in the region, and especially for their most disadvantaged children, increased access to quality early childhood education constitutes a particularly urgent priority. Beyond this, good-quality primary and secondary education is important in all contexts, but the specific challenges differ. *Low- and some lower-middle-income countries* still struggle with literacy skills in the early grades. Most other *middle-income countries* enjoy good basic cognitive skills in language and math, but struggle with higher-level cognitive skills, such as complex thinking and problem solving. For *upper-middle-income countries* aspiring to high-income status, and for *high-income economies* aiming to stay at the innovation frontier, these higher-level cognitive skills, and having more students continue on to tertiary education, are vital. For all economies, incorporating noncognitive skills into the curriculum remains an important research and policy challenge.

IV. Conclusions

The success of an educational system depends on its capacity to equip students with the skills needed to succeed in the labor market, as opposed to just expanding access to education. What students learn in school matters for their labor market success. Evidence is also emerging that the skills needed in the labor market go beyond the traditional literacy and numeracy skills that are the main focus of educational systems, and that the importance of such nontraditional skills increases with the country's level of development and the complexity of the job.

To meet increased demand for skilled workers, countries must approach skills-development strategies in a comprehensive, coherent way. Such strategies should be based on three pillars: (a) starting early through early childhood development; (b) developing solid, broad, cognitive skills through formal education; and (c) developing effective systems for building job-relevant skills in postbasic education, also including a role for employers in providing job- and firm-specific skills. The relative importance of each pillar, and the most appropriate policies within each pillar, will differ across countries.

Shifting from a focus on access to education, to ensuring that graduates have the right level and mix of skills for the labor market, constitutes a substantive but crucial change in mindset. Such a change is necessary to ensure that the impressive gains in access to education observed across the region are not wasted. The framework proposed in this note is one way to think systematically about what is required.

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II.B. International Migration and Development in East Asia and Pacific[1]

An estimated 22 million international migrants originate from East Asia and Pacific, of whom 7 million live inside the region. They remitted about US$112 billion to their home countries in 2013. Both small and large labor-sending countries, including the Philippines and Vietnam, depend significantly on remittances to boost household incomes, finance trade deficits, and maintain macroeconomic stability. Labor-receiving countries, such as Malaysia and Singapore, depend on migrant workers to meet acute labor shortages and maintain competitiveness. International migration will become even more important in the future, as a response to rapid aging in labor-receiving countries including Japan, the Republic of Korea, and Singapore. Policy measures could significantly increase the long-term benefits of migration. Labor-sending countries need to provide migrants with better information on opportunities, regulate recruiting agencies to avoid abuse, and improve financial services available to migrant families, enabling them to use remittances more productively. Labor-receiving countries need to focus on addressing market failures that prevent their own workers from upgrading their skills and engaging in more productive jobs. Such measures will ensure that their workers complement rather than compete with migrants, mitigating any adverse distributional implications of migration and reducing social frictions. The right of migrant workers to minimum wages and safe working conditions must also be enforced, to avoid a deterioration in working conditions affecting all workers.

International migration has been an important force for development in East Asia and Pacific. Labor-sending and labor-receiving countries have depended significantly on migrant workers and remittances for reducing poverty, boosting household incomes, and supporting macroeconomic stability and competitiveness. The 22 million international migrants originating from East Asia and Pacific remitted more than US$112 billion to their home countries in 2013.[2] These remittances are significant for both small economies, such as Tonga and Vanuatu, and for large economies, such as the Philippines and Vietnam. Remittances have important development impacts at the household level, and are also critical for macroeconomic management in labor-sending countries. Labor-receiving countries depend on migrant workers, who make up a significant part of the workforce in countries such as Malaysia and Singapore, to meet acute labor shortages, maintain competitiveness, and further develop their economies.

International migration in East Asia and Pacific will become an even more salient issue in the future, for two reasons. International migration, along with intraregional trade and finance, will become part of the drive toward "deep" economic integration in East Asia and Pacific taking place through the Association of Southeast Asian Nations (ASEAN) and various ASEAN Plus agreements. This is most explicitly recognized in the ASEAN Economic Community Goals, which include free movement for skilled workers by 2015. In addition, East Asia and Pacific is currently facing the onset of one of the most rapid demographic changes in history. In several labor-receiving countries, such as Japan, the Republic of Korea, Singapore, and even Thailand, rapidly aging

1 This note was prepared by Ahmad Ahsan, Lead Economist, Office of the Chief Economist, East Asia and Pacific Region (EAPCE), of the World Bank. The note draws on the forthcoming World Bank report, "International Migration and Development in East Asia and the Pacific."

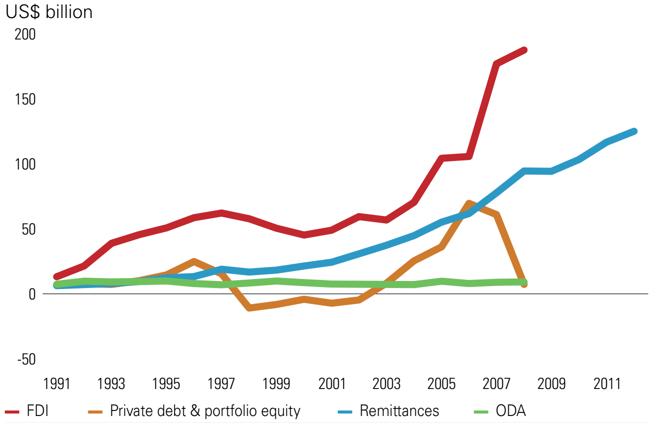
2 Data are drawn from World Bank (2011) (which is in turn based on UN Population Division estimates; http://esa.un.org/migration/index.asp?panel=5), and its April 2013 update, *Migration and Remittance Flows: Recent Trends and Outlook, 2013–2016*. Migrants are defined as those born outside their country of residence. Numbers on migration are notoriously imprecise, and are typically underestimated owing to the presence of irregular or undocumented workers.

populations will reduce domestic labor supply. At the same time, rising demand for nontradable services, especially for health care for the elderly, will increase labor demand. These two forces will combine to create important labor shortages in labor-receiving countries, which if unmet will lower economic growth and sharply increase fiscal and health costs. Given these factors, the key question concerning international migration in East Asia and Pacific is not whether it is desirable, but how it should be managed in the future.

I. Migration in East Asia and Pacific: Key Stylized Facts

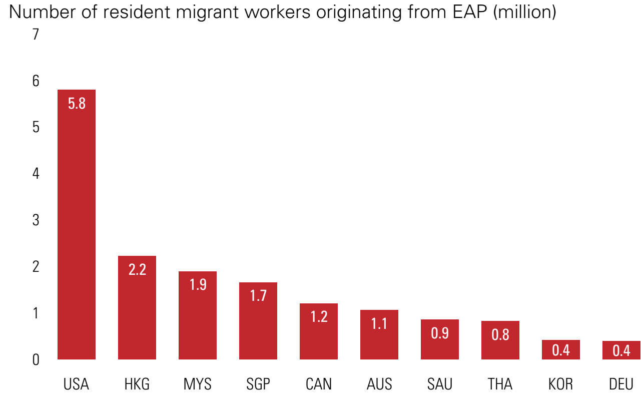
Five key stylized facts characterize international migration in East Asia and Pacific. First, **remittance flows in the region, already very large, are expanding faster than those to the developing world as a whole.** Between 1991 and 2013, remittances to East Asia and Pacific grew from US$20 billion to US$112 billion (Figure 1), an average annual growth rate of 15 percent compared with 7.8 percent for developing countries as a whole (World Bank 2014).[3]

Figure 1. Remittances flows to East Asia and Pacific have grown rapidly



Source: World Bank 2014.
Note: FDI = foreign direct investment. ODA = overseas development assistance.

Figure 2. East Asian countries are a major destination for migrant workers from the region



Source: World Bank 2011.

Second, **East Asia and Pacific is its own migration hub**, that is, five of the top 10 destination countries for migrants from East Asia and Pacific (Hong Kong SAR, China; Korea; Malaysia; Singapore; and Thailand) are also in the region (Figure 2).

Third, **migrants in East Asia and Pacific, including both those originating from the region and those working in the region, are overwhelmingly unskilled**. For instance, 98 percent of migrants from Indonesia and 73 percent of migrants from Vietnam are unskilled, defined as having less than a secondary school education. Migrants from the Philippines are more skilled, but even in that case, the share of migrants with tertiary education is only 14 percent. However, on average, migrant workers are slightly better educated than workers

3 These values reflect remittances sent by East Asian migrants working both outside and inside the region.

in their countries of origin, and this trend is particularly pronounced in the Philippines. From the receiving-country perspective, more than 90 percent of migrants in East Asia and Pacific are unskilled.

Fourth, **the share of undocumented workers is large**. In the early 2000s, more than 1.6 million undocumented migrants from the Philippines were estimated to be working abroad (Dimzon 2005). Similar estimates suggest that more than half of Indonesians migrating internationally do so through unofficial channels (Hugo 2005). Within the region, the major destinations for illegal migration are Japan, Korea, Malaysia, the Philippines, and Thailand. In Japan, between 2000 and 2004, more than 1 million migrants overstayed, of whom 25.8 percent were from Malaysia, the Philippines, and Thailand (Hugo 2005). Three factors drive such large-scale undocumented migration: the twin "push factors" of poverty and unemployment; the large, porous borders between countries in the Mekong region or between Indonesia and Malaysia; and barriers to migration erected by labor-receiving countries, making official migration a lengthy and costly process.

Fifth, **the share of female migrant workers has been rising rapidly**. Already by 2000, the estimated stock of female migrants from the region (5 million) surpassed that of male migrants (4.9 million) (Lee 2005). In the Philippines, more females than males migrated each year during the first decade of the 2000s, except for a slight dip during 2007–08. Again, females now account for the majority of migrant flows from Indonesia. Although their most frequent destination is Saudi Arabia, they are increasingly finding employment in other East Asian countries such as Hong Kong SAR, China; Malaysia; Singapore; and Taiwan, China (Nguyen and Purnamasari 2011). Indeed, more than two-thirds of Filipino and Indonesian migrants to Hong Kong SAR, China; Japan; and Singapore are women. Likewise, the female share of migrant flows from Vietnam increased during the 2000s, and almost half of migrants from Lao PDR and Cambodia to Thailand are now women.

II. Impact on Labor-Sending Countries

The large flows of remittances to the region help reduce poverty directly by increasing income for migrants' families, releasing credit constraints, and insuring households against shocks. The size of the poverty impact depends on whether it is households at the lower end of the income distribution that receive remittances. Remittances represent a significant source of income, even though only a small share of households receives remittances outside the Pacific Islands. In Indonesia, international remittances in 2007 accounted for 29 percent of per capita consumption among recipient households. While these households make up only 4 percent of total households, remittances reduced their poverty rate by 28 percent. In the Philippines, a typical 10-percentage-point increase in the ratio of international remittances to initial household income leads to a 2.8-percentage-point decline in the probability of being in poverty. The impact on the Pacific Islands is particularly dramatic. Remittances reduce poverty rates by 25 percentage points (or 43 percent) in Tonga, and 2.7 percentage points (or 7 percent) in Fiji (World Bank 2006). In Samoa, the poverty rate among migrant families is 55 to 65 percent lower than among similar families without migrants (Gibson, McKenzie, and Stillman 2009). Migrant households also invest significantly more in education in countries such as Indonesia and the

Table 1. Impacts of remittances on marginal spending in Indonesia and the Philippines Budget share of given category in remittance income compared to nonremittance income

Percentage difference

	Food	Housing	Education	Health
Indonesia, 2007	5.9	–3.3	332.5	–41.9
Philippines, 2003	–39.5	91.8	58.9	

Source: Adams and Cuecuecha 2010; Cabegin and Alba 2014.

Philippines (Table 1).[4] For instance, in Indonesia the share of remittance income spent by migrant households on education is 332 percent (that is, more than four times) higher than the share spent on education by the households before they received the remittance income. That said, the impact on actual school enrollment is more modest in Indonesia and Vietnam, perhaps because enrollment is already high in these countries and the share of migrant households in all households is small. Remittances can also lead to a decline in child labor when migrants are female, but not necessarily if the migrants are male. Temporary migration in the region does not automatically lead to strong knowledge and technology transfers that could raise productivity in the labor-sending country.

International remittances have a significant, positive short-term macroeconomic impact on labor-sending countries. Remittances can play a key role in financing trade deficits, raising external reserves, and reducing economic volatility (Chami, Hakura, and Montiel 2012). Remittances flows can be large, ranging from less than 1 percent of GDP in large countries like China and Indonesia, to 6 percent to 10 percent of GDP in, respectively, Vietnam and the Philippines, and 15 percent to 20 percent of GDP in small island nations like Samoa and Tonga. Remittances amount to more than twice the current account deficits of Vietnam and more than five times the deficits of Tonga and Samoa. Annual remittances are equivalent to half of foreign exchange reserves in Vietnam and more than 71 percent of reserves in the Philippines.

The long-term linkages among migration, remittances, and growth are, however, more tenuous (Bajaras et. al. 2009; Clemens and McKenzie 2014). There is some evidence that remittances can cause real exchange rate appreciation and Dutch disease, adversely affecting competitiveness. Also, across the nine labor-sending developing countries in the region, per capita income growth rates are uncorrelated with the growth rate of remittances; analogously, income levels are uncorrelated with remittance shares in GDP. Relatedly, the role of remittances in boosting savings and investment rates is weak; in the region, on average, an increase in the share of remittances in GDP is insignificantly related to investment rates (World Bank, forthcoming).

These data suggest two things. First, policies are needed to increase the impact of remittances on savings, investment, and growth in labor-sending countries. The main focus should be on providing services and incentives for workers to invest their remittances. Some of these policies are discussed below. Second, remittance inflows cannot be viewed as a substitute for domestic economic development. A striking example is the Philippines, which has proved extremely successful in exporting labor and receiving remittances over several decades, but has lagged in terms of economic development.

III. Impact on Labor-Receiving Countries

Overall, the economic contribution of migrant workers to labor-receiving countries is much more significant than commonly perceived. Migrant workers help to increase competitiveness and value added, especially in agriculture and labor-intensive sectors within manufacturing and services. They do not have a significant adverse effect on unemployment, given that labor-receiving countries in the region have tight labor markets. Employment of migrant workers leads to an increase in profits and hence investment.[5] In turn, this

4 In the Philippines, there is also evidence of significantly higher investment in housing among remittance-receiving households.

5 See Hur and Nho (2011) for evidence from Korea, and Yean and Siang (2011) for Malaysia.

can help to increase labor productivity in the medium term. Further, the availability of relatively unskilled migrant workers encourages native workers to become more skilled and take more productive jobs.

Detailed evidence on the contribution of migrant workers comes from a variety of recent research. General equilibrium modeling for Malaysia (Kanapathy 2010) suggests that a 10 percent net increase in low-skilled workers leads to an increase in real GDP of 1.1 percent. On the demand side, this is reflected in higher exports (1.7 percent), aggregate investment (1.2 percent), and household consumption and government expenditures (0.4 percent each). On the supply side, tradable industries record the largest increase in output. The increase in migrant workers lowers local unskilled wages, leading to a reduction in domestic prices and costs relative to foreign prices and costs. Results for Thailand are generally similar. For instance, a macroeconomic model (Pholphirul, Kamlai, and Rukumnuaykit 2010) finds that the presence of migrant workers leads to an increase in Thai GDP of 0.75 percent, with most of this taking place in agriculture (1.3 percent), followed by manufacturing (0.9 percent), and services (0.5 percent). Likewise, a general equilibrium model (Martin 2007) finds that foreign workers, estimated to account for about 5 percent of the total workforce, increase Thai GDP by 1.25 percent. In Singapore, the estimated contribution of migrant workers to economic growth is much larger.

The effects of migration on the labor-market outcomes of native workers, including wages, are modest and ambiguous. In Thailand, a doubling in the size of the (relatively low-skilled) immigrant workforce would be estimated to lead to only a marginal (less than 0.5 percent) reduction in the wages of less-skilled Thai workers with only a primary education (Lathapipat 2014; see Table 2). Conversely, the wages of skilled Thai workers with a high school or college education would actually increase by 0.5 percent. Immigration has a significant adverse effect only on the wages of previously arrived foreign workers; put differently, there is little substitutability between Thai and migrant workers. In Malaysia, estimates based on repeated rounds of labor force data indicate that, for every 10 percent increase in migrant workers, wages of native workers increase by 0.14 percent (Ozden and Wagner 2014).

Table 2. Simulated long-term effects of immigration on the Thai wage structure

Percent change

	Wages of previous immigrants	Wages of Thai workers
Schooling:		
Lower primary	−1.94	−0.03
Upper primary	−2.45	−0.79
High school	−1.09	0.56
College	n.a.	0.57

Source: Lathapipat 2014.

Note: Estimates refer to impact of a doubling in the size of the immigrant workforce. They are based on data for the five provinces with the highest share of foreign workers.

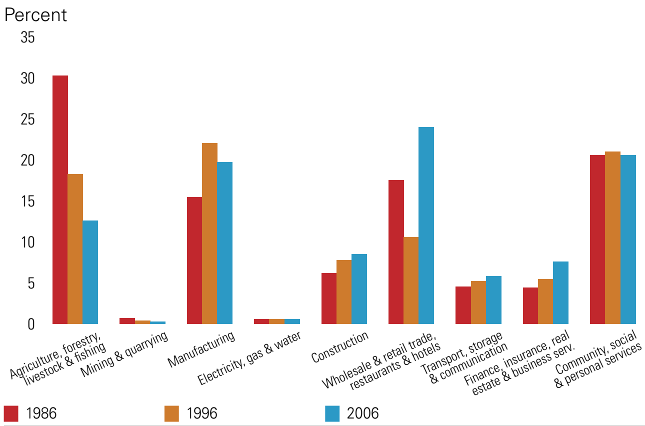
n.a. = not applicable.

The impact of migration on unemployment is limited. In Korea, migrant workers do not have an adverse effect on the employment of native workers. In fact, migrant employment reflects worker shortages in the small and medium enterprise sector. In Malaysia, there is also little evidence that migration has adversely affected unemployment. Unemployment rates fell progressively from 7.4 percent in 1970 to 2.8 percent in 1995, at a time when migrant employment was steadily rising. Although unemployment increased to 3.5 percent in 2005, it fell again in 2007 to 3.2 percent. In other words, Malaysia has had virtually full employment since the early 1990s, with the exception of the economic crisis years of 1997–98 and 2008–09. More detailed estimates suggest that, for every 1,000 migrant workers employed in a sector in a state, 410 new full-time jobs are created for Malaysian workers (Ozden and Wagner 2014). In Thailand, an increase in the number of immigrant workers with both lower and upper primary schooling was uncorrelated with the unemployment rates of native Thais in these respective schooling groups (Lathapipat 2014).

Migrant inflows boost competitiveness, although their impact on labor productivity is mixed. Analysis of a sample of approximately 2,300 manufacturing firms in Malaysia over a six-year period concludes that migrant inflows raise firms' competiveness. A 1 percent increase in the share of foreign workers results in a 0.2 percent decrease in unit labor costs, with particularly large declines for occupations such as technicians (0.5 percent) and plant and machine operators (0.4 percent) (Yean and Siang 2011). Average labor productivity decreases by 0.6 percent; however, the results are driven by an increase in the share of low-skilled foreign clerical workers.

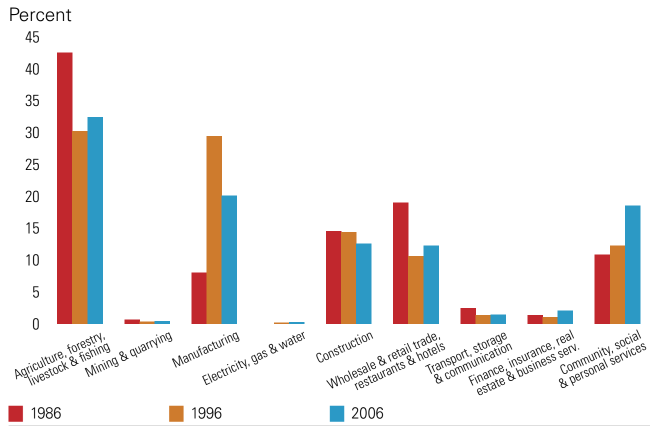
Over the long run, migration will be associated with an increase in the productivity of native workers, if supporting complementary policies encourage them to upgrade their skills and move to higher-productivity sectors. Unskilled migrant workers take up less-skilled positions in labor-intensive sectors, and this enables native workers to move into more skilled, higher-productivity jobs. In Malaysia, for instance, a significant restructuring of the labor force took place between 1986 and 2006. Native workers increasingly moved out of agriculture and concentrated in manufacturing and services, and in particular high-end services, including finance, insurance, and real estate, where the number of Malaysian workers tripled (Figure 3.A). Migrant workers, in contrast, continued to take up positions in agriculture, while also concentrating on personal services (Figure 3.B).

Figure 3.A. Sectoral employment patterns of native workers



Sources: Government of Malaysia, Economic Policy Unit and Department of Statistics, 2010.

Figure 3.B. Sectoral employment patterns of migrant workers



Sources: Government of Malaysia, Economic Policy Unit and Department of Statistics, 2010.

China's massive internal migration across provinces provides additional evidence that migration does not harm productivity. Approximately 260 million people have migrated within China, mostly from the inland and western provinces to the eastern coastal provinces. Overall, the inflow of migrant workers has been accompanied by an acceleration in the growth of key variables such as wages, productivity, and investment. There is little evidence that large-scale internal migration has hampered technological progress in the labor-receiving provinces (World Bank, forthcoming).

Nevertheless, migration can create economic and social tensions that labor-receiving countries must address. Migrant inflows can have adverse distributional impacts; as discussed, they put downward pressure on the wages of unskilled workers (although the effect is typically small), while acting to increase the wages of skilled workers and firms' profits. Relatedly, migration can lead to social tensions, especially where large-scale, unregulated inflows are perceived to enable firms to erode labor standards, or where they place pressure on public infrastructure. These issues are discussed below.

IV. Improving Regulatory Policies

International migration is a large industry in East Asia and Pacific. It involves thousands of recruiting and employing firms (some 500 such firms in Indonesia alone), remittance flows of more than US$100 billion dollars per year, and numerous financial organizations. Managed well, such an industry will match workers from one country with the labor needs of another, in ways that encourage formal rather than informal migration, protect workers' rights, and ensure that migrant workers' contributions (both financial and skill-related) are maximized in both receiving and sending countries.

Countries in the region use a range of agencies and policies to manage migration flows and the migration industry. The Philippines takes great care in promoting migration and protecting the interests of its overseas workers. Vietnam has a program to use labor exports to alleviate poverty in lagging regions. In these disadvantaged areas, the government is directly involved in recruiting and placing workers abroad, including by striking government-to-government arrangements with north Asian countries, such as Japan and Korea, and the Middle East. In Indonesia, after years of passive support for sending workers abroad, the government has begun to take a more active role. Government involvement has also been spurred by public concerns about how vested interests have taken advantage of the process to extract rents from workers. Among receiving countries, Singapore most extensively, but also Malaysia and Thailand, all have policies aimed at managing migration to meet the need of their economies while avoiding adverse impacts and addressing social concerns about migrant workers.

Despite these efforts, the migration industry remains marked by a wide range of market failures and implementation challenges. Large income differentials between labor-sending and labor-receiving countries, as well as porous borders in the Mekong region and between Malaysia and Indonesia, create powerful economic forces behind migration that are difficult to manage. Knowledge about available jobs, expenses, and regulations is limited and unreliable for workers, in particular, but also for employers. Transaction costs and fees are high, and more so for documented than undocumented workers, creating incentives for irregular migration. In such environments, inadequately regulated recruiting firms and brokers can engage in fraudulent and abusive practices. Lacking adequate knowledge, financing, and safeguards, migrant workers can lose substantial savings and assets. On the government side, duplicative institutional structures, for instance in Indonesia, sometimes force migrants to pay twice for the same services to government agencies. In Vietnam, predeparture charges are exceptionally high, because recruiters and employers in destination countries sometimes collude. Abroad, migrant workers can lack legal powers to protect their rights. High costs of sending remittances and the lack of good financial instruments can mean that remittance flows are lower than their potential, and are inadequately saved and invested for productive purposes. In receiving countries, weak regulations and the absence of workers' rights can lead to exploitive behavior by firms and the excessive use of foreign workers, to the detriment of native workers, causing social tension.

Against this backdrop, there is considerable scope to improve policies. For labor-sending countries, there are three priorities: improving the recruitment process for migrant workers, protecting worker welfare during their employment abroad, and improving the management of remittances.

Supporting the Recruitment Process for Migrant Workers

The information failures at the heart of poor migration outcomes can be mitigated by providing migrants with essential information before departure. Creating migrant information centers and encouraging the involvement of nongovernmental organizations, as most successfully done in the Philippines, can fill the information gaps and improve the transparency of the migration process. Many provincial and city governments in the Philippines now have migrant information centers where at least one officer is dedicated to providing the public with information on new regulations and developments in overseas employment. Television, radio, and other mass media are also used as important channels for spreading information, but require much more expertise to convey messages effectively. Authorities need to be equipped with specialized staff to support media campaigns.

Well-designed predeparture training programs are also important. Key elements include specific skills related to work needs, financial literacy and cultural awareness training, some introduction to the language, explanation of rights and obligations, ridding migrants of false expectations, and providing migrants with the means to respond effectively to mistreatment and exploitation. However, such programs can be ineffective if their content is inadequate or if they are provided too late. But some programs, especially those based on well-informed nongovernmental organization and migrant networks (as in the Philippines), or on good inputs and participation from would-be employers (as in the Pacific Island economies or for Vietnamese migrant workers going to Japan), provide valuable benefits.

Recruiting firms need to be regulated so that they have the incentive and ability to provide needed information and services to workers. Regulations need to ensure firms have adequate capital, a long-term perspective, a reputation to protect, and an adequate monitoring and resolution system. Implementation challenges can be significant because recruiting firms can be powerful, acting in collusion with government agencies, and able to take advantage of weak governance arrangements. In the Philippines, migration-promoting agencies have received quasi-judicial powers to regulate recruitment firms; previous campaigns against unauthorized recruiters failed owing to the lengthy process involved in prosecuting violators through the regular justice system. In Indonesia, policies have sought to restructure the recruitment industry by sharply raising the minimum capitalization of recruitment companies (to US$310,000), and requiring them to have branches in rural areas instead of using informal agents.

Protecting Workers' Rights Abroad

The protection of workers' rights abroad starts with ensuring that workers have clear contracts, and support from home-country governments. Written employment contracts are the most important instrument for protecting workers' rights and interests, especially in countries where there are no minimum wages, or where migrants usually face discriminatory treatment from the authorities or society in general. The Philippines has introduced wage benchmarks; Filipino migrants are not allowed to accept wages lower than the prevailing minimum for the same skills in the host country, or lower than the standards fixed by bilateral agreements or international conventions to which the host country is a signatory. In no case is a migrant allowed to receive a salary lower than the prevailing wage in the Philippines. Labor attachés of labor-sending countries must play an active role in avoiding abuses, in particular by ensuring that workers' contracts are enforced, and by guaranteeing basic rights such as health care and legal protection.

Increasing the Impact of Remittances

Reducing the costs of transferring remittances remains a key policy challenge. The average cost of transferring remittances in East Asia and Pacific, at 16 percent of the amount sent (based on a remittance of US$200), is high compared to other regions (Mohapatra and Ratha 2011). Further, this cost varies greatly across countries, from 2.5 percent to 26 percent. Two important steps can reduce costs: promoting competition among remittances service providers by removing any exclusivity arrangements between money transfer operators (MTO) and commercial banks; and creating mechanisms to bundle remittances from a particular area. Sri Lankan banks, for instance, have devised speedy, low-cost transfer bundling systems with correspondent banks and exchange houses in destination countries.

Channeling remittances via commercial banks and other financial institutions, such as microfinance institutions (MFIs) and savings cooperatives, enhances migrants' access to savings products and other financial instruments. Currently, remittances are typically transferred through MTOs, banks, and other traditional, formal financial sector institutions. However, new institutions and innovations such as MFIs, information-technology-enabled services, the securitization of remittances flows, and the issuance of "diaspora bonds" (bonds targeted specifically to migrants abroad) can mobilize more remittances, facilitate their transfer, and increase migrants' access to financial services. For instance, the Philippines has created collective remittances channels that channel capital to local infrastructure and development projects. A key concern is that most migrants have limited access to finance. Because bank loans are generally not available to finance migration costs, households without sufficient savings must resort to the hurried sale of assets and to high-cost informal sources of finance, such as migration agents and moneylenders. Providing migrants who have job offers abroad with predeparture loans secured against expected remittances will reduce their financial burden, enable them to retire loans from informal sources, and enhance migration opportunities for poorer households.

That said, sound macroeconomic conditions and an attractive investment climate in the receiving country will be the ultimate determinant of how productively remittances are used. Both remittance flows and their impact on development depend on strong fundamentals of good economic management and governance (Fajnzylber and Lopez 2008).

Policies in Labor-Receiving Countries

Labor-receiving countries should regulate migration in an efficient, flexible manner, while minimizing any perceived erosion of labor standards. As discussed, migration can have adverse distributional impacts and lead to social tensions. To address this:

- **Governments should rely on levies on firms employing migrant workers, rather than on quotas, which are administratively more difficult to enforce and can lead to rigidities.** Levies directly engage employing firms and recruiting agencies in enforcing migration laws, while at the same time maintaining flexibility to address labor requirements. Governments can adjust levies in response to migration flows, and the revenues raised can be used to offset any other financial costs imposed by migrant workers. Singapore, and more recently Malaysia, is increasingly using such levies.

- **The right of migrant workers to minimum wages, benefits, and safe working conditions should be enforced.** Well-enforced labor laws will minimize the likelihood that migrants become undocumented workers or become exploited, and also avoid an overall deterioration in working conditions that also affects native workers. Strong enforcement measures will require coordination across a number of relevant agencies, including immigration and law enforcement, labor and manpower, health and education, and the concerned industry ministries. Governments need to make employers and recruiting firms accountable for preventing the excessive use of migrants or the use of irregular workers, and providing wages and benefits as stipulated by contract.

Such policies must be based on a clear understanding of labor market requirements, and on an appreciation of the gains from migrant workers. Research is needed on the regions subject to labor shortages; the sectors and skills where migrant labor is most needed, in particular because technologies are relatively rigid and do not allow easy substitution of capital for labor; the types of workers needed; and the wages and benefits that should be provided to migrant workers.

Over the longer run, labor-receiving countries must focus on increasing the skills of native workers. Well-designed policies will encourage native workers to upgrade their skills, enabling them to work in more productive jobs and complement rather than compete with migrants. This will maximize the efficiency gains from migration, moderate its adverse distributional implications, and reduce social tensions.

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II.C. Pacific Island Countries: Economic Prospects and Policy Priorities[1]

The Pacific Island Countries (PICs) face unique challenges: their small size, remoteness from major markets, and internal dispersion combine to push up the costs of both private production and public administration. This narrows the feasible set of economic opportunities, with future improvements in living standards likely to be driven primarily by natural-resource-based industries, migration and remittances, and continued development assistance. In this context, there are three priorities for PICs. First, limited public resources should be focused on activities, such as minerals, fisheries, and tourism, which have a real prospect of being competitive in global markets. The required support includes providing infrastructure and human capital, facilitating business and trade, and implementing appropriate regulatory frameworks. Second, public sector reforms should focus on finding innovative ways to deliver services, for instance, through regional approaches to public regulation or service provision. Public financial management reforms will deliver particularly high payoffs in an environment of constrained resources. But long-term development assistance and capacity transfers will remain vital. Finally, PICs and their development partners should work to increase migration options for Pacific Islanders, including greater access to industries requiring higher skill levels.

I. Introduction

The 10 Pacific Island Countries (PICs) that are members of the World Bank have economic characteristics that are very different not only from the other East Asia and Pacific (EAP) countries, but also from most other countries around the globe.[2] The PICs range in size from Tuvalu, with about 10,000 people, to Fiji, with a population of 880,000, and in per capita income from the Solomon Islands at US$1,610, to Palau at US$10,970 (Table 1). Not only are their populations very small, the economies of all the PICs are also tiny, with the average gross domestic product (GDP) of the PICs just a quarter of a percentage point of the average GDP of middle-income countries (Figure 1). All of the PICs are archipelagos with multiple inhabited islands, ranging in number from Samoa, with four, to the Solomon Islands, with nearly 350. Most of the PICs are also dispersed geographically, with exclusive economic zones ranging from 132,000 square kilometers (km^2) for Samoa to 3.4 million km^2 for Kiribati (larger than the land area of India). They are also all extremely remote from large markets. As will be explored in the next section, their geographic dispersion and remoteness from large markets makes them quite distinct from the Caribbean islands and most other small island developing states around the globe.

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2 In this note, the term "PICs" refers to the 10 World Bank member countries in the Pacific region with populations below 1 million: Fiji, Kiribati, the Marshall Islands, the Federated States of Micronesia, Palau, Samoa, the Solomon Islands, Tonga, Tuvalu, and Vanuatu. The heterogeneity of this set of countries means the different arguments made in this note apply to different degrees in the different PICs, with Fiji—the largest PIC—at the margins of applicability in some respects.

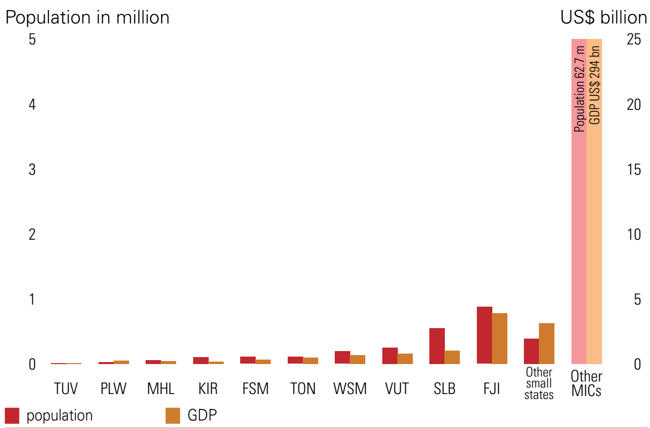
Table 1. Summary data for PICs

	Population[1]	GDP as a share of average GDP of other MICs[2]	GNI per capita, Atlas Method (current US$)[3]	Estimated number of inhabited islands[4]	Estimated EEZ (sq km)[5]	Average GDP-weighted distance from markets (km)[6]
PICs (Average)	*228,008*	*0.25%*	*4,494*	*69*	*1,428,143*	*12,035*
Fiji	881,065	1.26%	4,430	110	1,281,122	12,964
Kiribati	102,351	0.05%	2,620	21	3,437,345	11,531
Marshall Islands	52,634	0.05%	4,200	24	1,992,232	11,090
Micronesia, Federated States	103,549	0.11%	3,430	65	2,992,597	10,987
Palau	20,918	0.08%	10,970	8	604,289	10,600
Samoa	190,372	0.22%	3,430	4	131,812	12,627
Solomon Islands	561,231	0.34%	1,610	347	1,597,492	12,215
Tonga	105,323	0.15%	4,490	36	664,853	13,181
Tuvalu	9,876	0.01%	6,630	8	751,797	12,279
Vanuatu	252,763	0.26%	3,130	65	827,891	12,879

Sources: 1. Data for 2013, World Development Indicators (WDI). 2. GDP (current US$) – data for 2013, WDI. 3. Data for 2013, WDI. 4. CIA World Factbook, Wikipedia, and country sources. 5. The Sea Around Us Project (UBC and PEG 2014). 6. World Bank staff calculations using WDI and CEPII (2005) data.

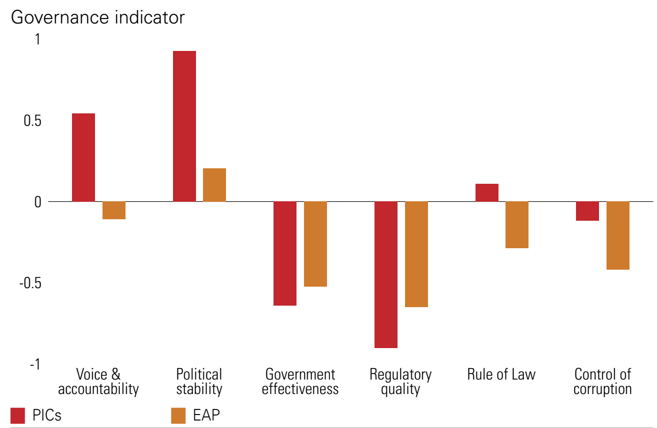
In general, PICs exhibit reasonably good income, poverty, social, and governance indicators, but in the area of economic growth they face major challenges, primarily as a result of their size and geography. While per capita income levels vary, most are in the range of US$2,500 to US$4,500, and all are classified as middle-income countries. Extreme poverty rates are low in most PICs, and many PICs exhibit reasonably good health and education indicators. In terms of governance, PICs compare well with the EAP region as a whole (Figure 2). It is the economic challenges and opportunities faced by PICs that are quite unique, not only within the region but even compared to those faced by most small island developing states in other parts of the world. This is largely due to their size and geography, and means that the development trajectories of PICs are likely to differ from those seen elsewhere, giving rise to a number of important policy implications.

Figure 1. The PICs have very small populations and economies relative to other MICs



Source: World Development Indicators.

Figure 2. On governance, indicators for PICs compare quite well with the wider EAP region



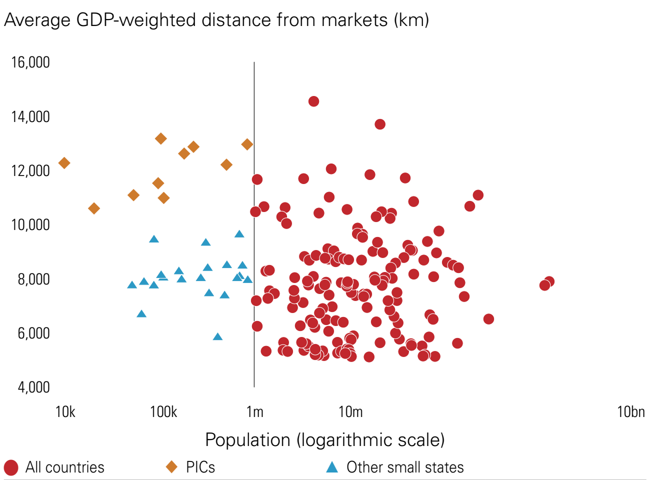
Source: World Development Indicators.

II. The Effects of Economic Geography: Smallness, Remoteness, and Internal Dispersion

The PICs Encounter Higher Costs of Private Production

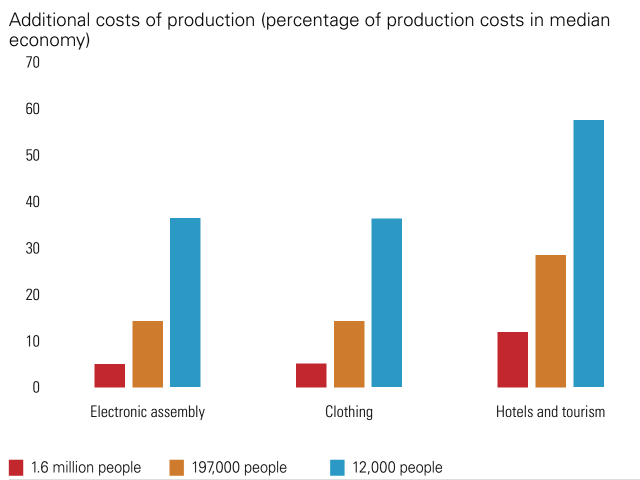
The combination of very small size and extreme remoteness from major markets pushes up private production costs in PICs. The PICs are unique in the way they combine very small size and extreme remoteness from major markets (Figure 3) (Gibson 2006, 4–6; Tumbarello, Cabezon, and Wu 2013, 5–6; World Bank 2011, 10–13). Remoteness means not distance per se but the costs of international trade. The PICs face high trade costs, owing primarily to their distance from major markets, small import and export volumes, geographic location away from major shipping routes, and lack of competition among the few international shipping lines that do serve them (Yang et al. 2013, 28–30).[3] In general, the small size of a domestic economy does not preclude the exploitation of economies of scale or scope in the production of tradable goods and services, because firms in a small state can trade internationally and thereby gain access to large markets for their products. But where very small size is combined with extreme remoteness from major markets, as in PICs, the costs of international trade can make access to global markets prohibitively costly, in which case the size of the domestic economy can act as a binding constraint on firms' productivity (Yang et al. 2013, 6–8). Moreover, for nontradable goods and services, production costs are higher because it is not possible for economies of scale or scope to be exploited. In addition, firms face inflated costs for nontradable and tradable inputs to production, also increasing the effective cost of producing each unit of output.

Figure 3. The PICs are unique in their combination of small size and remoteness from major markets



Source: World Bank staff calculations using *World Development Indicators* and CEPII (2005) data.

Figure 4. The increased costs of production in very small remote states can be severe



Source: Winters and Martins 2004.

For remote states that are as small as most of the PICs, the extent of the increased costs of private sector production can be severe. Winters and Martins (2004) estimate that for a remote state with a population of around 200,000 (smaller than Vanuatu and a little larger than Samoa), unit costs of production are increased

3 Some landlocked states in Sub-Saharan Africa may be subject to costs of international trade and levels of "remoteness" as high as in the PICs.

by about 15 percent for garment manufacturing and about 30 percent for tourism services, relative to the median state with a population of just over 10 million (Figure 4). Production in such a small remote state would be competitive with the median state only if wages were less than half those in the median state, or capital earned virtually no return. In micro states, the cost increases are even more pronounced. For a remote state with a population of around 12,000 (smaller than Palau and a little larger than Tuvalu), costs are estimated to be increased by over 35 percent for garment manufacturing and nearly 60 percent for tourism services. Production in a remote state of this size would not be competitive with the median state even if labor or capital were not remunerated at all. These increased costs in small remote states result both from higher production costs (because scope for economies of scale through production for the world market is reduced, and because the cost of intermediate inputs is increased), and from higher transportation costs on finished products. These increased costs are not limited to the production of goods; they are also significant for service industries due to the high costs of the nontradable and tradable inputs to services production.

The significantly increased costs for the private sectors in small remote economies have important implications for the economic activities in which they can be competitive in global markets. Small remote states still need to specialize in their areas of comparative advantage—that is, having a comparative advantage in a particular good or service is a necessary condition for their exports to be competitive in global markets. However, their high trade costs may mean that it is either not possible for them to export at global market prices in all of these areas, or they may not be able to remunerate their factors of production sufficiently if they do export at global market prices—that is, comparative advantage is not a *sufficient* condition for competitive exports (Winters and Martins 2004). Effectively, this means that firms in small remote states must be able to secure some form of market rent or premium price from global markets in order to cover their higher production costs. This tends to be possible in markets for natural resources, and can also be possible in markets for goods or services that capitalize on natural endowments, such as distinctive geographic characteristics. That is, the comparative advantages that PICs are likely to be able to realize are in activities that rely relatively intensively on natural resource endowments, where the available rents associated with the use of these endowments are sufficient to cover their higher costs of production.[4] In a more limited way, firms in such small remote states may be able to create and secure market rents sufficient to cover their higher production costs, through investment in sophisticated branding and product differentiation.

As a result of their unique economic geography, the growth paths that PICs can follow are therefore likely to be different from those seen in many other developing countries, including, in particular, other developing countries in the EAP region. The primary driver of growth in the developing countries that have managed to sustain rapid growth in the last four or five decades has been progressive increases in the value-added of their exports to global markets (World Bank 2011, 9). As a result of the higher costs of private sector production in PICs, including higher international trade costs, this is not likely to be a feasible model for PICs. While these higher costs are not immutable, the contributors to them are likely to change only slowly.

Technological changes that are facilitating the globalization of production chains may offer additional growth opportunities to PICs, although these are unlikely to constitute an escape from the constraints imposed by small size and remoteness. The globalization of production chains opens up opportunities that did not previously exist for firms in small states with limited sets of capabilities to integrate into production chains for high value-added products, by specializing in the production of goods or services that constitutes

4 Such sectors may well have less scope for productivity growth than, say, manufacturing, where it is, however, unlikely that PICs could be competitive, owing to the relatively greater significance of economies of scale and relatively greater reliance on a wide range of intermediate inputs.

fragments of overall chains. These small states do not have to have the broader capabilities needed to provide other aspects of the overall production chains. To take advantage of these opportunities, however, firms in small states need to be able to connect to these global production chains in a competitive manner, which is very difficult in small states that are remote from major markets. Technological changes that reduce the costs for firms in PICs of connecting to global production chains have the potential to alter the opportunities available to them over time, making investment in such connectivity—including with support from development partners—a high priority for PICs (Tumbarello, Cabwzon, and Wu 2013, 23; Yang et al. 2013, 32). But expectations about the significance of this potential opportunity should remain realistic. Even if firms in PICs are delivering services via ICT infrastructure to global production chains, and that ICT infrastructure can be provided at globally competitive costs, those costs do not constitute the firms' total cost base. That cost base will also contain nontradable goods and services and tradable inputs—all of whose costs are inflated by small size and remoteness. The overall point is that our framework for understanding the growth opportunities of PICs does not change fundamentally owing to the globalization of production chains and advances in ICT. These changes will not enable a complete escape from the constraints imposed by small size and remoteness. More simply, they will open up some new economic opportunities and reduce some of the high costs that would otherwise prevent PICs from taking advantage of these opportunities.

The PICs Encounter Higher Costs of Public Administration

In small remote states, economic geography also increases the costs of public administration. Lack of economies of scale plays a significant role in pushing up the cost of public administration in small states.[5] The provision of public goods and services is subject to a minimum scale (that is, there is a certain scale where this provision cannot be further divided, even if the need for the good or service is not sufficient to fully use what is being provided), making that provision disproportionately costly. The extent to which the need for a public good or service is not large enough in a small state to meet the minimum scale of provision will depend on the size and geography of the state in question and the specific function concerned. The evidence from local governments of comparable sizes suggests that it is likely that small states will not be large enough to take advantage of economies of scale in the provision of a significant proportion of administrative functions.[6] Key examples include major transport, energy, and water infrastructure; legislative functions; and general policy-making work—both in the core of the administration and at the policy level across all sectors of the administration.

Small states with populations that are very small, thinly dispersed, or territorially divided encounter a greater range of functions in which they are unable to take advantage of scale economies. Not only will small states that have very small populations be unable to take advantage of economies of scale in the provision of a greater proportion of public goods and services than other small states, total population may even understate the extent of this challenge. Where population densities are low—with people thinly dispersed rather than concentrated in one or a few major settlements—or where populations are divided over multiple separate territories—as with the islands of an archipelago—small states will be unable to take advantage of economies of scale in a greater range of state functions than total population figures would indicate (Tumbarello, Cabwzon,

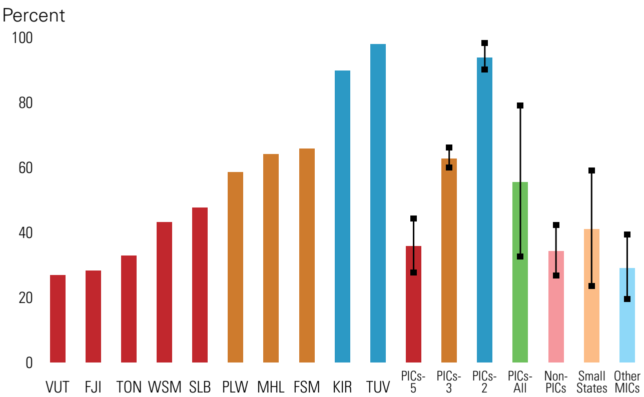
5 See, for instance, Srinivasan (1986, 211); Lowenthal (1987, 35, 43–44); Bray (1991, 67); Baker (1992, 15–17; Streeten (1993, 197–99); Farrugia (1993, 221–22); Medina Cas and Ota (2008, 13–14); Brown (2010, 52); and Sarapuu (2010, 34).

6 See Bish (2001, 14–15) for a survey of the evidence from literature, which finds that most researchers concluded that local governments were unable to take advantage of economies of scale in approximately 20 percent of their activities.

and Wu 2013, 6). In such contexts, states may not be able to exploit economies of scale in the provision of local roads, policing, or education—activities that account for large shares of public personnel and spending and where economies of scale can normally be exploited even with fairly small populations. The situation is likely to be similar for other infrastructure services like water, electricity, and telecommunications in small states with low population densities. In addition, small states that are extremely remote from major markets will encounter increased costs for inputs to government activities, further pushing up the cost of public administration. Just as the combination of small size and remoteness pushes up the cost of nontradable and tradable inputs to firms, so it pushes up the cost of these inputs to governments.

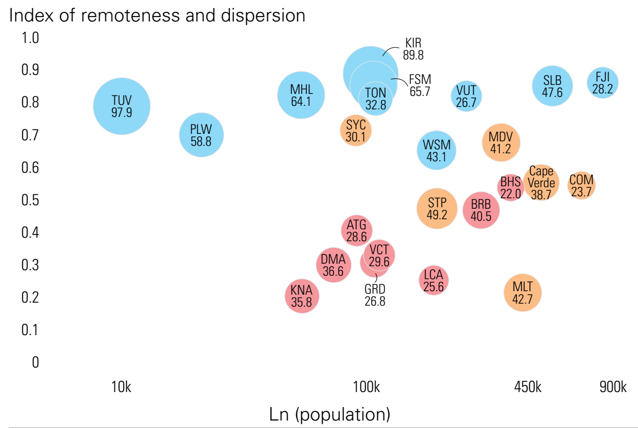
Analysis confirms that small size, remoteness, and territorial dispersion increase the cost of public administration in PICs. Many PICs have higher levels of public expenditure as a share of GDP than is typical in small states, although there is also considerable variation among PICs (Figure 5). More detailed analysis, employing a newly constructed index measuring remoteness from major markets (based on average GDP-weighted distance from markets), as well as a country's internal dispersion (based on the size of its Exclusive Economic Zone),[7] confirms that states that are either very small or have a high degree of remoteness and dispersion also have higher levels of public expenditure (Figure 6).[8] The contrast with other small island developing states in the Caribbean and elsewhere, which generally do not combine such small populations with such high degrees of remoteness and dispersion as PICs, is marked.

Figure 5. Many PICs have higher total expenditure shares of GDP than is typical of other small states



Source: World Development Indicators.
Notes: All data are averages for the latest three years available; black bars indicate standard deviations among country groups.

Figure 6. Small population size and a high degree of remoteness and dispersion appear to push up the cost of public administration in PICs



Sources: World Bank staff calculations using data from *World Development Indicators*, CEPII (2005), and the Sea Around Us Project (UBC and PEG 2014).
Note: The size of the bubbles indicates the extent of government expenditure as a share of GDP.

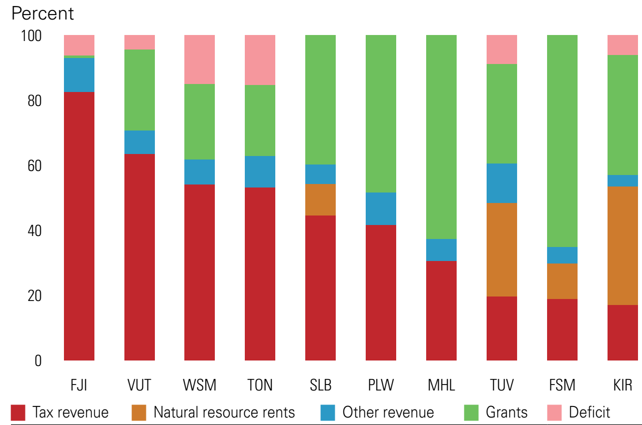
The challenges that small size, remoteness, and dispersion pose for public administration in PICs have important implications for the private sector. Given the disproportionate costs of public service provision in PICs, as well as the limited scope to raise taxes in light of the already high costs of private sector production, taxation is likely to be insufficient to fund the range and quality of services that might otherwise be expected.

7 See Annex 1 for details.

8 That said, the observed size of the public sectors in these states constitutes not an equilibrium or ideal size, but rather their actual size. This reflects several factors and constraints, such as the resources available to each state, including the amount of development assistance provided to supplement domestic revenue sources.

A number of PICs are able to supplement their tax revenue with considerable natural resource revenues, particularly from fisheries, and most receive large and fairly stable aid flows, enabling better service provision than would be possible from taxes alone (Figure 7). But this does not mean that all PICs can afford to supply the range of public functions typical of sovereign states at adequate levels of quality, nor does it solve the problems they face with drawing public servants from a limited pool of human capital sometimes lacking the requisite specialist expertise. Instead, there can be persistent gaps in the provision of state functions in PICs, with some functions provided to an inadequate standard or not at all, particularly where they depend on specialist expertise. An inadequate supply of public goods and services that are inputs to private sector production adds to the costs and inhibits the productivity of private sector firms. Especially relevant here are not only infrastructure services and policy-making functions, but the many critical public services that facilitate business development and trade.

Figure 7. Natural resource rents and aid flows play key roles in financing public services in PICs



Source: World Bank staff calculations based on International Monetary Fund data.

III. The Response of PICs to the Effects of Economic Geography

The PICs have responded to the effects of economic geography by specializing in the economic activities where they have the potential to be competitive globally, even if this means their growth is dependent on less traditional economic drivers than those used by many other developing countries. They have also sought to secure labor market access for their people abroad, in order to improve their living standards through migration and remittances. In addition, they have worked with development partners to secure a relatively high level of development assistance, which has helped fund the high cost of providing public goods and services in such small, remote, and dispersed states. This assistance has also financed regional institutions that have helped PICs maximize returns from key areas of comparative advantage, particularly fisheries, and press for greater labor mobility.

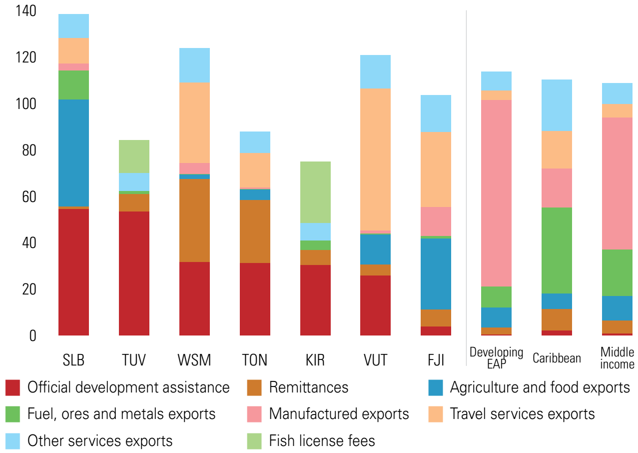
The Economic Structures of PICs Reflect their Economic Geography

The drivers of economic growth and increased living standards in PICs have tended to be those best suited to the effects of their economic geography. Economic growth in many of the PICs has been driven by natural resource industries and by goods and services production that is based on natural endowments (World Bank 2011, 13–14). Depending on the specific country, key natural resource industries have included mineral, forestry, mineral water, and other natural resource exports, and the license fees obtained in return for access to fisheries resources. Key goods and services based on natural endowments have included tourism and, to a more limited extent, general agriculture. A few PICs have also been able to become exporters of one or two niche, branded products (often with an agricultural base, like Vanuatu's beef, Tonga's vanilla, and Fiji's coconut-based cosmetics). Overall, there is a stark contrast in the structure of goods and services exports between PICs and the broader groups of EAP countries and middle-income countries, particularly with respect to the insignificance of manufactured exports for most PICs (Figure 8).

Migration and remittances have been critical drivers of increased living standards in PICs. In the context of globalization, agglomeration—with the greater opportunities it facilitates for specialization and for capturing positive externalities—is a key driver of productivity (World Bank 2009). Agglomeration itself is subject to path dependency, which drives ever greater levels of agglomeration, such that places that lack agglomeration are not only less productive but their relative lack of productivity typically increases over time as agglomeration itself intensifies. For PICs, this presents a significant challenge, because they not only lack agglomeration, they are also extremely remote from centers of agglomeration. In this context, access to labor markets abroad offers a critical development opportunity for PICs by enabling their people to move to economic areas where productivity is higher, increasing the productivity of migrating workers and improving not only their human development outcomes but also—via the remittances they provide and by knowledge transfers—human development outcomes for their extended families back home (Haque and Packard 2014, 11–23). Evidence from PICs shows that remittance income from migrant workers abroad improves living standards in PICs through the higher consumption it funds, and also increases investment—including in human capital through education (McKenzie and Gibson 2010). Over time, therefore, this may help to boost economic growth in PICs.[9] Even in the absence of such a relationship, expansions in access to labor markets abroad and increases in the human capital of emigrants that enhance their prospects for securing more highly skilled jobs abroad have the potential to facilitate further improvements in standards of living at home (Haque and Packard 2014, 11–23). Remittances are a significant contributor to living standards in several PICs (Figure 8; note that imports of goods and services provide a rough indication of living standards in economies as small as PICs). Related, access to labor markets abroad is also critical for several PICs (Figure 9).

Figure 8. Natural-endowment-based exports (including tourism), labor migration and remittances, and development assistance are critical to living standards in PICs

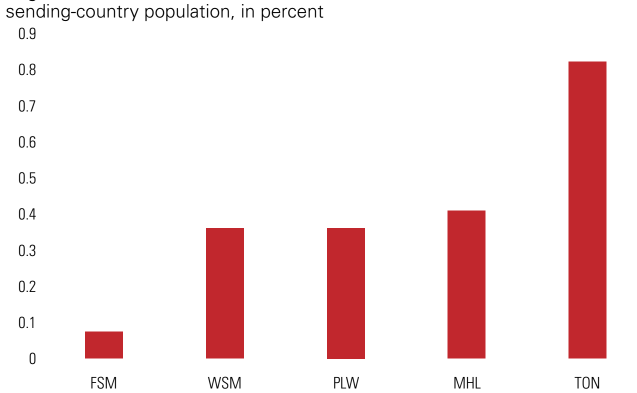
Sources of foreign exchange as a percentage of imports (annual average, 2010–2012)



Sources: *World Development Indicators.*
Notes: For the Solomon Islands, the disaggregation of goods exports is an estimate; log exports are included with agricultural exports. For Kiribati and Tuvalu, data are from, respectively, the 2014 and 2012 International Monetary Fund Article IVs, except for official development assistance data, which are from *World Development Indicators*; fish license fees are included, but further disaggregation of goods and services exports is not provided. For the Caribbean small states, data are from 2009–11.

Figure 9. Labor migration and remittances are a critical development opportunity for PICs

Migrants in Australia, New Zealand, and the United States as a share of sending-country population, in percent



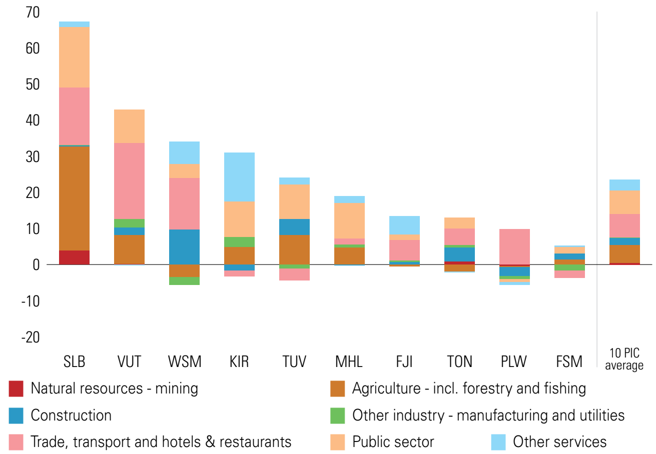
Source: World Bank 2014a.
Note: Data for Samoa exclude the U.S. diaspora due to the inability to isolate American Samoans in census data.

9 In the short run, with fixed levels of capital, emigration should improve labor productivity in the sending country through capital deepening, and could also be expected to improve labor productivity in PICs because the unemployment and underemployment in the existing labor force is so widespread.

Development assistance has also been a critical driver of increased living standards in PICs. In helping to fund the high cost of providing public goods and services in PICs, development assistance has helped raise living standards—particularly through supporting public sector provision of critical health and education services. In addition, it has helped support economic activity, not only through helping to provide a healthy and educated workforce, but through the provision of public goods and services—including infrastructure—that are critical inputs to private sector production or that help facilitate business development and trade. Development assistance has also supported economic activity in PICs by supporting government procurement of goods and services from the private sector, and by supporting demand for private sector goods and services from public servants. Overall, development assistance is very important to living standards in most PICs (Figure 8; again, note that imports of goods and services provide a rough indication of living standards in economies as small as PICs). Likewise, the public sector has been a critical contributor to growth in gross value added in many PICs over the last decade (Figure 10).

Figure 10. The public sector has contributed significantly to growth in many PICs over the last decade

Growth in GVA by sector, 2000–02 to 2010–12



Sources: World Development Indicators, Asian Development Bank.

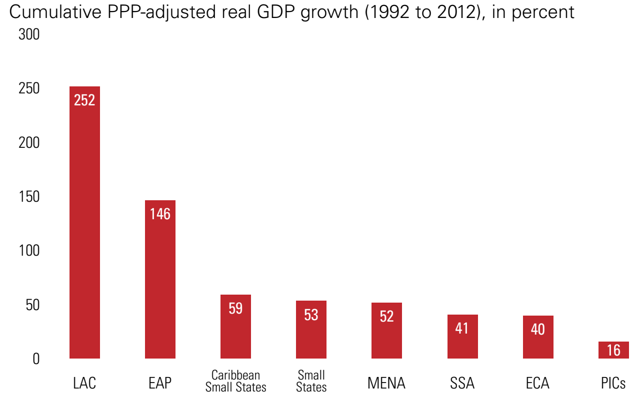
The Major Challenge for PICs is Economic Growth

The growth performance of PICs in recent decades has been disappointing. The low levels of economic growth in PICs in recent decades make them outliers on the global stage (Tumbarello, Cabezon, and Wu 2013, 18–23; Yang et al. 2013, 5). Over the last 20 years, growth in PICs has been lower than in any other regional group or grouping of small states (Figure 11). While PICs began this period with average per capita incomes above the Latin American and Sub-Saharan African regions, they have now slipped behind Latin America and are likely to be soon overtaken by Sub-Saharan Africa.

PICs' relatively poor growth performance is consistent with their economic geography. Economic geography has played a significant role in explaining low growth in PICs (Gibson 2006; Yang et al. 2013, 14–18). Notably, over the last decade, manufacturing has not played a significant role in the growth of any PIC. The three strongest growth performers have been the Solomon Islands, Vanuatu, and Samoa (Figure 10). For the Solomon Islands, logging has made the largest contribution to growth, followed by the public sector and trade and tourism-related services (as the Solomon Islands recovered from a period of civil conflict). For Vanuatu, trade and tourism-related services have made the largest contribution to growth, as regulatory changes in the

Figure 11. The PICs have not experienced strong and sustained economic growth in recent decades

Cumulative PPP-adjusted real GDP growth (1992 to 2012), in percent

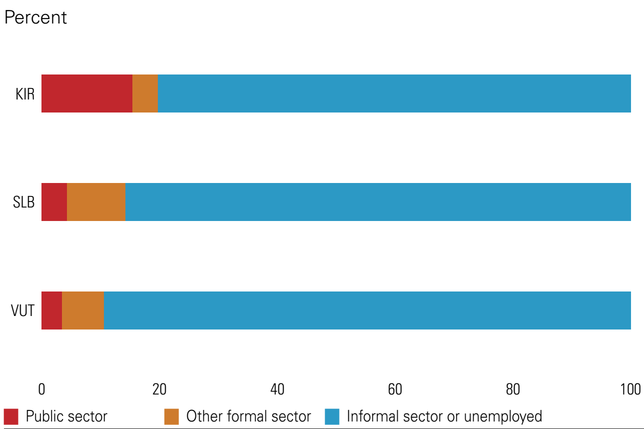


Source: World Bank staff calculations.

air transport and telecommunications sectors spurred a major expansion of the tourism industry. The public sector and agriculture have also contributed. Again, for Samoa, trade and tourism-related services have made the largest contribution to growth (with a role also for construction, much of it, however, linked to reconstruction in the wake of major natural disasters). For the other PICs, growth has been more limited (though a similar set of sectors have still driven what growth there has been).

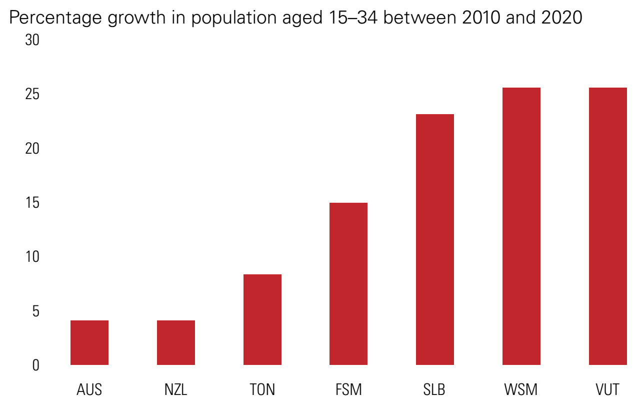
Reflecting the major challenge PICs face with economic growth, their economies have been unable to provide sufficient employment opportunities in recent decades.[10] Earnings from natural resources provide critical sources of government revenue and foreign exchange in PICs, but these industries tend to be capital-intensive and hence do not generate significant private sector employment. The formal jobs that are available in the private sectors of PICs tend to be derived more from tourism and from the public sector, given that the relatively large public sectors of PICs "crowd in" significant private sector activity and employment via public procurement and the demand derived from the wages paid to public sector employees. Public sector employment itself tends to play a significant role in the labor markets of PICs, particularly as a source of formal jobs. In the Solomon Islands, for instance, the public sector accounts for some 30 percent of formal sector jobs, while in Kiribati the public sector accounts for nearly 80 percent of formal sector jobs. Overall, formal sector job opportunities are fairly limited in PICs, with most working-age people confined to the informal sector (Figure 12). A significant share of the jobs that benefit Pacific Islanders are, in fact, abroad.

Figure 12. Formal sector job opportunities are scarce in PICs



Source: World Bank (2014), using provident fund and census data.

Figure 13. Young adult numbers in PICs are expected to grow rapidly in the coming years



Source: World Bank 2014a.

The limited employment opportunities in PICs is a significant concern, especially given their very young populations. The PICs face a youth bulge, with 54 percent of the population below age 24—a higher proportion than the average for the developing world. The number of people aged 0–14 substantially exceeds those aged 14–25, so the number of working-age youth is expected to grow quickly over the next decade from an already high base (Figure 13). Given the fairly limited job opportunities in PICs, unemployment—particularly among youth—is a significant problem. Even accounting for informal employment, the International Labour Organization estimates that the percentage of men aged 20–24 who are not engaged in productive activities (defined as "paid or unpaid activity that contributes to their personal livelihood or that of their family and community as a whole") is 58 percent in Kiribati, 46 percent in Samoa, and 44 percent in the Marshall

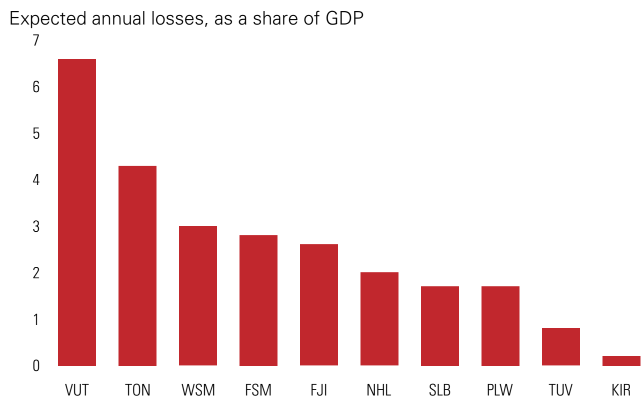
10 See the detailed report on employment challenges in PICs by Haque and Packard (2014).

Islands. At the same time, the spread of mass media and telecommunications has increased awareness of the wider world and fueled aspirations for higher living standards. This makes improving the quantity and quality of employment opportunities—including access to those available to Pacific Islands abroad—critical not just to living standards but also to social stability in PICs.

While extreme poverty is very low in most PICs, the absence of strong and sustained economic growth and the limited extent of employment opportunities have given rise to widespread hardship. Food poverty is estimated to be very low—below 5 percent—in most PICs, the exception being the Solomon Islands, where it was estimated at just over 10 percent in 2006. These low rates of food poverty suggest that reasonably widespread access to land for subsistence agriculture together with informal, community-based social safety nets have been reasonably effective in avoiding extreme hardship. While it is difficult to compare rates across PICs, basic needs poverty tends to be around 20 to 30 percent of the population in most PICs. In many PICs, large numbers of people are also vulnerable to falling into poverty.[11]

The narrow scope of livelihood opportunities and the limited extent of formal sector employment, together with the geographic characteristics of PICs, also create considerable vulnerability to shocks. With high rates of informality, underemployment, and unemployment, large segments of the populations of PICs are vulnerable to shocks. Households in PICs are also highly exposed to aggregate shocks that affect much of the population in each country and which households are not able to adequately mitigate. This is due in part to their extreme exposure to natural disasters, engendered primarily by their geography (Figure 14). It also reflects the concentrated nature of the external flows on which they depend for their standards of living, and the volatility of the key external flows—natural resource returns, tourism earnings, and remittances—that results from commodity price volatility, fish stock migration patterns, natural disasters, and economic shocks in tourist and remittance-source countries abroad (Tumbarello, Cabezon, and Wu 2013, 11–14).

Figure 14. The PICs are highly vulnerable to economic losses from natural disasters



Source: World Bank (2013), figure 60, p. 68.

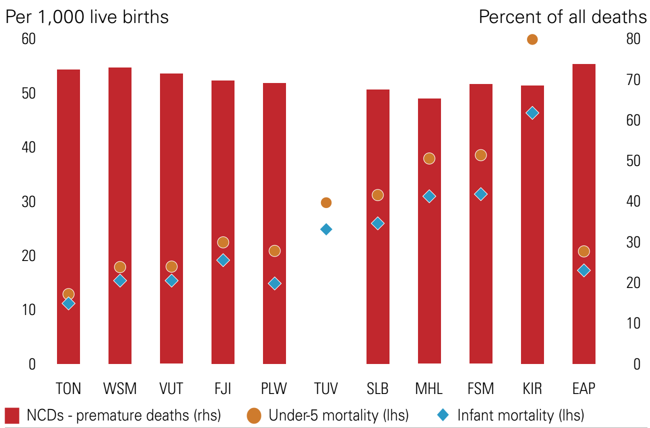
The strength of basic health and education indicators in many PICs, relative to the EAP region as a whole, suggests reasonable success in providing basic public goods and services in challenging circumstances. There is, however, considerable variation among PICs on basic health and education indicators. Many PICs have basic health indicators including infant and under-5 mortality rates that are on par with the EAP average, though for the other PICs it is clear that serious challenges remain (Figure 15). Many PICs also have basic education indicators including primary school enrolment rates that are on par with the EAP average, though again for some PICs serious challenges remain (Figure 16). Beyond the basic indicators, it is clear that all PICs face important, emerging challenges. On the health side, they face a noncommunicable disease (NCD) epidemic that their public sectors have not yet managed to tackle effectively, as indicated by their high and rising premature death rates from NCDs (Figure 15).[12] On the education side, secondary school enrolment rates are fairly poor across

11 For further details on poverty estimates in PICs, see *Hardship and Vulnerability in the Pacific Islands* (World Bank 2014b).

12 For further details on the NCD epidemic in PICs, see World Bank (2014).

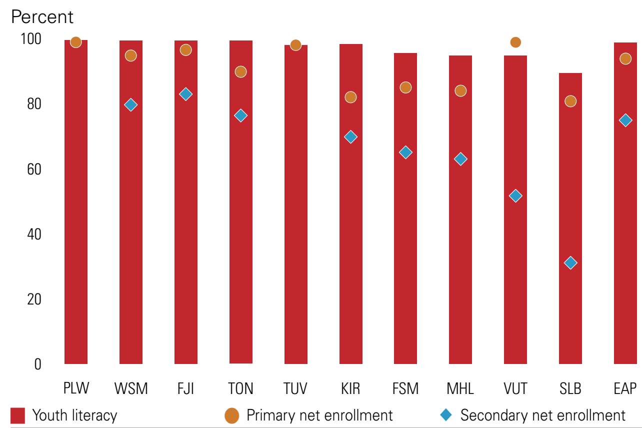
PICs relative to the EAP average, an important weakness given the significance of better access to higher-paid jobs in labor markets abroad for rising living standards in PICs (Figure 16).

Figure 15. Basic health indicators in many—but by no means all—PICs are on par with the EAP average



Sources: World Development Indicators and World Bank 2014a.
Note: NCDs=noncommunicable diseases.
rhs=right hand scale
lhs=left hand scale

Figure 16. Basic education indicators in many PICs—but not all—are also on par with the EAP average



Source: World Development Indicators and Pacific Islands Forum Secretariat 2013.

IV. Policy Implications

Particularly given the challenges of public administration in PICs, it is vital that their limited policy capacity be focused on supporting those economic activities that have a real prospect of being competitive in global markets. This includes ensuring that returns from natural resources are maximized, well-managed, and equitably distributed, and facilitating industries that capitalize on natural endowments or that serve niche markets. It also includes working to enhance the labor mobility of Pacific Islanders. In addition, it is vital for PICs to work with their development partners to strengthen the capacity of their public sector to improve living standards in PICs, and to recognize the policy implications of the public sector's dominant position in the labor markets and broader economies of PICs.

The first policy priority for enhancing living standards in PICs is to focus the limited resources of their public sectors on supporting economic activities that have a real prospect of being competitive in global markets, so as to contribute to stronger and more sustained growth. The success of firms in any state depends not just on private sector capabilities but also on the capability of the state to devise and implement the necessary regulatory frameworks, provide the relevant infrastructure (including infrastructure that connects firms to global markets), and solve the coordination problems and other market failures that would otherwise impede business development. Providing the regulations, infrastructure, and services that the private sector depends on for its success is a considerable challenge for states with such limited capacity as PICs. This underscores the critical importance of prioritizing policy and reform efforts, business infrastructure provision, and business and trade facilitation activities on those economic sectors that have the greatest potential to overcome the higher production costs in small remote economies by securing market rents or premium prices. Development partners should align their assistance with this focus.

In particular, this involves ensuring that returns from natural resources are maximized, well-managed, and equitably distributed, and facilitating industries that capitalize on natural endowments or that serve niche markets. International experience is replete with examples of how the exploitation of natural resources can fuel volatility in public finances, corruption, economic distortions, social inequity and conflict, and environmental degradation. Appropriate regulatory regimes that secure a fair share of the gains from such industries for the public and for local resource owners, and that protect against adverse social and environmental impacts, are vital. The public sector must also build the systems and capacity to manage revenue volatility. Some aspects of this policy work are likely to require specialist expertise that PICs may need to call on periodically over an extended period, which could be a priority for development partners to facilitate. Other aspects of this work, particularly with regard to maximizing returns from fisheries resources, can be best achieved through regional mechanisms, again with an important role for donor support.[13] Beyond natural resources, it is important for PICs to focus on facilitating industries that capitalize on natural endowments (in particular, tourism) and industries that serve niche markets. This facilitation is likely to involve, among other things, public investment in critical infrastructure for these industries, the provision of appropriate human capital development mechanisms, resources for industry-wide marketing, regulatory frameworks for standards, and the use of the state's convening power to enable firms to solve coordination problems in scaling up different components of these industries simultaneously.

A second policy priority is for PICs and their development partners to work to improve labor mobility, in terms of both expanding access for Pacific Islanders to labor markets abroad, and facilitating their capacity to take advantage of that access at progressively higher skill levels. As a result of special historical relationships, the access that different PICs have to labor markets abroad—particularly in the United States and New Zealand—is extremely uneven. More recent temporary migration programs in New Zealand and Australia have the potential to expand the labor market access of people in all PICs, improving their productivity as they move to centers of economic activity abroad, and enhancing the human development outcomes for their extended families back home, primarily through remittance flows. Migration and remittances will have a stronger potential to support continuous improvements in living standards in PICs if migration opportunities can be progressively expanded in terms of both the number of places, and allowing access to industries requiring higher skill levels. Domestically, it is important for PICs to continue to invest heavily in the health and education of their people, to enable them to take advantage of labor market opportunities abroad and to obtain higher quality and more secure positions within those labor markets. It is also important for them to strengthen the fairness and transparency of worker selection processes for temporary migration schemes, to support an equitable domestic distribution of benefits from these schemes.

A third policy priority is to strengthen the capabilities of public sectors in PICs, including through development assistance that is reasonably assured over the long term. The delivery of an adequate range and quality of public services to the people and private sectors of PICs is vital to their prospects for improving living standards and strengthening economic growth. But doing this in such small, remote, and dispersed states as PICs is particularly challenging and involves a disproportionate cost. To fund an adequate range and quality of public services in most PICs, taxation and natural resource revenues are likely to require supplementation with development assistance on a long-term basis. Because of endemic shortages of specialist skills within such small populations, capacity transfers to supplement local capacity are also likely to be required on a long-term

13 With support from a regional organization, a group of PICs are now successfully operating the "Vessel Day Scheme," a centralized regime for providing and trading access to the fisheries resources of the participating PICs, as a means of maximizing access fees and smoothing revenues in the face of migrating fish stocks. See Forum Fisheries Agency (2008) for details.

basis. Beyond this, and given the underlying challenges to public service delivery, there is a premium on reforms that strengthen public sector capabilities, for instance, by finding innovative ways to perform public functions or deliver services. This may involve adopting regional approaches to public regulation or service provision, or aligning regulations and sharing services with nearby large markets. Again, public financial management (PFM) reforms that help strengthen expenditure quality and service delivery will deliver particularly high payoffs when resources and capacity are as constrained as in PICs. The World Bank's experience in this area suggests many instances where expenditure quality and service delivery in PICs are hampered by attempts to follow best practice models that are not fit-for-purpose in PIC contexts. Adopting a more problem-driven approach to PFM reforms has the potential to improve outcomes by operating less capacity-intensive systems that get the key aspects of PFM for PICs right.[14]

Equally, in the context of public sector reform, it is vital for both PICs and their development partners to recognize the policy implications of the public sector's dominant position in the labor markets and broader economies of PICs. The overarching concern for public sector reform should be finding ways to make the public sectors in PICs more efficient and effective, so as to yield greater benefits to their people and private sectors. But public sector procurement, including that financed by development partners, is a significant source of demand for the private sector in PICs. The public sector in PICs is also a significant source of employment; this has a direct impact on living standards, and provides an indirect source of demand for the private sector. It clearly makes sense for public sectors in PICs to ensure that they do not structure procurement opportunities in ways that exclude local firms, and that their business facilitation efforts include building the capacity of the domestic private sector to be competitive in public tenders. But, beyond this, it is important that any public sector reform program take into account the impact of the public sector on aggregate demand. Experience with public sector downsizing in PICs suggests that failure to account for the dependence of some parts of their private sector on public sector demand, together with narrow growth opportunities for the private sector, leads to unrealistic assumptions about the potential of the private sector to reemploy retrenched public sector workers (Asian Development Bank 2009, 12–14, 20, 28–32).[15]

Ultimately, the major economic challenge for PICs is to sustain stronger economic growth, in order to expand their employment opportunities and reduce the widespread hardship and vulnerability they face. This note has outlined the challenges that PICs face owing to their unique economic geography, and has set out some broad policy priorities. But filling the many gaps in our knowledge of PICs would allow for more specific policy recommendations. In particular, in broad terms it is clear which economic sectors PICs could be globally competitive in. Less is known about why and how some of the industries that capitalize on natural endowments, or serve niche markets, have become successful in some PICs but not in others, or about the extent to which these industries lend themselves to creating extensive backward linkages—particularly linkages that generate employment. Similarly, the limited private sector job opportunities and the extreme household vulnerability to shocks in PICs are well understood. But detailed poverty analytics are limited, making it difficult to develop appropriate social protection schemes—including schemes to help households mitigate the impact of shocks (World Bank 2014). These two areas should be key components of the future research agenda in the region.

14 On this proposed approach, see Haque et al. (2013).

15 This does not mean that public sector employment in PICs should be used to directly stimulate living standards and private sector demand, as opposed to providing an adequate range and quality of public services. Rather, if public sector downsizing is under consideration, then both its positive and negative implications must be taken into account.

ANNEX 1: CONSTRUCTION OF THE REMOTENESS AND DISPERSION INDEX

The remoteness and dispersion index is constructed from two components, each of which is equally weighted in the aggregation to form the index.

Component 1: Remoteness

The basis of this remoteness component is the GDP-weighted distance from markets for each country. To convert the GDP-weighted distance from markets into a component for the index, the difference between the natural logarithm of it and that of least-GDP-weighted distance in the global sample (that of the Netherlands, at 5,106) is taken, and is scaled by the difference between the natural logarithms of the greatest and least-GDP-weighted distances in the global sample (the greatest being that of New Zealand, at 14,554), as follows:

$$\text{Remoteness component}_j=\{\ln(\text{Distance}_j)-\ln(\text{Distance}_{\text{global min}})\}/\{\ln(\text{Distance}_{\text{global max}})-\ln(\text{Distance}_{\text{global min}})\}$$

Component 2: Dispersion

The basis of this geographic dispersion component is the estimated Exclusive Economic Zone (EEZ) of each country. To convert the EEZ into a component for the index, the difference between the natural logarithm of it and that of the smallest EEZ in the sample (that of St. Kitts and Nevis, at 10,201 km^2), is scaled by the difference between the natural logarithms of the largest and smallest EEZs in the sample (the largest being that of Kiribati, at 3,437,345 km^2), as follows:

$$\text{Spatial dispersion component}_j=\{\ln(EEZ_j)-\ln(EEZ_{min})\}/\{\ln(EEZ_{max})-\ln(EEZ_{min})\}$$

Index of Remoteness and Dispersion

The two components and the resultant index for each country in the set are shown in Table A1.1. The closer the index is to zero, the smaller is the degree of remoteness and dispersion of that country; the closer the index is to one, the greater is the degree of remoteness and dispersion.

Table A1.1. Components of the Remoteness and Dispersion Index for Pacific, Caribbean, and other Small Island Developing States

	Average GDP-weighted distance from markets[1]	Remoteness index component	Estimated EEZ (sq km)[2]	Dispersion index component	Remoteness and dispersion index
Pacific (Average)	*12,035*	*0.82*	*1,428,143*	*0.79*	*0.80*
Fiji	12,964	0.89	1,281,122	0.83	0.86
Kiribati	11,531	0.78	3,437,345	1.00	0.89
Marshall Islands	11,090	0.74	1,992,232	0.91	0.82
Micronesia, Federated States	10,987	0.73	2,992,597	0.98	0.85
Palau	10,600	0.70	604,289	0.70	0.70
Samoa	12,627	0.86	131,812	0.44	0.65
Solomon Islands	12,215	0.83	1,597,492	0.87	0.85
Tonga	13,181	0.91	664,853	0.72	0.81
Tuvalu	12,279	0.84	751,797	0.74	0.79
Vanuatu	12,879	0.88	827,891	0.76	0.82
Caribbean (Average)	*7,915*	*0.42*	*130,012*	*0.28*	*0.35*
Antigua and Barbuda	7,788	0.40	107,914	0.41	0.40
Bahamas, The	7,499	0.37	629,293	0.71	0.54
Barbados	8,057	0.44	186,107	0.50	0.47
Dominica	7,920	0.42	28,626	0.18	0.30
Grenada	8,175	0.45	26,158	0.16	0.31
St. Kitts and Nevis	7,791	0.40	10,201	0,00	0.20
St. Lucia	8,011	0.43	15,484	0.07	0.25
St. Vincent and the Grenadines	8,078	0.44	36,314	0.22	0.33
Other (Average)	*8,355*	*0.46*	*571,779*	*0.60*	*0.53*
Cape Verde	7,421	0.36	796,840	0.75	0.55
Comoros	9,675	0.61	164,691	0.48	0.54
Maldives	9,366	0.58	916,189	0.77	0.68
Malta	5,874	0.13	55,556	0.29	0.21
São Tomé and Principe	8,314	0.47	165,364	0.48	0.47
Seychelles	9,483	0.59	1,332,031	0.84	0.71

Sources: 1. World Bank staff calculations. 2. The Sea Around Us Project (UBC and PEG 2014).

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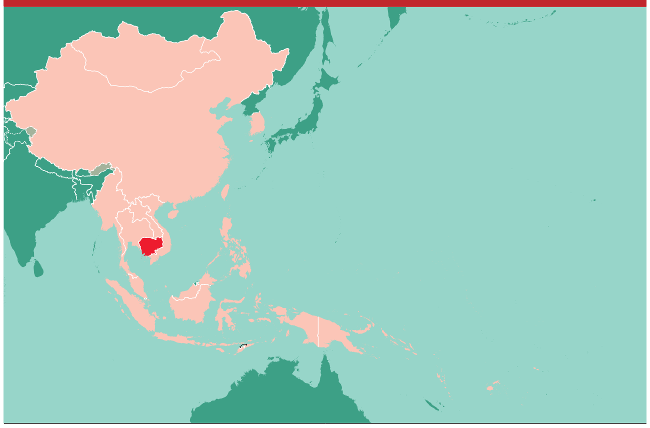
Part III. Country Pages and Key Indicators

CAMBODIA



Population	15.1 million
Population growth	1.8 percent
GDP (PPP, int'l US$)	46.0 billion
GDP per capita (PPP, int'l US$)	3,042
Surface area	181,040 sq. km.
Capital	Phnom Penh

Source: World Development Indicators.

Summary

Growth has held up well in Cambodia despite domestic uncertainty and instability in neighboring countries. Real growth for 2014 is estimated to reach 7.2 percent, driven by the garment, construction, and services sectors. Overall macroeconomic management has been good, with fiscal consolidation underpinned by improved revenue administration. With the expectation of renewed confidence and the return of political stability after ending a yearlong political deadlock in July 2014, bolstered by a strengthening global economy, Cambodia's real economic growth rate for 2015 is expected to improve further, achieving 7.5 percent. The downside risks to forecast growth are potential further labor unrest and the high season floods, as well as regional political uncertainty.

Recent Economic Developments

Garments continue to be Cambodia's key engine of growth, while construction overtook the decelerating tourism and crops sectors as the second most important growth driver. The garment sector grew at a year-on-year (yoy) growth rate of 14.1 percent by mid-2014, supported by an improved global economic environment and greater labor market stability. Construction has picked up on the back of renewed domestic confidence, overtaking tourism and crops. Services sector growth remains robust, although tourism sector growth has decelerated, with a yoy arrival growth rate of only 5.2 percent during the first six months, owing to political turmoil in Thailand and tensions between Vietnam and China. Agricultural growth also decelerated as world agricultural prices have been decelerating.

Poverty reduction continued thanks to growth, but at a slower pace than before. The poverty rate fell to 18.6 percent in 2012, down 1.9 percentage points from its 2011 level. However, the pace of poverty reduction in 2011–12 was slower than seen during 2004–11, when poverty fell by 4.7 percentage points per year on the back of increases in rice prices, which helped the rural poor.

This year's continued healthy economic growth is underpinned by stable external sector performance on the back of rising FDI inflows that help largely finance a slightly widened current account deficit contributing to an increase in international reserves. Garment export growth has continued, while FDI inflows are rising due to the return of relative labor market stability and investors' renewed appetite for the construction and real estate sector, leading to growing construction materials imports. Consumption goods imports also picked up, driven largely by vehicle and petroleum products. The current account deficit is projected to reach 11.3 percent of GDP, slightly higher than the 10.7 percent estimated for 2013, largely financed by FDI. Gross international reserves, therefore, have risen quickly to US$4.2 billion, or about 3.5 months of imports by mid-2014, from US$3.6 billion, or 3.4 months at end-2013.

Though there has been a slight increase in inflation, price stability remains within acceptable levels fostering economic expansion and supporting poverty reduction. Inflation rose to 4.9 percent yoy by mid-2014, slightly higher than the 4.6 percent by end-2013. The prices of most staple food items remain stable, although prices of some food items, such as meat and fruit, and other nonfood items, such as utilities, are inching up gradually. Regional and other developing-country inflation remains benign.

Private sector deposit growth has picked up swiftly thanks to renewed confidence on the economy, contributing to greater stability in the banking sector. Private sector deposits have picked up rapidly, reaching US$8.09 billion, or a 22.2 percent yoy increase by mid-2014, compared with US$6.88 billion, or 14.2 percent yoy growth by end-2013. Credit growth has also moderated, falling to 21.8 percent yoy from 26.7 percent during the same period. Increased deposit growth, together with moderated credit growth, resulted in the loan-to-deposit ratio decreasing to 82.2 percent by mid-2014, down from 90 percent at end-2013. The short-term borrowing rate declined slightly, reaching 11.2 percent by April 2014, compared with 11.3 percent at end-2013, as a result of heightened competition among banks.

The Cambodian riel (CR) continues to hover around CR 4,000 per U.S. dollar due to exchange rate targeting, resulting in a slight appreciation of the real effective exchange rate. The exchange rate reached CR 4,040 per U.S. dollar by mid-2014, compared with CR 3,995 per U.S. dollar at end-2013. The exchange rate targeting of around CR 4,000 per U.S. dollar has resulted in a slight appreciation of the real effective exchange rate, since the U.S. dollar has recently appreciated against other major currencies such as the euro and the Chinese yuan, which are also the currencies of Cambodia's major trading partners.

Fiscal performance has been further strengthened thanks to improved revenue administration; providing additional financing to support rising essential public spending without undermining macroeconomic stability. The overall fiscal deficit (including grants) is projected to decline to 2.5 percent of GDP in 2014, from 2.7 percent in 2013. This improvement is being led by enhanced revenue collection, which has expanded rapidly by rising 21 percent during the first four months, while expenditure, which was initially slow, will likely remain as budgeted. The deficit continues to be overfinanced by external funds. Government savings, therefore, rose to US$931 million by mid-2014, compared with US$700 million at end-2013. Cambodia's debt distress rating, as assessed by the joint World Bank-International Monetary Fund Debt Sustainability Analysis conducted in 2013, remains low.

Outlook and Emerging Challenges

The outlook for growth appears promising, with renewed domestic political stability, strengthened recovery in the United States, and stability in Thailand supporting GDP growth to reach 7.5 percent in 2015, similar to that of 2013. The prospects for garment exports remain positive, while vibrant activity in the construction and services sectors is also expected, as is recovery of the tourism sector thanks to the greater stability in Thailand. Agricultural sector growth, however, will likely continue to be affected by dampened agricultural commodity prices in the international market.

However, there are downside risks to forecasted growth. These include potential further labor unrest; rainy season floods, which may have a greater negative impact on crops than normal due in part to the El Niño weather pattern; the further dampening of rice prices with the resumption of Thai rice exports in the third quarter of the year; and potential regional political uncertainty.

How can Cambodia maintain and boost economic growth and reduce poverty further? The key challenge will be to stimulate the agricultural and tourism sectors once again. Rice production growth has decelerated since 2012 and given the land area constraint, its recovery will depend from now on more on increases in rice productivity and quality than on area expansion. Measures to increase agricultural productivity—including increased public investment in farm advisory services, seed development and irrigation infrastructure—enhance shock resilience, and open up new markets would help the agricultural sector rebound. Improving rice milling and logistics costs would help address the two main reasons for Cambodian rice losing the competitiveness that it has at farm gate price. Improved access to finance for rice producers and millers and reduced costs of doing business would help increase milling volumes and reduce milling costs. Improving logistics will also enhance the competitiveness of agricultural production and exports helping Cambodia get closer to its one million rice milled export target. Improved road transportation, together with greater coordination of efforts between central and local governments, the private sector and local communities, would help promote diversification of tourist destinations beyond the Angkor Archeological Park.

Facilitating the growth of the manufacturing sector will also be instrumental to maintain and boost economic growth. The latest Enterprise Survey of the forthcoming Investment Climate Assessment indicates that the business environment continues to hamper the competitiveness of firms in Cambodia. The key constraints for firms continue to be electricity cost and access, informal payments and uncompetitive practices. The survey also shows that Special Economic Zones (SEZ), which were meant to provide an improved business environment, are not yet delivering the benefits expected by foreign investors. The present robust economic growth therefore presents an opportunity to improve the business environment by addressing the high cost of electricity with transparent solicitation; continuing the automation of business processes; improving trade facilitation; increasing the attractiveness of SEZs; completing competition and investment laws that enhance the investment climate; and simplifying business registration. To further strengthen exports by maximizing the benefits from the global recovery, it is also important to maintain political stability and to reach a conclusive and transparent process in tripartite minimum wage negotiations for the garment sector. This will also help attract additional foreign investment projects relocating from more advanced economies in the region.

Safeguarding stability in the financial sector through enhanced banking supervision will help prevent a bubble in the construction and real estate sectors, while also strengthening the country's resilience in facing possible higher volatility in international financial markets.

More broadly, increasing capital investment, deepening structural reforms, and improving formal and vocational education will help Cambodia return to a higher growth path. Further broadening the tax base and strengthening tax administration will help finance this much needed development spending. The successful implementation of reforms would help investment increase by more than 5 percentage points of GDP and allow Cambodia to attain a GDP growth path above 8 percent.

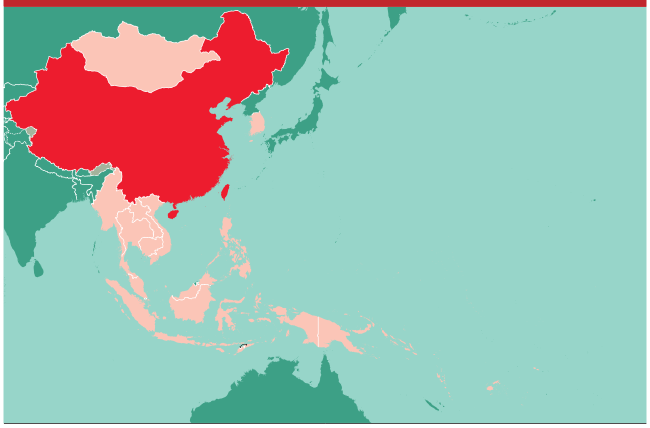
The development of very specific reform agendas with targets linked to priority reforms and a strong monitoring framework would help enhance the effectiveness of government implementation. The Royal Government of Cambodia’s (RGC) new five-year Rectangular Strategy (RS) III, clearly identifies the development challenges and priorities for the country. The development of very specific and detailed action plans linked to the priorities and the establishment of a strong monitoring system to check regularly performance, would help Cambodia address development challenges and meet its priorities more effectively.

Cambodia: Key Indicators

	2012	2013e	2014f	2015f	2016f
	Year	Year	Year	Year	Year
Output, Employment, and Prices					
Real GDP (% change yoy)	7.3	7.4	7.2	7.5	7.2
Domestic demand (% change yoy)	14.9	12.1	12.4	11.0	10.7
Consumer price index (% change yoy)	2.5	4.6	5.0	5.5	6.0
Public Sector					
Government revenues (% GDP)	15.3	15.1	16.1	16.4	16.4
Government expenditures (% GDP)	21.0	21.5	20.4	20.9	21.3
Government balance, excluding grants (% GDP)	-5.7	-6.4	-4.3	-4.5	-4.9
Government balance, including grants (% GDP)	-3.3	-2.7	-2.5	-3.5	-3.3
Foreign Trade, BOP, and External Debt					
Trade balance (millions US$)	-2,456	-2,598	-2,908	-2,956	-2,856
Exports of goods (millions US$)	5,633	6,890	8,193	9,700	11,572
(% change yoy)	7.9	22.3	18.9	18.4	19.3
Key export (% change yoy) [1/]	7.0	17.6	15.0	15.5	15.0
Imports of goods (millions US$)	8,089	9,489	11,102	12,656	14,428
(% change yoy)	20.6	17.3	17.0	14.0	14.0
Current account balance (millions US$) [2/]	-1,366	-1,639	-1,849	-1,989	-1,834
(% GDP)	-9.6	-10.7	-11.3	-11.2	-9.6
Foreign direct investment (millions US$)	1,405	1,299	1,380	1,400	1,450
External debt (millions US$)	4,559	5,124	5,631	6,019	6,380
(% GDP)	32.1	33.3	34.4	33.9	33.3
Debt service ratio (% exports of g&s)	1.1	1.1	1.2	1.1	1.3
Foreign exchange reserves, gross (millions US$)	3,463	3,643	4,300	4,600	5,100
(months of imports of g&s)	3.1	3.4	3.5	3.3	3.2
Financial Markets					
Domestic credit (% change yoy)	29.6	26.7	20.0	19.5	18.0
Short-term interest rate (% p.a.)	11.6	11.3	11.2	11.0	11.0
Exchange rate (Riel/US$, eop)	3,995.0	3,995.0	4,065	4,076	4,050
Real effective exchange rate (2000=100)	105.4	109.9	112.1	113.5	115.5
(% change yoy)	5.4	9.9	2.0	1.3	1.7
Memo: Nominal GDP (millions US$)	14,188	15,373	16,367	17,759	19,173

Sources: National data sources; IMF; and World Bank staff estimates.
e = estimate.
f = forecast.
g&s = goods and services.
p = projection.
1/ Garments.
2/ Excluding official transfers.

CHINA



Population	1.4 billion
Population growth	0.5 percent
GDP (PPP, int'l US$)	16.2 trillion
GDP per capita (PPP, int'l US$)	11,904
Surface area	9,6000,000 sq. km.
Capital	Beijing

Source: World Development Indicators.

Summary

China's growth stabilized in Q2 from a slowdown in Q1, on the back of supportive fiscal and monetary policies. However, recent activity data suggest that economic growth may have moderated again in Q3, and that more growth-supportive policy measures may be required in order for the authorities to meet their growth target. We anticipate China's fiscal and monetary policy stance to stay accommodative. We expect the economy to expand by 7.4 percent this year, and growth to decelerate to 7.2 percent in 2015 as the structural adjustment continues. The main risk for China's growth outlook is a possible disorderly deleveraging of local governments, which could trigger a sharp slowdown in investment growth, and a contraction of select sectors, especially the real estate sector. Another risk is a weaker-than-expected recovery of advanced economies.

Recent Economic Developments

China's economic growth stabilized in Q2 from a moderation in Q1. Growth picked up from 7.4 percent (yoy) to 7.5 percent in Q2. The seasonally adjusted sequential quarter-on-quarter growth quickened to 2.0 percent in Q2 from 1.5 percent in Q1. Investment was the leading driver of growth, contributing 4.1 percentage points to GDP growth. Net exports became a stronger driver of growth, contributing 0.9 percentage points. Growth contribution by consumption weakened to 2.5 percentage points in Q2 from 5.7 percentage points in Q1.

The growth recovery in Q2 was driven by supportive fiscal and monetary policies. These growth-supportive measures include the acceleration of public investment spending, selective cuts in required reserve ratios that aim at increasing access to finance for small and agricultural businesses, and pledged supplementary lending of Y 1 trillion (approximately 1.7 percent of GDP) by the central bank to the China Development Bank, which will relend funds to local government financing vehicles for shantytown redevelopment projects. The China Banking Regulatory Commission recently announced a revision in the method of calculating banks' loan-to-deposit ratio, which allows additional deductible items in the calculation of total loans and effectively loosens the limit on bank lending.

Recent activity data show mixed evidence on whether the growth acceleration can be sustained in the latter half of 2014 without additional policy support measures. Latest activity data suggest that China's economy might have slowed at the beginning of Q3, after acceleration in Q2. On the supply side, overall industrial production growth fell from 9.2 percent (yoy) in June to 9.0 percent in July. In August, industrial production growth fell significantly to 6.9 percent. On the demand side, monthly retail sales growth stayed flat in July and August, at about 10.6 percent in real terms. Fixed asset investment grew by 16.5 percent (yoy) from January to August, down from 17.0 percent during January–July. On the external front, export growth picked up further from 7.2 percent (yoy) in June to 14.5 percent in July, albeit moderated to 9.4 percent in August. July import growth turned negative at -1.6 percent (yoy). Imports continued to decline by 2.4 percent in August. As a result, August witnessed a historical high monthly trade surplus of US$49.8 billion, compared to US$47.3 billion in July and US$31.6 billion in June. The trade surplus was US$102.5 billion in the first half of 2014, and US$199.7 billion during January–August.

China's external position improved in Q2. Balance-of-payment data show that China has accumulated US$35.7 billion of foreign exchange reserves in Q2 2014, compared to US$125.8 billion in Q1 2014. The current account surplus jumped 10 times from US$7.0 billion in Q1 to US$72.2 billion in Q2. For H1 2014, the current account surplus amounted to about 0.9 percent of GDP. Net FDI was strongly positive in Q2, at US$40.3 billion, compared to US$53.7 billion in Q1. Recent monthly data indicate that export growth hit a 15-month high of 14.5 percent yoy in July and remained robust in August. Export recovery is broad-based across both emerging and developed markets.

Consumer Price Index (CPI) inflation remained benign, while Producer Price Index (PPI) deflation widened in August. CPI inflation fell to 2.0 percent (yoy) in August from 2.3 percent in July. Food price inflation eased from 3.6 percent in July to 3.0 percent in August. Nonfood inflation moderated slightly from 1.6 percent (yoy) in July to 1.5 percent in August. PPI deflation widened from -0.9 percent (yoy) in July to -1.2 percent in August. Given the fact that inflation remained well below the official target of 3.5 percent (yoy), there is ample room for further monetary policy easing.

Latest data suggest that China's credit growth moderated but monthly new loans picked up. The monthly increase in bank loans fell to Y 385.2 billion in July from Y 1,080 billion in June, but then recovered to 702.5 billion in August. Total social financing growth dropped from 15.9 percent (yoy) in July to 15.1 percent in August. Growth in outstanding bank lending fell from 13.4 percent to 13.3 percent. The central bank offered an interpretation of the data on its official website, citing seasonality and the decrease of monetary demand from the real economy in July due to the slowdown in the real estate sector, and the reduction of commercial bank lending due to risk considerations.

The real estate sector continued to cool. According to recently published housing price data, 68 of the 70 cities monitored by the National Bureau of Statistics witnessed property price declines in month-on-month terms in August. Preowned housing prices also fell in recent months. Among first-tier cities, Beijing, Shanghai, Guangzhou, and Shenzhen all witnessed falling housing prices. Guangzhou led the other top-tier cities with a decline of 1.4 percent (month-on-month) in August.

Outlook and Emerging Challenges

Chinese economic growth is gradually slowing as the structural transformation of the economy continues. Growth in 2014 is expected to be 7.4 percent supported by an improving external environment and an accommodative policy stance. The contribution of net exports is expected to increase gradually due to the economic recovery in advanced economies. Growth in 2015 is expected to decelerate to 7.2 percent, assuming a robust but moderating growth path. Quarterly economic growth is expected to remain volatile, reflecting tensions between a gradual transition from investment- to consumption-based growth and near-term demand management measures taken by the government.

Fiscal and monetary policies are expected to stay growth-supportive. The authorities will likely continue to accelerate fiscal spending for affordable housing and infrastructure projects. In line with the recently announced State Council guidelines for "easier access to finance," monetary policy may stay accommodative, with more easing measures in the latter half of 2014. In addition, the authorities are likely to lift the home buying restrictions in more cities to restore confidence in the housing market.

Risks to orderly and gradual adjustment remain. The structural adjustments will likely be orderly and gradual—although an abrupt unwinding of accumulated imbalances cannot be completely ruled out. The main risk is a possible disorderly deleveraging of local governments, which could trigger a sharp slowdown in investment growth, and a contraction of select sectors such as the real estate sector. A possible abrupt change in the cost of capital could also significantly reduce economic activities. Additional risk is related to the expected recovery of net exports, which may not materialize if the recovery in advanced economies weakens.

China: Key Indicators

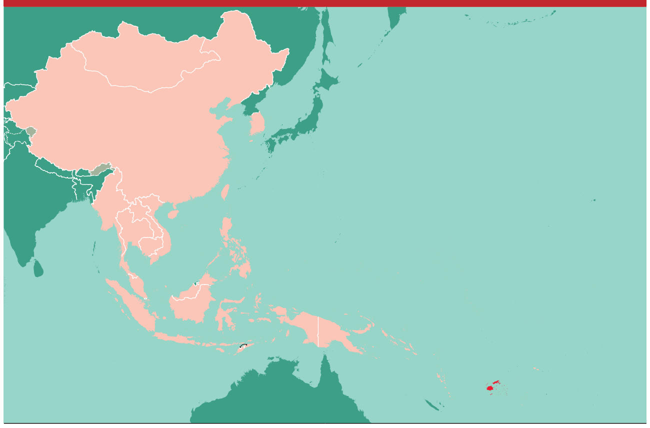
	2012	2013	2014f	2015f	2016f	2013		2014						2014
	Year	Year	Year	Year	Year	Q3	Q4	Q1	Q2	Apr	May	Jun	Jul	Aug
Output, Employment, and Prices														
Real GDP (% change yoy)	7.7	7.7	7.4	7.2	7.1	7.8	7.7	7.4	7.5					
Domestic demand (% change yoy)	8.1	8.3	7.4	7.5	7.3									
Industrial production index /1														
(% change yoy)	10.0	9.7	8.0	8.0	7.5	10.1	10.0	8.8	8.9	8.7	8.8	9.2	9.0	6.9
Unemployment (%) 2/	4.1	4.1	4.1	4.1	4.1	4.0	4.1	4.1	4.1					
Real wages (% change yoy)	9.0	7.3	7.3	7.3	7.3									
Consumer price index (% change yoy)	2.6	2.6	3.0	3.0	3.0	2.8	2.9	2.3	2.2	1.8	2.5	2.3	2.3	2.0
Public Sector														
Government revenues (% GDP)	22.6	22.7	21.8	21.7	22.1									
Government expenditures (% GDP)	24.2	24.6	23.9	23.8	24.1									
Government balance (% GDP)	-1.5	-2.1	-2.0	-2.0	-2.0									
Domestic public sector debt (% GDP) /3	14.9	15.3	15.8	16.4	16.8									
Foreign Trade, BOP, and External Debt														
Trade balance (billions US$)	230.3	259.2	290.7	298.0	308.2	61.5	90.5	16.6	85.9	18.5	35.9	31.6	47.3	49.8
Exports of goods (billions US$)	2,048.7	2,209.0	2,339.0	2,485.5	2,649.5	562.2	595.4	491.3	570.8	188.5	195.5	186.8	212.9	208.5
(% change yoy) 4/	7.9	7.8	5.9	6.3	6.6	3.9	7.4	-3.5	4.9	0.8	7.0	7.2	14.5	9.4
Key export (% change yoy) 5/	8.4	7.9				3.8	7.4	-3.7	5.0	1.0	7.2	7.0	14.7	
Imports of goods (billions US$)	1,818.4	1,950.0	2,048.2	2,187.5	2,341.3	500.7	504.8	474.8	484.9	170.1	159.6	155.2	165.6	158.6
(% change yoy) 4/	4.3	7.2	5.0	6.8	7.0	8.4	7.2	2.0	1.3	0.7	-1.7	5.5	-1.5	-2.1
Current account balance (billions US$)	215.4	183	184	206	225	40.4	44.0	7.0	72.2					
(% GDP)	2.6	2.0	1.8	1.9	1.9									
Foreign direct investment (billions US$) /6	121.1	117.6				26.6	29.0	31.5	31.8	8.7	8.6	14.4	7.8	7.2
External debt (billions US$)	737.0	863.2												
(% GDP)	9.0	9.4												
Short-term debt (billions US$)	540.9	676.6												
Debt service ratio (% exports of g&s)	1.6	1.6												
Foreign exchange reserves, gross (billions US$)	3,311.6	3,821.3	3,981.0	4,185.5	4,423.2									
(months of imports of g&s)	21.9	23.5	23.3	23.0	22.7									
Financial Markets														
Domestic credit (% change yoy)	17.1	15.1				16.4	15.1	14.9	17.1	15.9	16.5	17.1		
Short-term interest rate (% p.a.) 7/	3.3	3.3												
Exchange rate (RMB/US$, eop)	6.29	6.10				6.17	6.12	6.13	6.16	6.2	6.2	6.2	6.2	6.2
Real effective exchange rate (2000=100)	118.4	127.7				126.0	126.3	128.7	122.8	123.3	122.5	122.6	123.4	125.4
(% change yoy)	2.2	7.8				8.4	7.6	5.8	-1.4	-0.5	-1.9	-1.8	-2.0	-0.3
Stock market index (Dec. 19, 1990=100) /8	2,316	2,284				2,186	2,260	2,136	2,134	2,121	2,135	2,145	2,305	2,321
Memo: Nominal GDP (billions US$)	8,229.4	9,181.4												

Source: National data sources.

f = forecast. *g&s* = goods and services.

1/ Annual data are not comparable with the quarterly and monthly data. Annual data cover all industrial enterprises while the quarterly and monthly data only refer to those enterprises with sales above RMB 5.0 million. *2/* Official urban unemployment only, not including laid-off workers. *3/* Includes treasury bonds, policy financial bonds, and other financial bonds (end-period outstanding). *4/* Nominal growth rate. *5/* Manufactured exports. *6/* Gross FDI utilized. *7/* Central Bank loans to financial institutions, less than 20 days. *8/* Shanghai Stock Exchange A-Share Price Composite.

FIJI



Population	874,742
Population growth	0.8 percent
GDP (PPP, int'l US$)	4.3 billion
GDP per capita (PPP, int'l US$)	4,943
Surface area	18,270 sq. km.
Capital	Suva

Source: World Development Indicators.

Summary

The Fijian economy is estimated to have grown by 3.5 percent in 2013 and is projected to grow by around 3.75 percent in 2014, supported by fiscal stimulus as well as rising investments, partly explained by rising confidence of the private sector. Tourism also continues to be a pillar of support to the economy. Monetary policy remains expansionary and credit growth continues to pick up pace, although inflation remains moderate underpinned by the introduction of free primary and secondary education scheme and moderating international food prices. While fiscal policy has been supportive of growth, an orderly wind back of recent fiscal expansion will be key to ensuring longer term sustainability. The first election since the 2006 coup was held in September and delivered victory to the incumbent Prime Minister and coup leader. The return to democracy in the context of expected policy and political stability may support improved economic performance through expanded access to development financing and greater private sector confidence.

Recent Economic Developments

The Fiji economy is estimated to have grown by 3.5 percent in 2013 and is projected to grow by around 3.75 percent in 2014. Growth estimates have been revised due to the Fiji Bureau of Statistics' rebasing of national accounts. The economy, in the lead-up to the 2014 elections, is expected to be supported by a fiscal stimulus and rising investment, partly explained by the rising confidence of the private sector. Private consumption growth is, however, expected to moderate in the medium term as the effects of the stimulus including tax cuts and public sector pay rises in the 2013 and 2014 budget wear off. Growth is projected at around 2.5 percent in the medium term.

Investment is estimated to have reached 28 percent of GDP in 2013, but is projected to moderate to around one-quarter of GDP in 2014. According to the Reserve Bank of Fiji, total investment is estimated to have reached the highest level in more than 20 years, driven by purchases of airplanes by Fiji Airways in 2013, investment in the tourism- and mining-related sectors, and government-funded capital infrastructure. The value of projects implemented in the first quarter of 2014 is estimated to have risen by 27 percent. Cement sales cumulative to July also rose by 14.1 percent compared to the same period last year. Overseas investor interest in Fiji is also rising, with an increasing number of new applications from foreign investors, although commitment and implementation may be delayed until after the 2014 elections.

Tourist arrivals rose by 4 percent in the year to June after a year of negligible growth in 2013. In 2014, authorities project tourist arrivals to grow by 2 percent. Growth in tourist arrivals is anticipated on the back of improving economic conditions in Fiji's tourism source markets (arrivals from Australia and New Zealand account for 60 percent of total arrivals, and arrivals in Q1 from these markets grew by 6.5 percent). Strong marketing efforts and an increase in the number of conference events and cruise ship arrivals also augur well for the industry.

Inflation is expected to remain moderate. Inflation in July 2014 was 0.8 percent, among the lowest since 2009, underpinned by the introduction of a free primary and secondary education scheme and moderating international food prices. Authorities expect inflation to remain at a moderate level of 3 percent in 2014, although exposed to downside risks stemming from commodity price shocks and weather-related events.

Monetary policy remains expansionary and credit growth continues to pick up pace. The Reserve Bank of Fiji has maintained the policy rate at 0.5 percent since 2011. The bank lending rate fell to 5.71 percent at end-July 2014 from a peak of 7.43 percent at the beginning of 2012. Private sector credit grew by 10 percent in 2013 and 12.6 percent in June 2014. Strong growth in variable rate residential mortgages has been observed, raising concerns about household debt and the prospect of a negative consumption response to any future interest rate increases.

The current account deficit is expected to narrow from 15.5 percent of GDP in 2013 to around 8.75 percent in 2014. As the one-off effect of the purchase of aircraft by Fiji Air normalizes, the current account deficit is expected to narrow to around 8.75 percent of GDP in 2014. Excluding aircraft purchases, the trade deficit to April 2014 widened by 28 percent compared to the same period in 2013 as domestic demand outpaced export growth. Imports rose by 14.9 percent, reflecting domestic demand, while exports grew by 6.4 percent. Inward remittances rose by 14.2 percent cumulative to June 2014 compared to the same period in 2013. Foreign reserves stood at US$900 million at end-August 2014, equivalent to 4.5 months of imports of goods and nonfactor services.

Fiscal expansion continued in the run-up to the September 2014 elections. Operating expenditures are expected to rise from 21.5 percent of GDP in 2013 to 23.5 percent of GDP in 2014, explained by further increases in the salaries and wages of all staff, expected costs associated with the 2014 elections, and an increasing expenditure allocation to make primary and secondary education free. Capital expenditures are expected to further increase from 10 percent of GDP in 2013 to 13 percent in 2014 to fund energy and roads projects. Total government revenue is projected to increase from 28 percent of GDP in 2013 to 35.5 percent, explained by the one-off divestment of the government's stake in the airports, ports, and electricity authority (equivalent to around 6.25 percent of GDP). As a result, the budget deficit is expected to narrow from around 2.7 percent of GDP in 2013 to 2.0 percent (8.2 percent of GDP excluding one-off divestment).

Outlook and Emerging Challenges

The return to a democratically elected regime is expected to result in increased access to development funding. However, the medium-term outlook will rely on political stability. Since the government unveiled its fourth constitution and announced the seven-member Electoral Commission, development partners such as Australia have restored full diplomatic ties with Fiji. This could lead to increased access to financing for development, from both bilateral and multilateral agencies, providing some support to the economy in the medium term. However, in the medium term, the broader economic outlook will rely on political stability.

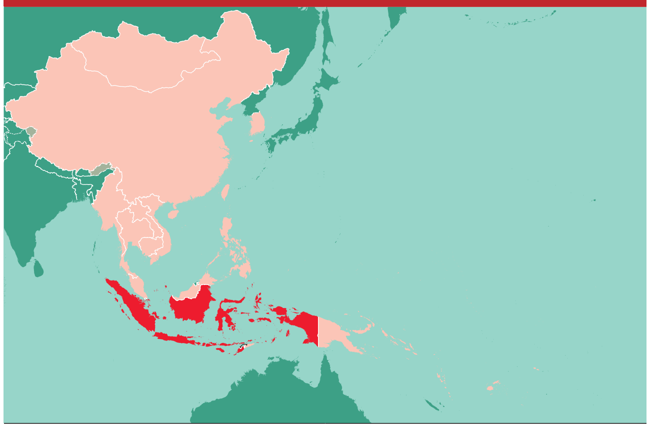
An orderly wind back of recent fiscal expansion would be necessary to ensure sustainability. Fiscal expansion, including investment in public assets, had been above trend and a key driver of growth in recent years. This has partly resulted in public debt remaining at above 50 percent of GDP (external debt is equivalent to around 14 percent of GDP) and contingent liabilities of nearly 30 percent of GDP. Although the 2014 budget indicates a narrowing of the fiscal deficit compared to 2013, this is contingent on the successful sale of state-owned enterprises. Furthermore, the projected increase in government borrowing unveiled in the 2014 budget will add to public debt. As such, an orderly wind back of recent fiscal expansion would be key to ensuring longer-term sustainability.

Fiji: Key Indicators

	2012	2013e	2014f	2015f	2016f
	Year	Year	Year	Year	Year
Output, Employment, and Prices					
Real GDP (% change yoy)	1.7	3.5	3.7	2.5	2.5
Tourist arrivals (thousands)	661	658	670	690	710
(% change yoy)	-2.1	-0.4	1.9	3.0	2.9
Unemployment rate (%)					
Consumer price index (% change yoy)	1.5	3.4	3.0	3.0	3.0
Public Sector					
Government revenues (% GDP)	28.0	28.2	34.3	28.3	28.3
Government expenditures (% GDP)	29.1	29.7	34.7	29.4	29.3
Government balance (% GDP)	-1.0	-2.8	-2.0	-2.5	-2.4
Domestic public sector debt (% GDP)	38.8	34.7	33.3	33.7	34.1
Foreign Trade, BOP, and External Debt					
Trade balance (millions US$)	-783	-1,277	-996	-1,048	-1,095
Exports of goods (millions US$)	575	547	572	596	625
(% change yoy)	3.7	-4.9	4.6	4.2	4.8
Key export (% change yoy) 1/	7.3	-2.5	-0.6	0.2	0.0
Imports of goods (millions US$)	1,939	2,408	2,154	2,237	2,319
(% change yoy)	2.1	24.2	-10.5	3.8	3.7
Current account balance millions US$)	-71	-604	-346	-380	-408
(% GDP)	-1.8	-15.5	-8.7	-9.3	-9.7
Foreign direct investment (millions US$)	266	198	322	354	378
Total external debt (millions US$)	679	1,034	1,105	1,107	1,107
(% GDP)	17.5	27.4	28.2	27.6	26.9
Debt service ratio (% exports of g&s)	2.6	3.1	4.2	4.1	13.8
Foreign exchange reserves, gross (millions US$) 2/	853	974	1,041	1,076	1,111
(months of imports g&s)	4.0	4.9	4.5	4.5	4.5
Financial Markets					
Domestic credit (% change yoy) 3/	6.6	9.3			
Short-term interest rate % p.a.)	0.6	0.2			
Exchange rate (FJ$/US$, eop)	1.77	1.88			
Real effective exchange rate (2005=100)	95.0	96.0			
(% change yoy)	3.1	1.1			
Memo: Nominal GDP (millions US$)	3,830	3,882	3,959	4,081	4,205

Source: National data sources.
e = estimate.
f = forecast.
g&s = goods and services.
1/ Sugar.
2/ Rise in debt service ratio in 2016 reflects the maturity of the US$250 million global bond, which may be refinanced.
3/ Domestic credit to the private sector.

INDONESIA



Population	249.9 million
Population growth	1.2 percent
GDP (PPP, int'l US$)	2.4 trillion
GDP per capita (PPP, int'l US$)	9,559
Surface area	1,904,570 sq. km.
Capital	Jakarta

Source: World Development Indicators.

Summary

Indonesia's economy has slowed, in part due to policy makers' needed focus since mid-2013 on macroeconomic adjustment to address a widening current account deficit amidst still uncertain external financing conditions. Yet export performance has remained weak, limiting the narrowing of the current account deficit, and growth still remains vulnerable to renewed external financing constraints. The fiscal sector has been pressured by slower revenue growth and high energy subsidy spending. The incoming government, which will take office in October 2014, faces both the challenge and the opportunity to move ahead with implementation of key fiscal and structural reforms so as to enhance economic resilience and growth over the near and medium term.

Recent Economic Developments

Economic growth in H1 2014 has been markedly slower than in recent years, at 5.2 percent yoy compared with 5.8 percent over 2013, and 6.3 percent in 2012. This moderation reflects the ongoing impact of weaker commodity prices, weighing on exports and investment; and tighter monetary policy and credit conditions, particularly since the period of external financing pressure experienced by Indonesia and other emerging market economies in 2013. Private consumption remained robust through midyear, growing 5.6 percent yoy over H1 2014 (likely supported by election-related spending), but fixed investment growth was low compared with recent years, at 4.7 percent yoy. Real government consumption growth in H1 2014 was just 1.1 percent yoy, reflecting weaker nominal revenue growth and budget execution challenges, with a new administration taking office in October.

Indonesia's current account deficit has remained relatively sticky, totaling US$13.3 billion in H1 2014 compared to US$16.1 billion over the same period in 2013. Export performance has been subdued, with total export revenues falling 2.3 percent yoy in H1 2014 on the back of lower oil export revenues and flat nonoil export revenues. Imports have fallen sharply to 4.4 percent lower in U.S. dollar terms in H1 2014 than a year ago, although oil imports remain little changed. Largely as a result of this compression of imports, Indonesia's goods trade surplus rose from US$1 billion in H1 2013, to US$2.9 billion in H1 2014, with most of the rest of the narrowing in the overall current account deficit due to reduced services imports and higher personal transfer inflows.

Despite the slow pace of current account adjustment, the external balance pressures of 2013, which remained in sharp focus at the time of the last East Asia and Pacific Economic Update, have been assuaged by a record net portfolio investment of US$16.8 billion over H1 2014. Direct investment has also remained robust, at US$8.3 billion over H1 2014, up by US$1 billion from the comparable period in 2013. This helped foreign reserves rise by approximately US$12 billion in 2014 through September, to US$111.2 billion.

Indonesia's monetary policy has remained geared toward restraining the current account deficit, with Bank Indonesia keeping its policy rates unchanged following the 1.75 percent increase over June–November 2013. A more flexible exchange rate has also supported the external adjustment; despite the strength of capital inflows so far in 2014, the rupiah appreciated by only approximately 4 percent against the U.S. dollar through August, and in real effective (trade-weighted) terms remains 13 percent below its 2010–12 average (as measured by the Bank for International Settlements). CPI inflation has halved over 2014 to 4 percent yoy in August, as the one-off increase due to the large subsidized fuel price increase of mid-2013 dropped out of the annual comparison. Inflation momentum remains subdued, at 4 percent, as measured by the annualized three-month/three-month increase in the core CPI in August.

Fiscal space has been constrained by the combination of weaker nominal revenue growth and high energy subsidy spending. In the revised 2014 budget, passed in June, the fiscal deficit was raised to 2.4 percent of GDP, from 1.7 percent. Revenues are targeted to grow 14.8 percent yoy in nominal terms under the revised 2014 budget, down from 17 percent originally. Energy subsidy costs are budgeted at Rp 350 trillion (approximately US$30 billion or 3.5 percent of GDP). To contain spending and ensure that the legal limit of 3 percent of GDP for the national budget deficit is not breached, line ministries face significant budget cuts of Rp 43 trillion, and the government is authorized to carry over approximately Rp 50 trillion in energy subsidy payments to 2015.

Outlook and Emerging Challenges

In the base case, Indonesia's GDP growth is projected to be 5.2 percent for 2014 as a whole, moving up to 5.6 percent in 2015 on the back of stronger investment and external demand. However, the risks to this forecast are skewed to the downside due to both domestic and external factors. The anticipated strengthening in investment depends on domestic and foreign investor confidence being supported by more policy certainty and pro-investment regulatory reforms, and on the outlook for domestic and external demand. The anticipated strengthening of exports depends on both a stabilization in the prices in key commodity export products (notably coal, and crude and palm oil, which have recently continued to be under downward pressure), and on Indonesia's ability to capitalize on the expected strengthening in global demand by attracting additional foreign investment and increasing export production, especially of manufactures.

The current account deficit is expected to be US$26.1 billion, or 3.1 percent of GDP, in 2014. Export performance over H2 2014 should be helped by the resumption of copper exports, due to the revision in August of the partial ban and escalating tax on unprocessed mineral exports promulgated in January, which caused mineral exports to stop in H1 2014. In 2015, the current account deficit is expected to narrow modestly to 2.8 percent of GDP. In light of Indonesia's substantial gross external financing needs, due not only to the current account deficit but also to sizable external debt amortizations, a further risk to the growth outlook is a renewed deterioration in global risk appetite and a tightening in external financing conditions. Such a scenario would necessitate more import compression to bring down external finance needs, while increased financing costs would negatively impact the domestic investment outlook.

Structural/Policy Changes

The strong portfolio inflows in 2014 year-to-date are a testament to Indonesia's successful macroeconomic stabilization since mid-2013, although they also reflect supportive global liquidity conditions and strong inflows into emerging market assets in general. From a more structural perspective, Indonesia still faces an urgent challenge to make progress on long-standing fiscal and structural reforms to support a higher, sustainable, and more inclusive level of growth.

Meeting this challenge will require strengthening and improving the quality of domestic investment, including in export-generating industries. Given Indonesia's limited pool of domestic savings, this argues for a strong focus on securing ample high-quality external financing, notably including FDI. There is also a need to build the economy's ability to absorb short-term funding shocks, which currently is reduced by the vulnerability of the fiscal sector to higher rupiah-denominated fuel costs due to high energy subsidies.

Reducing energy subsidy spending would not only boost the flexibility of the economy to respond to external shocks, but is also a prerequisite for maintaining a sustainable fiscal stance and enabling more needed infrastructure and social spending. This will also depend on increasing tax revenues from their current level of approximately 12 percent of GDP, including through tax administration improvements.

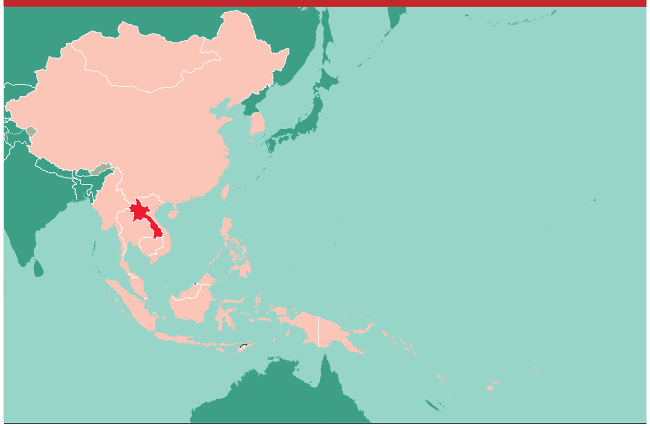
Demand and funding for investment can also be supported by making progress toward overcoming the large infrastructure and skills gaps in the economy, and by addressing the policy and regulatory uncertainties that weigh on investment decisions. Over the coming months, Indonesia's incoming government has an opportunity to establish positive momentum toward much needed propoor, progrowth reforms and policy implementation. Credible progress in these key areas would have an immediate positive impact by signaling that a higher sustainable growth path lies ahead. The task is urgent to realize Indonesia's ambitious development goals despite what may be a more constrained financing environment ahead.

Indonesia: Key Indicators

	2012	2013	2014f	2015f	2016f	2013		2014					2014
	Year	Year	Year	Year	Year	Q3	Q4	Q1	Q2	Apr	May	Jun	Jul
Output, Employment, and Prices													
Real GDP (% change yoy) 1/	6.3	5.8	5.2	5.6	5.6	5.6	5.7	5.2	5.1				
Domestic demand (% change yoy)	6.1	5.1				5.5	5.1	5.3	4.7				
Industrial production index (2000=100)	108.4	114.9				115.0	117.2	116.9	119.6				
(% change yoy)	4.1	6.0				7.2	1.5	3.5	4.6				
Unemployment (%)	6.1	6.2											
Consumer price index (% change yoy) 2/	4.3	8.4	4.4	4.8		8.4	8.4	7.3	7.0	7.4	7.6	7.0	4.5
Public Sector 3/													
Government revenues (% GDP)	16.2	15.2	15.4										
Government expenditures (% GDP)	18.1	17.5	18.2										
Government balance (% GDP)	-1.9	-2.3	-2.8										
Government debt (% GDP)	24.0	25.7											
Foreign Trade, BOP, and External Debt													
Trade balance (billions US$) 4/	-1.9	-6.2	-2.4	-1.3	-2.4	-2.7	1.6	1.1	-3.4	-2.0	0.1	-0.3	0.1
Exports of goods (billions US$) 5/	187.9	182.1	178.1	184.7	195.0	43.8	48.1	43.9	44.2	14.3	14.8	15.4	14.2
(% change yoy)	-4.4	-2.8	-2.2	3.7	5.6	-3.2	2.8	-2.2	-2.3	-3.2	-7.8	4.4	-6.0
Imports of goods (billions US$) 5/	178.7	177.9	170.2	175.8	187.1	43.7	43.4	40.6	44.7	16.3	14.8	15.7	14.1
(% change yoy)	10.6	-0.4	-3.4	3.3	6.4	3.8	-5.7	-6.4	-2.5	-1.3	-11.3	0.4	-19.3
Current account balance (billions US$)	-24.4	-29.1	-26.1	-26.6	-29.2	-8.6	-4.3	-4.2	-9.1				
(% GDP)	-2.8	-3.4	-3.1	-2.8	-2.8	-4.0	-2.2	-2.0	-4.3				
Foreign direct investment (billions US$)	21.2	23.3				7.2	5.2	6.1	6.4				
External debt (billions US$)	252.4	265.6				262.6	265.6	276.3	284.9	277.4	284.3	284.9	290.6
(% GDP)	28.8	30.6											
Short-term debt (billions US$)	44.3	45.4				45.8	45.4	46.4	50.1	45.7	49.7	50.1	50.0
Debt service ratio (% exports of g&s)	17.3	20.8				16.8	26.0	21.6	23.4				
Foreign exchange reserves, gross (billions US$)	112.8	99.4				95.68	99.39	102.59	107.68	105.6	107.0	107.7	110.5
(months of imports of g&s)	6.3	5.6				5.4	5.6	5.9	6.1				
Financial Markets													
Domestic credit (% change yoy)	24.2	22.1				22.5	22.0	20.3	18.0	19.0	17.9	17.2	15.7
Short-term interest rate (% p.a.) 6/	5.8	6.5				6.9	7.4	7.5	7.5	7.5	7.5	7.5	7.5
Exchange rate (Rupiah/US$, ave)	9,387	10,461				10,938	11,800	11,755	11,704	11,532	11,611	11,969	11,591
Real effective exchange rate 7/	93.8	82.9				87.6	82.9	88.6	84.8	87.9	86.9	84.8	86.8
(% change yoy)	-5.3	-11.6				-6.9	-11.6	-8.6	-13.0	-9.46	-10.9	-13.0	-12.4
Stock market index (Aug. 1982=100) 8/	4,119	4,606				4,374	4,347	4,602	4,871	4,840	4,894	4,879	5,089
Memo: Nominal GDP (billions US$)	876.7	868.4				215.7	200.7	204.5	212.0				

Sources: National data sources and World Bank staff estimates.
f = forecast.
g&s = goods and services.
1/ Based on GDP 2000 base.
2/ End of period.
3/ Central government data. World Bank estimates for 2012.
4/ Goods and services trade balance.
5/ Goods trade on BOP basis from Bank Indonesia with exception of monthly figures from BPS.
6/ Policy rate.
7/ BIS REER, 2005 avg. 100; end-of-period.
8/ Jakarta Composite Index, end-of-period.

LAO PEOPLE'S DEMOCRATIC REPUBLIC



Population	6.8 million
Population growth	1.9 percent
GDP (PPP, int'l US$)	32.6 billion
GDP per capita (PPP, int'l US$)	4,812
Surface area	236,800 sq. km.
Capital	Vientiane

Source: World Development Indicators.

Summary

Growth in the Lao People's Democratic Republic is estimated to moderate to 7.5 percent in 2014 due to lower direct output contribution from the resource sectors. Key growth drivers in 2014 are expected to come from robust activity in the construction and construction-related industry in the resource sector and related spillovers, forestry (wood exports), and services. Inflation decelerated in August due to a slowdown in food price inflation. After a sharp expansion in the fiscal deficit in FY2012/13, resulting from substantial increases in the public sector wage bill, the fiscal deficit in FY2013/14 is expected to narrow due to adopted fiscal consolidation measures, which are expected to help ease the pressure in the next fiscal year, as well. The overall current account deficit is expected to slightly narrow, helped by an increase in nonresource sector exports, particularly wood exports, while the resource sector current account deficit will still be driven by imports to support the construction of large projects and an estimated fall in mining export earnings. In June 2014, reserves rebounded compared to June last year but fell from the peak in April this year. The reserves coverage of imports remains low at 1.5 months, leaving the country with very thin buffers against adverse shocks.

Recent Economic Developments

Growth in the Lao PDR is estimated to moderate to 7.5 percent in 2014 due to lower direct output contribution from the resource sectors. This was revised upward from the initial projection of 7.2 percent to reflect the updated information about wood exports in 2013–14.[1] Key growth drivers in 2014 are expected to come from robust activity in the construction and construction-related industry related to the resource sector and spillovers, forestry (wood export), and services. In the resource sector, the hydropower output is expected to have a slow increase in 2014 from existing plants and other smaller projects. However, the development of several large-scale projects has boosted the construction and construction-related industries, as well as spillovers. In the mining sector, the overall drop in gold output is likely to offset some gains from higher copper production. Overall, the construction and construction-related materials sectors, particularly related to large power projects, continue to have solid growth driven by the rise in FDI in the resource sector, which will more than offset the slowdown in nonresource investment and a decline in public investment spending this year. Forestry's (mostly timber's) contribution is estimated to rise significantly in 2014, reflecting a significant increase in exports to neighboring countries this year. Services are also estimated to have stable growth this year driven by wholesale and retail, transportation, storage, and communication, some of which are spillovers from the resource sector construction.

Overall inflation decelerated in H1 2014, driven primarily by slower growth in food price inflation. The headline inflation rate was 3.6 percent yoy in August, down from 6 percent in January driven by

1 Based on information from China Customs (http://www.customs-info.com/) and Vietnam customs data (http://www.customs.gov.vn).

a deceleration in food price inflation, which almost halved from 11.5 percent to about 6 percent during the same period as the slower growth of meat prices more than offset the rise in rice prices, which follow the price trend of the Thai rice market. Energy inflation rose by 3.7 percent in June yoy compared to a fall of 3.2 percent in January, while core inflation moderated in June.

The fiscal deficit commitment for FY2013/14 is estimated to decline from the last fiscal year helped by spending cut measures. The fiscal deficit on a commitment basis is estimated at 4.5 percent this fiscal year, down from 6 percent in FY2012/13. Total spending is estimated to decline from 25.3 percent in FY2012/13 to 22.1 percent in FY2013/14 due to the suspension of new benefits to all civil servants, a stable nominal public wage bill, and cuts in capital and nonwage recurrent spending. An early expenditure measure was the cut in public sector benefits that barely offset the second 40 percent wage increase in FY2013/14. As a result, wages and benefits as a ratio to GDP are estimated to decline from 10.5 percent to 9.4 percent in FY2013/14. With revenue growth slower than GDP growth, a new round of fiscal corrective actions was announced in mid-2014, with spending cuts equivalent to about 0.6 percent of GDP. In addition, off-budget spending is estimated to notably decline due to the commitment to halt direct lending to local infrastructure projects. However, the deficit on a cash basis, which includes the settlement of past fiscal year arrears (about 1.3 percent of GDP), is estimated to increase from about 4.6 percent in FY2012/13 to 5.9 percent this fiscal year.

On the revenue side, total revenue as a ratio to GDP is estimated to decline mainly due to a fall in mining revenue and grants. Domestic revenue is estimated to fall from 17.4 percent to 16.2 percent this fiscal year as mining-related revenue fell due to lower commodity prices. Nonresource revenue still increased in nominal terms, particularly import duties, the excise tax, and the value-added tax, but overall at a slower pace than nominal GDP growth. Grants are also expected to decline from 1.9 percent to 1.4 percent. The slower growth in revenue still implies pressure on the financial position of the government.

While the Bank of Lao PDR maintains the nominal exchange rate stability of the Lao kip against major currencies, foreign exchange policy should give more consideration to reserve management and competitiveness. In nominal terms, the kip depreciated 0.3 percent against the U.S. dollar during January–July 2014, while it depreciated against the Thai baht by about 2.3 percent over the same period. The real effective exchange rate slightly depreciated by about 1 percent during the same period. Nevertheless, the real exchange rate has appreciated by more than 30 percent in the last five years, which still implies a deterioration of competitiveness for Lao PDR's tradable exports, which exacerbates pressure on the external balance.

The external balance is expected to slightly improve helped by nonresource exports. The current account deficit is estimated to decline from 11.5 percent of GDP to 11.2 percent due to the estimated significant increase in wood exports this year that will partly offset the increase in imports. Nevertheless, other nonresource exports are still expected to experience relatively slower growth this year. The resource sector current account deficit is expected to increase to about 3.8 percent of GDP from 1.1 percent due to higher imports to support the construction of the resource projects.[2] In addition, mining export earnings are expected to slightly decline due to lower commodity prices and lower gold output that will more than offset the rise in copper output. The expected increase in copper output will not be sufficient to offset this decline.

Foreign exchange reserves showed some signs of rebound in June 2014 compared to last year, but still remain low. Reserves were recorded at US$714 million in June, up by 7 percent from end-December 2013, but down 20 percent from their peak at end-April 2014. Reserves are projected to

2 These include the Hongsa Lignite; Xayaboury; Nam Ngiep 2; Nam Ou 2, 5, 6; and Xepian Xenam Noi hydropower projects, and other such projects.

reach a slightly higher level by year end, still at a low level equivalent to 1.5 months of imports of goods and services (or about 2.2 months of nonresource imports). Since mid-2013, the Bank of Lao PDR has limited lending in foreign currency by commercial banks to businesses with insufficient foreign currency earnings.

Despite slower credit growth by June 2014, other financial soundness indicators exhibited signs evoking continued concerns. Domestic credit grew at about 21 percent yoy in June compared to 28 percent yoy in the same period last year, as a slowdown in credit growth to the private sector offset an increase in lending to SOEs (the latter accounting for about 20 percent of bank loans), albeit a smaller share, especially from commercial banks. However, the health of the banking system is of increasing concern, particularly of state-owned banks, which account for about 52 percent of total banking sector assets. Their average capital adequacy ratio was reportedly down to only about 3 percent by Q2 2014 from an average of 7 percent at end-2013, while nonperforming loans have more than doubled to 8.2 percent of total loans at end-June 2014 (from 2.8 percent at end-2013).

Outlook and Emerging Challenges

Going forward, real GDP growth is projected to slow in 2015, reflecting the implementation timing of new power projects, the effects of tighter fiscal policy, an expected decline in wood exports after the recent surge, and projected mild growth in neighboring countries. Real GDP is projected to ease to 6.4 percent in 2015, before accelerating again in the medium term. The fiscal deficit should narrow to about 4.2 percent as recent fiscal consolidation measures take effect, with stable revenues to GDP despite lower resource-sector revenues and a moderate degree of expenditure containment. The external current account deficit should continue to reflect high FDI-funded imports, and only gradually improve in the medium term, beyond 2015, as power projects come onstream and new electricity exports expand at a fast clip.

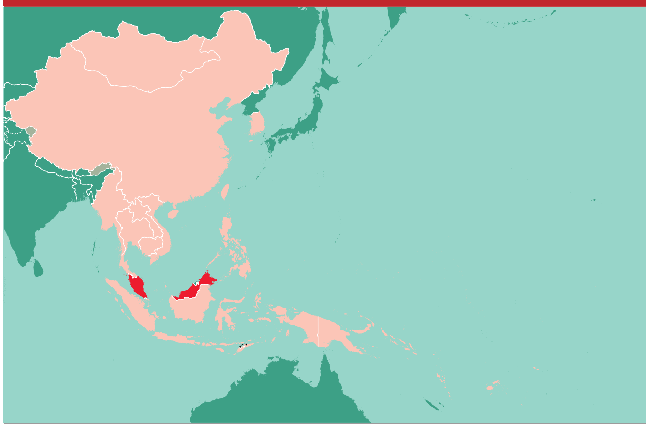
With regard to prospects for longer-term inclusive growth, the shortage of labor, especially skilled labor, has emerged as one of the top investment climate constraints in Lao PDR and is a potential hindrance to nonresource sector growth. Businesses, particularly in the manufacturing and services sectors, are reporting difficulty in finding labor (even unskilled labor) due to demand and supply mismatches, relatively high labor turnover, and migration. In an economy where the majority of people are engaged in subsistence and low-productivity agriculture, the structural transformation that will underpin development is likely to require a significant shift in population out of agriculture. The government is working on updating its Human Resource Development Strategy, which will provide an important framework for education and labor market development going forward.

Lao PDR: Key Indicators

	2012	2013e	2014f	2015f	2016f
	Year	Year	Year	Year	Year
Output, Employment, and Prices					
Real GDP (% change yoy)	8.0	8.5	7.5	6.4	7.0
Consumer price index (% change yoy)	4.3	6.4	5.0	5.0	5.0
Public Sector 1/					
Government revenues (% GDP)	19.8	19.3	17.6	17.4	17.4
Government expenditures (% GDP)	21.1	25.3	22.1	21.6	20.9
Government balance (% GDP) 2/	-1.3	-6.0	-4.5	-4.2	-3.5
Foreign Trade, BOP, and External Debt					
Trade balance (millions US$)	-1,262	-1,377	-1,469	-2,064	-2,108
Exports of goods (millions US$)	3,114	3,559	4,159	4,170	4,287
(% change yoy)	18.0	14.3	16.8	0.3	2.8
Key export (% change yoy)	23.0	14.1	22.1	-1.6	-6.0
Imports of goods (millions US$)	4,377	4,936	5,628	6,234	6,395
(% change yoy)	29.4	12.8	14.0	10.8	2.6
Current account balance (millions US$)	-1,194	-1,291	-1,324	-1,939	-2,225
(% GDP)	-12.7	-11.5	-11.2	-14.9	-15.4
Foreign direct investment (millions US$)	1,743	1,968	2,341	2,799	2,489
External debt (millions US$)	8,887	10,419	12,181	13,332	13,966
(% GDP)	87.5	94.2	102.0	102.3	97.8
Debt service ratio (% exports of g&s)	60.5	78.5	76.0	69.1	119.6
Foreign exchange reserves, gross (millions US$) 3/	740	662	726	820	900
(months of imports of g&s)	1.9	1.5	1.5	1.5	1.6
Financial Markets					
Domestic credit (% change yoy) 4/	26.6	34.5	26.6	21.1	20.0
Short-term interest rate (% p.a.) 5/	7.0	7.0			
Exchange rate (Kip/US$, ave)	7,982	7,862	8,035	8,035	8,035
Real effective exchange rate (2000=100)	133.7	141.3			
(% change yoy)	5.1	5.7			
Memo: Nominal GDP (millions US$)	9,390	11,187	11,837	13,030	14,421

Source: National data sources.
e = estimate.
f = forecast.
g&s = goods and services.
1/ Fiscal year basis.
2/ After grants.
3/ Excluding gold.
4/ Excludes government lending funds.
5/ Treasury bill rate.

MALAYSIA



Population	29.7 million
Population growth	1.6 percent
GDP (PPP, int'l US$)	692.3 billion
GDP per capita (PPP, int'l US$)	23,298
Surface area	330,800 sq. km.
Capital	Kuala Lumpur

Source: World Development Indicators.

Summary

Malaysia's economy performed better than expected in H1 2014. The global recovery spurred on growth in exports, leading projections of GDP growth to be revised upward to 5.7 percent for 2014. Domestic demand continued to be a key driver of growth, but began to wane as tighter fiscal and monetary conditions started to constrain consumption and investment growth. Albeit at a slower pace, private consumption continued to expand as tight labor markets, rising wages in the manufacturing sector, and credit conditions remained supportive of growth. To avoid the build-up of financial imbalances that might undermine Malaysia's growth, the central bank raised the policy rate for the first time in three years by 25 basis points in July, and signaled that another hike might occur later in the year. While Malaysia's near-term growth outlook remains positive, the full effects of fiscal consolidation and less accommodative monetary policy remain to be seen, especially since a second round of fuel subsidy cuts has been postponed. As these are introduced, along with the goods and services tax (GST) in the next quarters, growth is expected to moderate to 4.9 percent in 2015.

Recent Economic Developments

Malaysia's economy recorded robust growth in H1 2014, largely led by exports. GDP grew by 3.4 percent on a sequential basis in Q1, picking up to 7.5 percent in Q2 (quarter-on-quarter, seasonally adjusted annualized rate [qoq SAAR]).[3] Much of this growth derived from the recovery in exports, which have performed consistently since Q3 2013. Exports expanded by 5.0 percent qoq SAAR in Q2 2014, moderating slightly from 6.1 percent in the previous quarter. In particular, the export-oriented E&E manufacturing sector continued its upward trajectory, expanding for the sixth consecutive quarter (Q1: 9.8 percent, Q2: 4.4 percent, qoq SAAR [World Bank estimates]). Moreover, higher energy prices and larger volumes of natural gas exports in Q2 2014 also supported the growth momentum.

Strong export performance offset some deceleration in domestic demand as headwinds from fiscal and monetary tightening continued to blow, albeit at a moderate pace. Domestic value added absorbed domestically is estimated to have expanded by 2.6 percent on a sequential basis in Q2 2014 (World Bank estimate), the smallest increase in 11 quarters. This correlated with a slowdown in the services sectors from 6.2 percent in 2013 to 3.4 and 3.7 percent in Q1 and Q2 2014, respectively (qoq SAAR). Private consumption growth unexpectedly accelerated (Q2: 8.7 percent; Q1: 6.8 percent qoq SAAR), due to a healthy labor market, steady credit growth, and declining inflation as the government postponed further rounds of subsidy cuts to the second half of the year. Government consumption was volatile, but was up 6.6 percent for the first half of the year as a whole (half-on-half SAAR).The high pace of investments moderated into 2014, partially due to slower public investment. Overall, gross fixed capital formation slowed from 12.4 percent to 5.5 percent on a sequential basis in Q2 2014. This deceleration in investments is linked to a contraction

3 Quarter-on-quarter seasonally adjusted figures are taken from the official figures published by the Department of Statistics whenever available, and otherwise are indicated as World Bank estimates.

in construction investment (-2.6 percent qoq SAAR [World Bank estimate]). Meanwhile, investments in equipment expanded by 15.2 percent Q2 (qoq SAAR; [World Bank estimate]). Large public investment projects such as PETRONAS' Pengerang Integrated Complex and the Mass Rapid Transit are likely to pick up later this year, suggesting that investment growth is likely to remain at robust levels.

Electrical-and-electronics-driven improvements in the noncommodity trade balance and higher energy prices kept the current account in a healthy surplus in H1 of the year. Despite strong export growth, the overall trade balance declined to RM 18.4 billion in Q2 from RM 26.3 billion previously, thanks to an increase in the imports of intermediate and capital goods (Q2 2014: 9.1 percent qoq SAAR) linked to the continued expansion of equipment investment. The resulting current account surplus of 6.2 percent of GDP (Q1: 7.9 percent) remained well above the 2013 figure of 4.0 percent. Despite increased inflows of portfolio investments as foreigners returned to Malaysian securities markets, and lower FDI outflows as Malaysian companies slowed their overseas investments, the financial account posted a deficit of 4.5 percent of GDP in Q2, down from 14.9 percent of GDP in Q1. Due to large outflows in errors and omissions, the balance of payments posted a deficit of 0.4 percent of GDP. International reserves remained at a comfortable US$131.6 billion as of August 2014, sufficient to finance 8.9 months of retained imports, and is 1.2 times the short-term external debt.

Fiscal consolidation continues, despite a postponement of additional subsidy cuts. The budget deficit for H1 2014 came in at 3.7 percent of GDP compared to 4.1 percent in 2013. About 0.1 percentage points of the reduction reflect a slightly lower nominal deficit, with the remainder accounted for by the high nominal GDP growth in the period (10.3 percent) that boosted the denominator. The government is expected to meet its deficit target of 3.5 percent of GDP for 2014 if it remains on a path of fiscal consolidation and carries out additional steps toward rationalizing fuel subsidies. An announcement of the details of a targeted mechanism for reducing subsidy costs while maintaining the prices of fuel for lower-income households is expected by end-2014. Such details, as well as those related to the implementation of the GST in 2015 and strategies to contain the growth in operating expenditures beyond subsidies, will be critical for the medium-term fiscal outlook. Federal government debt remained stable at the government's self-imposed ceiling of 55.0 percent of GDP (December 2013: 54.7 percent).

Inflation remained relatively stable into 2014, thanks to delays in the implementation of fuel subsidy cuts. Consumer price inflation climbed modestly from an average of 2.6 percent in H2 2013 to 3.4 percent in H1 2014. Although global food prices increased in early 2014, food inflation decelerated from an average of 4 percent to 3.8 percent, while core inflation (excluding food, beverages, and energy) increased only slightly from 1.1 percent to 2.1 percent. Mild inflationary pressures are expected to push Malaysia's headline inflation rate higher in H2 2014, with expectations of a new fuel subsidy scheme and preparations for the implementation of the GST.

Monetary policy became less accommodative. For the first time in three years, the central bank hiked the Overnight Policy Rate by 25 basis points to 3.25 percent in July 2014, citing the need to avoid the buildup of financial imbalances that could undermine Malaysia's growth prospects. The hike was expected amid concerns that real interest rates had ventured into negative territory, and that household debt had continued to climb, reaching 86.5 percent in 2013. The rate hike is likely to have a relatively larger impact on household budgets than in the past, since the stock of mortgage debt held by households is relatively high (35 percent of GDP as of April 2014 compared to 26 percent of GDP as of April 2008). Given the strong economic performance so far, there is a possibility that the central bank will announce a further hike of 25 basis points by end-2014.

Economic Outlook and Emerging Challenges

Malaysia's export-dependent economy will continue to benefit from the recovery in advanced economies. Driven by higher energy commodity and petrochemical production, and by the continuation of the pickup in the electrical and electronics sector, exports are projected to expand further into 2014 and 2015. Meanwhile, although headwinds have started to weigh on domestic demand, private consumption did not drag down growth as much as expected in the H1 2014. This better-than-expected performance in H1 2014 leads us to revise projections of GDP growth to 5.7 percent for 2014, up from 5.4 percent previously.

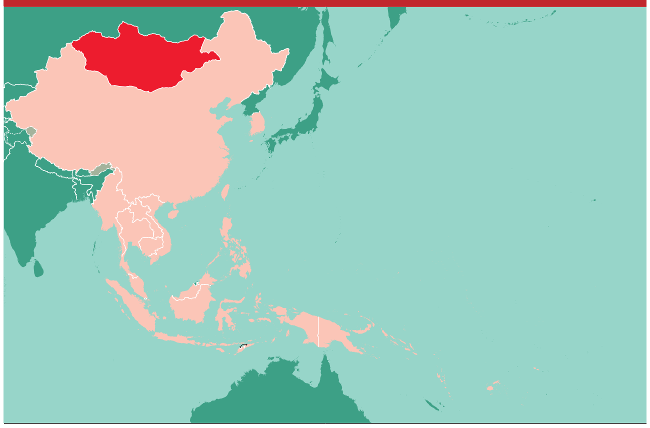
The full effects of tighter fiscal and monetary conditions at home, as well as higher inflationary pressures, will constrain domestic sources of growth. The implementation of fuel subsidy realization and a potential consecutive hike in real interest rates will further constrain household consumption, which will moderate into H2 2014 and further into 2015. Coupled with the introduction of the GST early next year, GDP growth is projected to slow to 4.9 percent in 2015 and to stabilize at 5.0 percent in 2016.

Malaysia: Key Indicators

	2012	2013	2014f	2015f	2016f		2013		2014				2014
	Year	Year	Year	Year	Year	Q3	Q4	Q1	Q2	Apr	May	Jun	Jul
Output, Employment, and Prices													
Real GDP (% change yoy)	5.6	4.7	5.7	4.9	5.0	5.0	5.1	6.2	6.4				
Domestic demand (% change yoy)	11.1	6.4	6.7	5.7		4.7	6.3	5.3	2.0				
Industrial production index (2000=100)	113.1	116.2				111.2	114.6	111.0	115.9	113.3	117.1	117.2	
(% change yoy)	4.4	2.7				5.5	2.9	4.7	5.8	4.7	5.9	6.9	
Unemployment (%)	3.0	3.1				3.1	3.2	3.2		2.9	2.9		
Real wages (% change yoy) 1/	4.7	5.6				7.3	5.4	1.9	2.6	2.8	3.3	1.7	
Consumer price index (% change yoy)	1.7	2.1	3.0	3.4		2.2	3.0	3.5	3.3	3.4	3.2	3.3	3.2
Public Sector													
Government revenues (% GDP) 2/	22.1	21.6	21.6	21.3		22.8	23.0	19.1	20.1				
Government expenditures (% GDP) 2/	26.5	25.5	25.5	24.8		24.9	28.2	24.2	22.4				
Government balance (% GDP) 2/	-4.5	-3.9	-3.5	-3.0		-2.2	-5.2	-5.1	-2.3				
Domestic public sector debt (% GDP) 2/	53.3	54.7	52.8	51.2		54.8	54.7	55.5	55.0				
Foreign Trade, BOP, and External Debt													
Trade balance (billions US$) 3/	35.3	29.1	33.9	38.6		6.9	9.1	9.4	8.2	2.7	1.8	1.3	1.1
Exports of goods (billions US$)	222.4	215.6				53.8	56.7	54.1	56.3	20.3	20.2	19.1	19.2
(% change yoy)	-2.8	-3.1				3.7	6.0	10.3	11.7	18.7	16.2	7.9	0.6
Key export (% change yoy) 4/	-5.0	9.3				14.7	24.3	23.1	22.9	38.8	20.3	12.0	5.7
Imports of goods (billions US$)	181.8	181.2				45.4	46.3	43.9	47.0	17.6	18.4	17.8	18.0
(% change yoy)	1.4	-0.3				3.2	7.6	8.5	6.3	5.0	11.8	8.9	-0.7
Current account balance (billions US$)	17.7	12.7	15.9	19.2		3.1	4.6	6.0	4.9				
(% GDP)	5.8	4.0	4.4	4.8		4.0	5.9	7.6	6.2				
Foreign direct investment (billions US$) 5/	9.2	12.1				7.6	9.1	7.7	8.2				
External debt (billions US$)	82.6	96.9				95.9	98.8	100.3	104.5				
(% GDP)	27.1	30.9				30.9	31.5	31.8	32.8				
Short-term debt (billions US$)	30.4	39.0				36.9	39.0	39.4	40.7				
Debt service ratio (% exports of g&s)	10.1	10.3				10.5	9.4	10.7	8.3				
Foreign exchange reserves, gross (billions US$)	139.7	134.9				136.5	134.9	130.2	131.9	131.2	130.9	131.9	131.8
(months of imports of g&s) 3/	9.6	9.2				9.4	9.5	9.4	8.6	9.3	9.1	9.1	9
Financial Markets													
Domestic credit (% change yoy) 6/	12.0	10.0				9.3	10.1	10.6	9.7	10.0	9.7	9.3	8.6
Short-term interest rate (% p.a.) 7/	3.0	3.0				3.0	3.0	3.0	3.0	3.0	3.0	3.0	3.3
Exchange rate (Ringgit/US$, eop)	3.06	3.28				3.26	3.28	3.27	3.21	3.27	3.22	3.21	3.19
Real effective exchange rate (2000=100) 8/	99.7	100.1				98.1	99.4	98.1	99.1	98.6	99.0	99.8	100.8
(% change yoy)	-0.1	0.4				-0.9	-0.6	-2.3	-3.3	-3.9	-5.3	-0.6	1.1
Stock market index (Jan. 1, 1997=100) 9/	1,610	1,746				1,769	1,867	1,849	1,883	1,872	1,873	1,883	
Memo: Nominal GDP (billions US$)	305.3	313.2				77.3	82.7	77.9	81.3				

Sources: National data sources; World Bank staff estimates.
f = forecast.
g&s = goods and services.
1/ Manufacturing wages only.
2/ Federal government only.
3/ Balance of goods and services.
4/ Thermionic valves & tubes, photocells, etc.
5/ Inward FDI.
6/ Total loans in the banking system.
7/ Overnight Policy Rate (OPR).
8/ Source: BIS.
9/ FTSE Bursa Malaysia Composite, end-period.

MONGOLIA



Population	2.8 million
Population growth	1.5 percent
GDP (PPP, int'l US$)	26.8 billion
GDP per capita (PPP, int'l US$)	9,433
Surface area	1,564,120 sq. km.
Capital	Ulaanbaatar

Source: World Development Indicators.

Summary

The Mongolian economy has slowed in 2014 despite continuous expansionary economic policies. The current economic slowdown reflects an adjustment of the economy in response to high inflation and strong balance-of-payments pressure. The current account deficit has narrowed significantly in 2014, but a large drop in FDI keeps the balance-of-payments deficit large, putting heavy pressure on international reserves and currency value. Continued currency depreciation and expansionary economic policies pushed inflation into double-digit territory. These economic imbalances have been fed by a dampening global minerals market and aggressive expansionary economic policies that kept economic growth at double-digit levels over the last three years. The primary objective of economic policies needs to be restoring internal and external economic stability and avoiding a more vulnerable situation. Monetary and fiscal policy needs to be tightened in order to tackle the immediate economic challenges and preserve financial and fiscal soundness. Parallel efforts are needed to promote foreign and domestic investment.

Recent Economic Developments

Mongolia's economic growth slowed to 5.3 percent in H1 2014, from 14.4 percent in H2 2013. While mineral GDP growth remained robust at 16.1 percent in H1, nonmineral GDP growth dropped to 2.8 percent during the same period. Domestic demand has been under growing pressure from high inflation and continued currency depreciation. Manufacturing output expanded 0.3 percent and the production of the wholesale and retail sector contracted 12.3 percent during the period, reflecting waning domestic demand. On the expenditure side of economic growth, a drop in investment by 32.4 percent has been a main factor behind slowing economic activities amidst a continued decline in foreign direct investment and uncertainty over the investment environment.

National headline inflation has been on an accelerating path, reaching 14.9 percent (yoy) in July 2014. The price level has been under mounting pressure from the currency depreciation and expansionary economic policies through aggressive monetary easing, and off-budget spending through the Development Bank of Mongolia. Core inflation—which largely reflects demand-side pressure—picked up to 17.9 percent (yoy) in July 2014 from 12.1 percent (yoy) at end-2013.

The current account deficit narrowed significantly in H1 2014, largely due to a narrowing trade deficit. The current account balance recorded a deficit of US$603 million in the first six months of the year, a significant drop from US$1,607 million during the same period last year. The trade account recorded a slight surplus of US$35 million (Free On Board) between January and June, a turnaround from a deficit of US$756 million during the same period a year ago. In the first seven months of 2014, total exports increased by 24.9 percent largely thanks to strong copper export growth over 150 percent from the new Oyu Tolgoi mine. Total imports dropped by 14.6 percent during the same period, driven by a 41.7 percent drop in machinery and equipment imports, reflecting weakening investment activities.

Despite the narrowing current deficit, balance-of-payments pressure still remains high due to declining foreign capital inflow. The capital and financial account registered a surplus of US$29.8 million in H1 2014, a sharp drop from a surplus of US$914 million during the same period in 2013. Net FDI inflow fell to US$370 million over H1, down 70 percent from a year ago. As a result of a smaller capital and financial account surplus, the overall external financing gap remained high despite the narrowing current account deficit. The overall external financing gap during H1 2014 eased only slightly to US$915 million—equivalent to 7 to 8 percent of annual GDP—from US$983 million a year ago.

The large financing gap in the balance of payments has led to a continuous decline in the international reserve level and a sliding currency value throughout the year. The gross international reserve of the central bank fell to US$1.2 billion in July 2014, down 58 percent from US$3.1 billion a year ago and 70 percent from its peak of US$4.1 billion in December 2012. The local currency value depreciated 24.8 percent over the last 12 months through July and 13 percent for the first seven months of the year, amidst the persistent balance-of-payments pressure and the effect of loose monetary policy.

Outlook and Emerging Challenges

The long-term prospects of the Mongolian economy are still promising, given its vast natural resources, but the economy is facing significant challenges in the near term that should be urgently addressed. In 2014, the Mongolia economy will likely remain under growing pressure from the large economic imbalances that have been accumulated over the last three years. Annual economic growth is expected to soften to 6.3 percent in 2014, reflecting weak nonmineral sector growth. Inflation will likely remain in double digits in the coming months. The current account deficit is projected to narrow to around 14 percent of GDP in 2014, down from 25 percent in 2013 due to robust copper exports and weaker import demand. However, the balance-of-payments pressure will likely remain high, putting heavy pressure on the international reserves. Expansion of the bilateral currency swap agreement with the People's Bank of China to Y 15 billion will likely provide a significant buffer to the declining international reserves in the near term. However, the current economic situation calls for structural changes in the focus of economic policies away from growth stimulus to economic stability in order to avoid a more vulnerable situation.

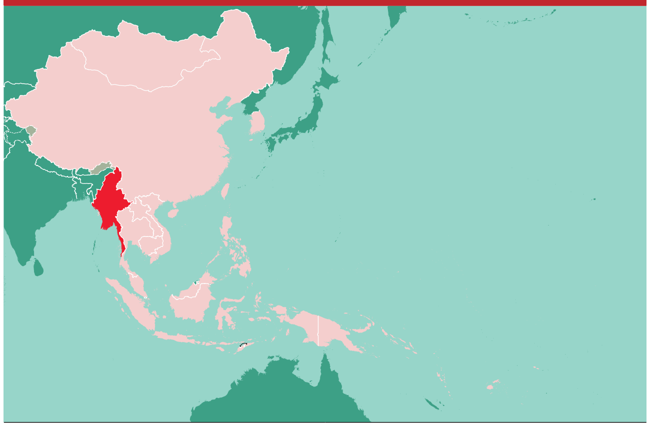
The primary objective of economic policies should be restoring internal and external economic stability. Monetary and fiscal policy needs to be tightened in order to tackle the immediate economic challenges and preserve financial and fiscal soundness. Parallel efforts are needed to promote foreign and domestic investment. Restoration of FDI, particularly, would help restore investment and create jobs without jeopardizing economic stability. Economic policies recently show some signs of tightening, but further efforts are needed in light of the high inflation and substantial balance-of-payment pressure. The Bank of Mongolia announced that it would raise its policy rate by 150 basis points in July and strengthen some bank prudential regulations. However, the low-rate mortgage financing program relying on liquidity injection of the central bank will likely continue, which will limit the effect of the gradual unwinding of monetary easing programs. Also, prudential regulation and supervision on the banking sector needs to be further strengthened, including eliminating prudential regulatory forbearance that was allowed to policy loans issued by the monetary authorities under the Price Stabilization Program, in the wake of high loan-to-deposit ratios, concentration of loans, rising NPLs, and likely inadequate provisioning. Fiscal policy still remains expansionary despite the expected tightening of the official budget and the smaller off-budget spending compared with last year. A large amount of capital spending channeled through the Development Bank of Mongolia (DBM) still remains outside the official budget, which will push the fiscal deficit, including DBM spending, to over 7 percent of GDP in 2014. All fiscal spending, including DBM spending, needs to be consolidated into the budget, and a proper medium-term fiscal consolidation plan needs to be established to reduce the consolidated structural fiscal deficit down to the 2 percent limit of the Financial Stability Law in the coming years.

Mongolia: Key Indicators

	2012 Year	2013e Year	2014f Year	2015f Year	2016f Year
Output, Employment, and Prices					
Real GDP (% change yoy) 1/	12.4	11.7	6.3	6.2	6.6
Mineral GDP (%, yoy)	8.3	19.4	12.9	11.6	6.2
Consumer price index (% change yoy)	14.2	12.3	13.2	11.1	8.0
Public Sector					
Government revenues (% GDP)	29.7	31.0	28.2	27.9	26.8
Government expenditures (% GDP)	39.8	40.3	35.3	33.1	30.1
Government balance (% GDP) 2/	-10.1	-9.3	-7.1	-5.2	-3.3
Total public sector debt (% GDP)	51.3	58.1			
Foreign Trade, BOP, and External Debt					
Trade balance (millions US$)	-1,553	-1,303	-126	68	-146
Exports of goods (millions US$)	4,385	4,273	4,920	5,523	5,958
(% change yoy)	-9.0	-2.6	15.1	12.3	7.9
Imports of goods (millions US$)	5,938	5,576	5,046	5,455	6,104
(% change yoy)	2.2	-6.1	-9.5	8.1	11.9
Current account balance (millions US$)	-3,362	-3,156	-1,710	-1,676	-2,064
(% GDP)	-27.4	-25.1	-13.9	-12.5	-13.7
Foreign direct investment (millions US$)	4,407	2,342			
Foreign exchange reserves, gross (millions US$)	4,126	2,242			
(month of imports of g&s)	6.4	3.5			
Financial Markets					
Domestic credit (% change yoy)	24.1	54.3			
Reserve money (% change yoy)	30.5	54.0			
Short-term interest rate (% p.a.) 3/	13.3	10.5			
Exchange rate (Tugrik/US$, eop)	1,392	1,674			
Real effective exchange rate (2000=100)	140.0	136.5			
(% change yoy)	5.1	-2.5			
Stock market index (Dec. 2000=100) 4/	17,714	16,736			
Memo: Nominal GDP (millions US$) 5/	12.3	12.5	12.3	13.4	15.1

Sources: Bank of Mongolia; National Statistical Office; Ministry of Finance; IMF; World Bank staff estimates.
e = estimate.
f = forecast.
g&s = goods and services.
1/ Real GDP estimates before 2014 are based on 2005 prices. GDP estimates from 2014 to 2016 are based on 2010 prices.
2/ Government expenditures and balance include the off-budget spending by the Development Bank of Mongolia.
3/ Base policy rate.
4/ Top-20 index.
5/ Nominal GDP estimates are based on the new historical data released by the National Statistics Office in August 2014.

MYANMAR



Population	52.3 million
Population growth	0.9 percent
GDP (PPP, int'l US$ billions)	..
GDP per capita (PPP, int'l US$)	..
Surface area	676,590 sq. km.
Capital	Nay Pyi Taw

Source: World Development Indicators.

Summary

The Myanmar economy continued to accelerate in FY2013/14, with real GDP growth estimated to have been 8.3 percent, higher than the 7.3 percent achieved in FY2012/13. Growth has been driven mainly by strong performance in construction, manufacturing, and services. The country's investment rate has been steadily rising, augmented by growing domestic investment and a strong inflow of FDI. The overall macroeconomic environment remains stable, and Myanmar's real economic growth rate for FY2014/15 is expected to increase further to 8.5 percent. The outlook for Myanmar is positive, although predicated on sustained reforms in a broad range of policy areas.

Recent Economic Developments

Real growth in FY2013/14 is estimated to have reached 8.3 percent, driven mainly by construction, manufacturing, and services. Recovery in agriculture is estimated to have contributed to the growth. The economy is projected to increase further to 8.5 percent in FY2014/15, led by gas production and investment. Gas exports are estimated to have reached US$4.2 billion in FY2013/14 and are forecasted to reach US$5.8 billion in FY2014/15, surpassing the FY2012/13 record of US$3.5 billion. FDI declined from 5.0 percent of GDP in FY2012/12 to an estimated 4.6 percent in FY2013/14, but is expected to increase to 5.1 percent of GDP in FY2014/15. Most of this investment has so far been in the energy sector, the garment industry, information technology, and food and beverages.

Inflation in FY2013/14 averaged 5.6 percent and is projected to rise to 6.6 percent in FY2014/15. After experiencing a downward trend from September through December 2013, inflation was on the rise and stabilized at around 6 percent from February to June 2014. The main driver has been rising food prices. Contributing to the rise in food prices are weaker-than-expected agricultural performance. A salary increase for civil servants, among others, also likely contributed to additional demand. End-of-period inflation for FY2013/14 was 6.3 percent compared to a modest 4.7 percent in FY2012/13. The rise in electricity prices at the beginning of current FY2014/15 is also expected to contribute to a slightly higher projected inflation rate of 6.6 percent. Broad money is estimated to have grown by almost 34 percent in FY2013/14, down from 47 percent in FY2012/13. The high growth in FY2012/13 was due to a revaluation of foreign currency deposits following the introduction of a managed float exchange rate regime. Commercial bank lending to the private sector grew by 67 percent in FY 2013/14, higher than the 51 percent growth registered in FY2012/13.

After depreciating since the beginning of FY2013/14, the nominal exchange rate has recently stabilized. The Myanmar kyat reached a high of K 987 to one U.S. dollar in January 2014 before gradually appreciating to K 962 in April. More recently, the exchange rate appears to have stabilized at around K 970. Meanwhile, the official and parallel exchange rates have largely converged since the kyat was floated.

Despite expenditure increases, the fiscal deficit in FY2013/14 is estimated to have declined to 1.6 percent of GDP due to one-off telecommunications licensing fees and improved performance of state economic enterprises. Expenditure increases were due to increased civil service salaries and transfers to states and regions, higher interest spending, and higher allocations to education. Although still very low, the allocation to education increased from 1.6 percent of GDP in FY2012/13 to 1.9 percent in FY2013/14. The underlying fiscal deficit where one-off revenues from telecommunications licenses are excluded is estimated to be 3 percent of GDP in FY2013/14, down from 3.4 percent in FY2012/13. Transfers to states and regions are budgeted to further increase in FY2014/15, and the underlying fiscal deficit is expected to widen to around 5.5 percent of GDP in FY2014/15. However, additional one-off revenues from telecommunication licensing fees and foreign aid are expected to ease fiscal pressures in the short term, bringing the deficit to 4.5 percent of GDP in FY2014/15. The government's target is a budget deficit below 5 percent of GDP.

The current account deficit is estimated to have widened to around 5.4 percent of GDP in FY2013/14, up from 4.3 percent in FY2012/13, but gross international reserves continued to accumulate. Capital account inflows, especially FDI, have been adequate to finance the growing current account deficit. Despite improved export performance, the widening of the current account deficit is mainly due to a surge in imports following a relaxation of some import and foreign exchange restrictions. Gross international reserves are estimated to have reached US$5.5 billion in FY2013/14, equivalent to 3.4 months of imports. International reserves held by the central bank continue to grow, and in FY2013/14 they are estimated to have increased US$4.5 billion, equivalent to 2.9 months of imports. The growing reserves indicate that the current account deficit is covered through capital account inflows. The current account balance in FY2014/15 is forecast to decrease to 5.3 percent of GDP.

The most recent joint World Bank-International Monetary Fund Debt Sustainability Analysis assesses Myanmar as being at low risk of debt distress. The analysis assumes that Myanmar's nonconcessional financing will gradually reduce as it regains access to more concessional resources. In January 2013, arrears to multilateral institutions (the World Bank and Asian Development Bank) amounting to US$932 million were cleared, while an agreement was reached on the resolution of the US$10.0 billion arrears to Paris Club creditors, which included a 50 percent write-off of arrears and rescheduling of the rest of the arrears over 15 years with a seven-year grace period. This has resulted in a decline in Myanmar's total external debt, from 27.3 percent of GDP in FY2011/12 to 24.6 percent in FY2012/13 and 19.2 percent in FY2013/14. The government's goal is to use nonconcessional external borrowing only to finance economically viable projects in priority sectors. The Debt Sustainability Analysis found that public debt sustainability is vulnerable to fiscal slippages and low real GDP growth; hence, it is important to continue with the prudent fiscal policy and the modernization of public financial management.

Outlook and Emerging Challenges

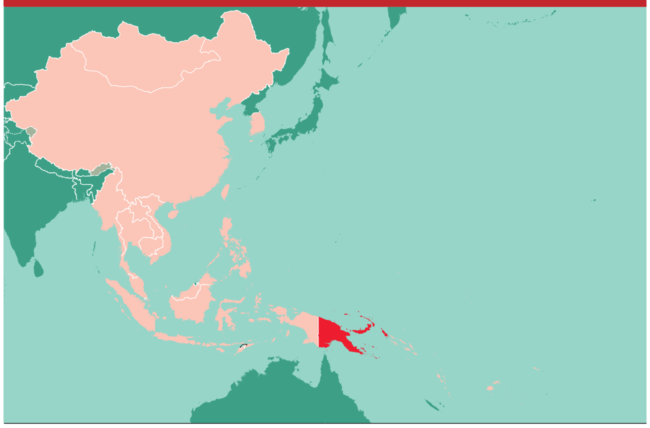
While Myanmar's near-term outlook remains positive, ensuring growth is sustainable and inclusive requires a broad range of policy and structural reforms. The growth forecast for the three-year forecast period from FY2014/15 through FY2016/17 has been revised upward from 6.9 percent per year to around 8.5 percent per year, largely due to the stronger-than-expected estimated outcome in FY2013/14. Myanmar has been pursuing a wide-ranging economic reform program against a background of political liberalization and international reengagement. Economic reforms have so far focused on securing and safeguarding macroeconomic stability and building the framework and institutions to support sound macroeconomic management. While the reform program remains in its early stages, steady progress on institution building should allow for a revival of investment and trade. These growth outcomes also assume continued progress with investments in infrastructure, investments in human capital, and peace building. The main challenge is the capacity of the government to remain focused on the economic reform agenda in the run-up to the fast-approaching elections in 2015.

Myanmar: Key Indicators

	2012/13	2013/14e	2014/15f	2015/16f	2016/17f
	FY	FY	FY	FY	FY
Output, Employment, and Prices					
Real GDP (% change yoy) 1/	7.3	8.3	8.5	8.5	8.2
Consumer price index (% change yoy)	2.8	5.7	6.6	6.3	6.6
Public Sector					
Government revenues (% GDP) 2/	23.3	24.8	24.2	24.0	23.7
Government expenditures (% GDP) 2/	25.0	26.5	28.7	28.6	28.5
Government balance, official (% GDP) 2/	-3.4	-1.6	-4.5	-4.6	-4.8
Domestic public sector debt (% GDP) 3/	22.8	20.6	21.1	21.3	21.8
Foreign Trade, BOP, and External Debt					
Trade balance (millions US$)	-2,135	-2,685	-2,515	-3,264	-3,699
Exports of goods (millions US$)	10,329	12,197	14,925	16,599	18,659
(% change yoy)	1.0	18.1	22.4	11.2	12.4
Imports of goods (millions US$)	12,464	14,882	17,440	19,863	22,358
(% change yoy)	19.4	19.4	17.2	13.9	12.6
Current account balance including grants (millions US$)	-2,405	-3,099	-3,513	-3,838	-4,192
(% GDP)	-4.3	-5.4	-5.3	-5.2	-5.1
Foreign direct investment (millions US$)	2,800	2,621	3,350	3,850	4,274
External debt arrears (millions US$)	2,372	0	0	0	0
Total external debt including arrears (millions US$)	13,700	10,900	11,900	13,400	14,900
(% GDP)	24.6	19.2	18.2	18.2	18.1
Debt service ratio (% exports of g&s) 4/	2.3	3.3	2.8	2.8	2.2
Foreign exchange reserves, gross (millions US$) 5/	4,782	5,482	6,270	8,547	10,067
(months of imports of g&s)	3.5	3.4	3.5	4.2	4.3
Financial Markets					
Domestic credit (% change yoy)	5.1	30.4	32.5	25.3	21.6
Official exchange rate (Kyat/US$) 6/	880.0	964.0			
Parallel effective exchange rate 6/	878.0	965.0			
(% change yoy)	6.8	9.9			
Memo: Nominal GDP (millions US$) 7/	55,800	56,800	65,300	73,600	82,200

Sources: Myanmar Central Statistical Organization; Ministry of Finance; Central Bank of Myanmar; IMF staff estimates; World Bank staff estimates.
e = estimate.
f = forecast.
FY = fiscal year.
g&s = goods and services.
1/ Including manufacturing, power, construction, energy, and mining.
2/ Consolidated public sector including Union Government and State Economic Enterprises.
3/ Domestic Public Sector debt.
4/ Assumes exports of nonfactor services are 7 percent of exports F.O.B.
5/ Includes official reserves held outside the central bank.
6/ Authorities adopted a managed float on April 1, 2012.
7/ Before FY2012/13, GDP converted at a weighted exchange rate, where the official and FEC market rates are weighted with about 8 and 92 percent, based on the respective shares of the public and private sectors in GDP.

PAPUA NEW GUINEA



Population	7.3 million
Population growth	2.1 percent
GDP (PPP, int'l US$)	18.6 billion
GDP per capita (PPP, int'l US$)	2,538
Surface area	462,840 sq. km.
Capital	Port Moresby

Source: World Development Indicators.

Summary

Papua New Guinea's economy is progressing through a period of transition, with the Papua New Guinea Liquefied Natural Gas Project (PNG-LNG Project) moving from the construction to the production phase. While exports of liquefied natural gas (LNG) will yield considerable revenues to the government in the medium term, benefits will be limited in the short term, while growth in the nonresource economy is projected to be very low in 2014 and relatively modest from 2015 onward. The government has adopted a much looser fiscal policy in 2013 and 2014 in an attempt to provide some support to the macroeconomy and at the same time improve the "development enablers" of health, education, infrastructure, and law and order. However, the resulting increase in public debt means that fiscal restraint and a focus on improving the quality of spending will be necessary in the coming years.

Recent Economic Developments

The first cargo of LNG from the PNG-LNG Project was delivered to Japan in early June, ahead of schedule, and LNG exports are likely to account for most of the economic growth in 2014. The government expects growth of 5.4 percent in 2014, similar to last year, but a downward revision from the 2014 budget estimate of 6.2 percent. The downward revision is attributable to declines in production and a scaling back of operations in some mines, including Ok Tedi, and weaker-than-expected cocoa and coffee production, due in part to the cocoa pod borer pest and aging coffee trees. At the same time, global prices for a number of PNG's main agricultural exports have risen since late 2013, including coffee, copra, cocoa, and palm oil, while key metals prices generally have remained well below their 2011 peaks.

Growth in activity outside the resource extraction sector is likely to be weak this year, with the production phase of the LNG boom having much smaller spillovers to the nonresource sectors of the economy than the construction phase. Nonresource GDP is projected to grow by 0.4 percent in 2014, compared to the 9.2 percent recorded during the peak of the construction phase of the PNG LNG project in 2012.

The current account deficit narrowed in early 2014, due mainly to a decline in goods imports, in part resulting from the tapering of PNG-LNG construction. The commencement of LNG production is expected to significantly boost exports in H2 2014 and 2015, resulting in current account surpluses for the next year onward. However, there has been significant downward pressure on the kina over the last two years, due to lower commodity prices and export volumes; generally resilient demand for imports, in part associated with infrastructure investment and increases in public expenditure; and, more recently, a slowing of capital inflows associated with the PNG-LNG Project (offsetting the effect of the decline in imports). During this period, the Bank of Papua New Guinea (BPNG) has intervened in the foreign exchange market in an attempt to slow the kina's depreciation. As of May, reserves had fallen to US$2.6 billion, down from over US$4 billion in early 2012.

In early June, BPNG issued an instruction to banks and foreign exchange dealers to trade foreign currency in a 150 basis point band around BPNG's official reference rate, which led to an immediate revaluation of around 17 percent in the value of the kina against the U.S. dollar. It also led to a reduction in the spread between the rates at which PNG banks are allowed to buy and sell foreign currency. There have been reports of foreign currency shortages in the wake of the revaluation, despite continued intervention by BPNG in the foreign exchange market, suggesting that the kina exchange rate remains above its market-clearing level. The official rate has declined only modestly in the period since the revaluation.

CPI inflation was recorded at 5.1 percent over the year to June 2014, slightly above the 5 percent recorded over the previous year. The long-awaited update to the CPI basket was released by the National Statistical Office in May and was used to calculate the March and June quarter CPIs, although there are still some issues with its construction, and it is difficult to compare recent inflation outcomes (calculated using the new CPI basket) with the historical data. Looking ahead, lagged pass-through effects from the depreciation of the kina over the last two years could continue to put upward pressure on tradables prices. A 40 percent increase in the country's minimum wage to K 3.20 an hour, which came into effect in July, is also likely to have an effect in coming quarters, depending on the extent to which it is enforced.

The 2014 fiscal deficit is expected to be 6.9 percent of GDP. The fiscal stance in 2013 and 2014 has been significantly looser than in previous years, due mainly to the government's focus on expanding expenditures on the "development enablers" of education (including tuition subsidies), health, infrastructure, and law and order. Much of the growth in budget expenditure has been in capital spending, although execution rates remain low due to significant capacity constraints. With capital expenditure in the six months to June only around a quarter of the total 2014 budget, realized expenditure and hence the budget deficit could be lower than projected. Budget revenues have also increased markedly in the last two years, due in part to improved tax compliance measures. However, revenue from mining and petroleum taxes now looks to be weaker than forecasted at the time of the 2014 budget.

As a result of the large budget deficits in 2013 and 2014, public debt has continued to rise, and is currently forecasted to be around 37 percent of GDP in 2014, in breach of the 35 percent debt ceiling set out in the Fiscal Responsibility Act and the Medium-Term Fiscal Strategy. With current yields on longer-term government debt at 10 to 15 percent (due in part to a lack of depth in government bond markets), fiscal restraint in the coming years will be necessary to reduce the debt servicing burden and achieve debt sustainability.

Outlook and Emerging Challenges

The economy is projected to grow by 20 percent in 2015, with the large majority of this growth attributable to the ramping up of LNG exports. However, given that the project is approximately 80 percent owned by nonresidents, only a fraction of LNG receipts will be retained in the domestic economy. In the short term, tax receipts will be negligible as a result of accelerated depreciation schedules, while dividends will initially be used to service the loans funding the government's equity holdings in the project. In the longer term, the revenue stream from PNG-LNG exports will be subject to risks from oil price fluctuations (LNG contract prices in Asia are typically linked to the Japan Customs-cleared Crude oil price). While various proposals for a second LNG project continue to be discussed, it is still not clear when investment decisions will be made, and new LNG projects risk selling on less favorable terms as new conventional and unconventional supply comes online from other countries.

Because the export phase of the LNG boom is much less labor-intensive than the construction phase, an important challenge in the transition period will be to spur the nonmining economy to generate sufficient jobs to employ available labor. Growth in the nonmining economy is expected to recover to around 4 percent in 2015, which is still well below rates observed earlier in the decade, and will likely provide only modest support to employment growth. The projected recovery is mainly attributable to a rebound in construction activity, including construction of the 2015 Pacific Games facilities, and the ongoing maintenance and upgrading of roads in the National Capital District, and in Gulf and Morobe provinces.

Looking forward, pressures on public finances will require restraint in public expenditure, particularly on capital spending, with fiscal consolidation necessary to meet the government's debt targets over the medium term. As a result, focusing on the quality of public spending will be paramount in the coming years. There are signs that the fast pace of growth in capital expenditure over the last two years has been overly ambitious given PNG's capacity constraints, leading to low rates of implementation or low-quality outputs. Growth in capital spending also appears to have squeezed recurrent expenditures in some cases, with service provision and maintenance suffering as a result. The recent push to devolve spending to provincial and district levels of government also raises a number of issues that need to be addressed, including risks of reduced transparency and accountability, and leakages or delays in the disbursement of funds.

Absent efforts to allow the kina exchange rate to move more quickly to a market-clearing level, reports of foreign exchange shortages by importers are likely to persist, while exporters will receive lower kina prices for their products. If the central bank is forced to intervene to prop up the currency, this will add to pressure on foreign exchange reserves, which have already declined substantially over the last two years. At the same time, the current account deficit is likely to narrow as a result of inflows from LNG exports in the coming years, potentially mitigating the downward pressure on the exchange rate. Overall, a floating exchange rate has served the PNG economy well in recent years, with the depreciation since mid-2012 timely in helping the PNG economy adjust to lower commodity prices and reduced impetus from resource-related investment.

The pending establishment of the Sovereign Wealth Fund (SWF) and the consolidation of state-owned assets (including those in petroleum and mining) under the umbrella of a single "Kumul Trust" will be particularly important in the period ahead, given expectations among the population that benefits flowing from the extraction of the country's natural resources will be more broadly distributed.[4] Reports suggest that the SWF will have explicit savings and stabilization functions (with a savings fund replacing the originally envisaged development fund), and will be integrated with the budget process. However specific governance arrangements and rules relating to contributions, investment, and withdrawals had not been released at the time of writing. Questions also remain about the relationship between the Kumul Trust and the SWF, and in particular the proportion of resource revenues that will be channeled to each. The timely resolution of these issues—in a manner that ensures that funds flow through the national budget process and that the SWF is adequately resourced—should be a priority. Indeed, the impact of PNG-LNG and other resource projects on living standards across the country will be determined largely by how well the revenues flowing from these projects are managed and spent.

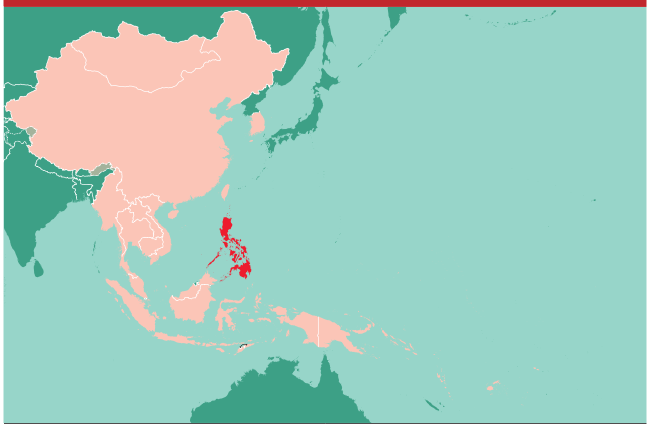
4 The Kumul Trust serves as a vehicle for consolidating state-owned assets.

Papua New Guinea: Key Indicators

	2012	2013	2014f	2015f	2016f
	Year	Year	Year	Year	Year
Output, Employment, and Prices					
Real GDP (% change yoy)	8.1	5.5	5.6	20.0	4.0
Real nonresource GDP (% change yoy)	9.2	5.4	0.4	4.0	4.5
Formal employment (BPNG index, % change yoy)	6.4	2.4	-1.6	1.0	1.0
Consumer price index (% change yoy)	5.8	2.9	6.5	5.0	4.0
Public Sector					
Government revenues (% GDP)	29.2	28.2	30.1	25.3	24.6
Government expenditures (% GDP)	32.4	36.1	37.0	27.8	27.1
Government balance (% GDP)	-3.2	-8.0	-6.9	-2.5	-2.5
Nonresource government balance (% GDP)	-6.6	-9.9	-8.6	-5.8	-5.3
Public and publicly guaranteed debt (% GDP) 1/	26.7	34.0	37.0	31.0	30.0
Foreign Trade, BOP, and External Debt					
Trade balance (millions US$)	-1,207	75	2,000	7,800	7,500
Exports of goods (millions US$)	6,267	5,592	6,400	12,500	12,500
(% change yoy)	-11.0	-10.8	14.4	95.3	0.0
Key export (% change yoy) 2/	-7.3	-10.0	11.0	124.4	0.0
Imports of goods (millions US$)	-7,705	-5,517	-4,400	-4,700	-5,000
(% change yoy)	17.1	-28.4	-20.2	6.8	6.4
Current account balance (millions US$)	-8,244	-4,750	-1600	2,900	2,700
(% GDP)	-53.6	-30.8	-10.0	14.5	12.6
Foreign direct investment (millions US$)	1,883	904	2,100	630	630
Foreign exchange reserves, gross (millions US$)	4,001	2,634	2,500	3,600	4,000
(months of imports of g&s)	5.0	4.0	3.8	5.2	5.5
Financial Markets					
Domestic credit (% change yoy)	12.1	17.5	9.5	12.0	14.0
Short-term interest rate (% p.a.)	7.00	6.25	6.25	7.00	7.00
Exchange rate (Kina/US$, eop)	2.10	2.42	2.56	2.44	2.44
Real effective exchange rate (2005=100)	147.0	144.0	142.0	149.0	149.0
(% change yoy)	15.3	-2.0	-1.4	4.9	0.0
Memo: Nominal GDP (billions US$)	15.4	15.4	16.0	20.0	21.5

Sources: National data sources; IMF; World Bank staff estimates.
e = estimate.
f = forecast.
g&s = goods and services.
1/ Not including debts of state-owned enterprises, or assets of Bank of Papua New Guinea.
2/ Resource exports.

PHILIPPINES



Population	98.4 million
Population growth	1.7 percent
GDP (PPP, int'l US$)	642.8 billion
GDP per capita (PPP, int'l US$)	6,533
Surface area	300,000 sq. km.
Capital	Manila

Source: World Development Indicators.

Summary

Real GDP growth accelerated to 6.4 percent in Q2 2014, from 5.6 percent in Q1, to bring H1 2014 growth to 6 percent. However, this growth is lower than the 7.8 percent recorded in H1 2013. This lower growth was due to weak government consumption and the decline in public construction (i.e., infrastructure spending). As in previous years, the economy's expansion was driven by private consumption, which was supported by remittances that reached US$12.7 billion in H1 2014. In the near term, the Philippines is expected to maintain growth at 6.4 percent in 2014 and 6.7 percent in 2015. These projections hinge on the implementation of the government's planned spending for typhoon reconstruction and planned expenditure programs. In the medium term, higher, sustained, and more inclusive growth can be achieved by accelerating structural reforms and investing in infrastructure, health, and education.

Recent Economic Developments

Philippine economic growth decelerated to 6.0 percent in H1 2014. After sustaining growth of above 6 percent for 8 consecutive quarters, growth slowed due to weak government consumption and public construction. Private consumption continued to drive growth, and was supported by remittances that reached US$12.7 billion in H1 2014 (equivalent to 4.7 percent of H1 GDP). Moreover, the recovery of net exports after five quarters of contraction contributed to growth. On the supply side, the services sector remained the key driver of growth, contributing 3.6 percentage points (ppt) to overall H1 growth, while agriculture remained weak. Despite the slowdown in H1, the country's growth rate compares favorably to other countries in the East Asia region, surpassed only by China (7.4 percent) and Malaysia (6.3 percent).

After many years of slow poverty reduction, poverty incidence among the population declined by 3 ppt between 2012 and 2013 to 24.9 percent, lifting 2.5 million Filipinos out of poverty. This significant reduction in poverty in 2013 came after many years of weak poverty reduction, averaging only 0.2 ppt annually between 2006 and 2012. Stronger job creation of more than 1 million in July 2014 suggests that faster poverty reduction is expected to continue.

Strong liquidity and credit growth continue to exert some risks to price and financial stability. This along with higher food, electricity, and petroleum prices, drove inflation to reach 4.4 percent in the first 8 months of the year. To help mitigate risks to price and financial stability, the reserve requirement ratio (RRR) was increased by 2 ppt to 20 percent, while the special deposit account rate was increased by 25 basis points to 2.25 percent in May. In September, policy rates were increased by a total of 50 basis points to 4 and 6 percent for the overnight borrowing and lending rates, respectively. As a result, after 10 consecutive months of over 30 percent growth, money supply (M3) growth declined below 30 percent in May and continued to ease through July at 18.3 percent. Meanwhile, higher lending to real estate increased the real estate exposure of banks to ₱ 1 trillion in Q4 2013 (around 8 percent of GDP).

The government has shifted efforts from relief to reconstruction in areas affected by Typhoon Yolanda. It has secured adequate fiscal space (₱ 162 billion or around 1.4 percent of GDP) in the 2013 and 2014 budgets combined to support the reconstruction phase for Yolanda, the Bohol earthquake, and other smaller disasters. To transparently track the reconstruction effort, the government has launched openreconstruction.gov.ph, which aims to provide a comprehensive and timely overview of proposed, approved, and ongoing reconstruction projects. Through May 2014, the Department of Budget and Management released ₱ 32 billion, with physical works to ramp up considerably in H2 2014.

Outlook and Emerging Challenges

Strong macroeconomic fundamentals, along with sound fiscal and monetary policies, would continue to support growth in the near term, while further structural reforms would allow the country to sustain growth at above 6 percent in the medium term. Despite the weak but recovering external environment and the impact of natural disasters, the Philippines is positioned to remain on the path of high growth. Building on this achievement through deeper structural reforms would allow the country to sustain its current high GDP growth rate, achieve more inclusive growth, create more and better jobs, and reduce poverty at a much faster rate.

Given the slow start in Q1 2014, weaker government spending in Q2 2014, and monetary policy tightening, baseline growth projections are being revised downward from 6.6 to 6.4 percent for 2014 and from 6.9 to 6.7 percent for 2015. Strong domestic demand would continue to drive overall growth, but growth will depend heavily on the ability of the government to ramp up spending. Private consumption is expected to contribute more than half of GDP growth, supported by a strong inflow of remittances and strong consumer confidence. Ongoing and recently awarded public-private partnership projects equivalent to around 1.5 percent of GDP are also new sources of growth. An acceleration of reconstruction spending can support growth at above 6 percent.

A number of external and domestic factors could pose risks to growth. External risks could come from disorderly policy normalization in high-income countries, a disorderly adjustment in China's property market, political tensions in the Middle East and Eastern Europe, and territorial disputes with China. On the domestic side, the main sources of risk are low government consumption, slow reconstruction spending, and domestic reform lags, in particular reforms to raise tax revenues needed to raise infrastructure, and social services spending.

CPI inflation is projected to reach the ceiling of the central bank's 3 to 5 percent target. Strong credit expansion and rising food and fuel prices would continue to pose inflationary risk. Food supply could remain tight throughout 2014 because of poor harvests due to weather-related disturbances, and could be exacerbated by droughts due to El Niño. In addition, because rice is a basic consumption necessity with inelastic demand, mistiming the importation of rice, which is controlled by the government, could result in sharp increases in rice prices. Moreover, short-term depreciation of the peso and higher fuel prices are sources of inflation. If inflation remains high, monetary tightening and greater use of macroprudential measures, such as further increases in the RRR, would be warranted to buffer risks to price and financial stability.

In the medium term, growth can be sustained and made more inclusive by pursuing structural reforms and investing more in human and physical capital. Key structural reforms include protecting property rights, promoting more competition, and simplifying regulations. These are discussed in the World Bank Philippine Development Report, "Creating More and Better Jobs," launched in September 2013.

The government's planned doubling of infrastructure spending to 5 percent of GDP, and significant increases in health and education spending, require new sources of revenues. This can be achieved through a package of tax policy and administrative reforms. There is scope to increase tax revenues, by, for example, broadening the base and making the tax system simpler, more efficient, and more equitable, while simultaneously lowering certain tax rates to increase the political feasibility of such a package.

The government has successfully raised taxes by 1.2 ppt of GDP in the last 3 years through the sin tax reform, improved tax administration, and higher growth. Accelerating the current reform momentum would help the country yield additional tax revenues to create the fiscal space needed to enhance growth in the coming years.

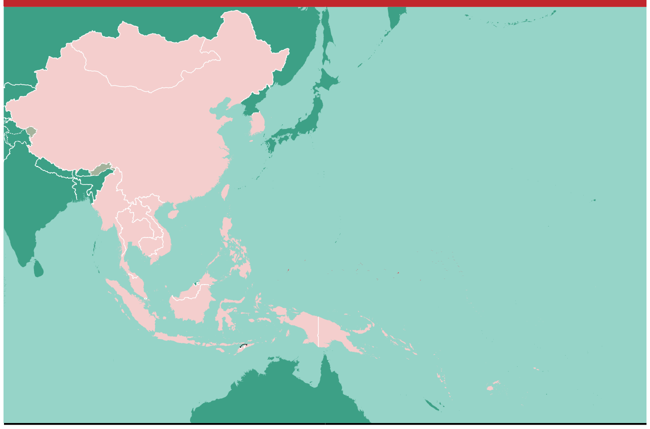
These reforms can help the country become more competitive, and in the process create more and better jobs and accelerate poverty reduction. With further economic reforms, especially in areas that would have more impact on the lives of the poor, the government can help put the country on an irreversible path of inclusive growth and meet the jobs challenge.

Philippines: Key Indicators

	2012	2013	2014f	2015f	2016f	2013		2014					2014
	Year	Year	Year	Year	Year	Q3	Q4	Q1	Q2	Apr	May	Jun	Jul
Output, Employment, and Prices													
Real GDP (% change yoy)	6.8	7.2	6.4	6.7	6.5	6.9	6.5	5.6	6.4				
Industrial production index (2000=100)	100.2	115.4				119.0	132.4	106.1	122.3	116.4	125	126.3	
(% change yoy)	7.7	15.1				17.7	24.7	4.3	13.0	13.0	13.4	13.3	
Unemployment (%) [1/]	7.0	7.1				7.3	6.4	7.5	7.0				
Nominal wages (% change yoy) [2/]	4.7	4.6				2.2	3.7	4.5	4.5	4.5	4.5	4.5	4.5
Real wages (% change yoy) [2/]	1.8	2.9				1.5	1.8	0.4	-0.1	0.3	0.0	0.1	-0.4
Consumer price index (% change yoy)	3.2	3.0	5.0	4.5	4.0	2.5	3.5	4.1	4.3	4.1	4.5	4.4	4.9
Public Sector													
Government revenues (% GDP)	14.5	14.9	15.2	15.6	16.0	15.3	13.8	13.9	17.12				
Government expenditures (% GDP)	16.8	16.3	17.2	17.6	18.0	17.0	15.8	16.8	16.16				
Government balance (% GDP) [4/]	-2.4	-1.5	-2.1	-2.1	-2.1	-1.9	-2.0	-2.9	1.0				
Domestic public sector debt (% GDP) [4/]	49.4	47.2	46.3	45.2	43.9								
Foreign Trade, BOP, and External Debt													
Trade balance (billions US$) [5/]	0.0	-18.5	-24.3	-25.2	-28.3	-5.6	-4.4	-4.1	212.5	-0.8	0.7	0.7	
Exports of goods (billions US$) [5/]	46.4	44.7	48.7	53.6	59.2	11.4	11.7	10.9	15.5	4.5	5.5	5.4	
(% change yoy)	21.2	-3.6	8.9	10.0	10.4	3.8	9.0	7.4	14.6	10.2	12.1	21.3	
Key export (% change yoy) [6/]	0.0	-2.5				4.9	14.6	21.3	12.8	11.2	18.4	9.2	
Imports of goods (billions US$) [5/]	65.3	63.3	73.0	78.8	87.5	17.0	16.1	15.0	15.3	5.3	4.8	4.7	
(% change yoy)	11.3	-3.1	15.4	8.0	11.0	10.8	5.4	8.2	-3.1	3.3	-9.4	-3.0	
Current account balance (billions US$) [5/]	6.9	9.4	5.7	7.1	8.7	1.9	3.7	2.0					
(% GDP)	2.8	3.5	2.0	2.2	2.4	2.9	4.9	3.1					
Foreign direct investment (billions US$) [5/]	3.2	3.9	4.2	4.5	5.5	1.0	0.7	1.9		0.6	0.5		
External debt (billions US$) [7/]	68.6	76.3	79.7	88.6	97.4	59.1	58.5	58.3					
(% GDP)	28.1	28.0	27.8	27.3	26.7								
Short-term debt (billions US$) [7/]	8.5	11.2				9.9	11.2	10.5					
Debt service ratio (% exports of g&s)	14.2	15.3											
Foreign exchange reserves, gross (billions US$)	83.8	83.2	85.2	86.3	86.7	83.5	83.2	79.6	80.7	79.8	80.2	80.7	81.0
(months of imports of g&s)	11.9	11.5	10.1	10.0	9.1	11.9	11.9	10.9	11.0	10.9	11.0	11.0	11.0
Financial Markets													
Domestic credit (% change yoy) [8/]	8.5	11.3				11.4	11.3	12.2	12.6	12.3	11.7	12.6	
Short-term interest rate (% p.a.) [9/]	4.1	2.2				2.0	2.0	2.0	2.0	2.0	2.0	2.1	2.3
Exchange rate (₱/US$, ave)	43.3	42.4				43.7	43.6	44.9	44.1	44.6	43.9	43.8	43.5
Real effective exchange rate (2005=100) [10/]	105.5	109.8				107.3	107.9	106.8	107.8	106.4	108.4	108.7	
(% change yoy) [13/]	4.8	4.0				0.1	-0.4	-5.0	-3.3	-5.6	-4.2	0.1	
Stock market index (Jan. 2, 1985=100) [11/]	5,168	6,479				6,391	6,248	6,197	6,740	6,645	6,789	6,778	6,887
Memo: Nominal GDP (billions US$)	244.0	272.4	286.7	324.7	364.6	64.1	74.5	63.9	70.9				

Source: National data sources.
f = forecast.
g&s = goods and services.
1/ Figures are from the Labor Force Survey.
2/ Nonagriculture minimum wage, National Capital Region. *Source:* CEIC.
3/ IMF Government Financial Statistics basis.
4/ Total consolidated nonfinancial public sector domestic debt.
5/ Yearly data are central bank data, balance-of-payments BPM format; monthly and quarterly data are Philippines Statistics Authority data.
6/ Electronic products and other electronics. Philippine Statistics Authority data.
7/ Central bank data.
8/ Based on Depository Corporations Survey.
9/ Interbank call rate.
10/ IMF, IFS data.
11/ PSEi Composite, period average.

SMALL NORTH PACIFIC ISLAND COUNTRIES



Marshall Islands	
Population	52,634
Population growth	0.2 percent
GDP (PPP, int'l US$)	195.3 million
GDP per capita (PPP, int'l US$)	3,710
Surface area	180 sq. km.
Capital	Majuro
Federated States of Micronesia	
Population	103,549
Population growth	0.2 percent
GDP (PPP, int'l US$)	368.4 million
GDP per capita (PPP, int'l US$)	3,558
Surface area	700 sq. km.
Capital	Palikir
Palau	
Population	20,918
Population growth	0.8 percent
GDP (PPP, int'l US$)	315.7 million
GDP per capita (PPP, int'l US$)	15,092
Surface area	460 sq. km.
Capital	Melekeok

Source: World Development Indicators.

Summary

The North Pacific Island Countries are small, geographically isolated and dispersed, and highly dependent on external aid (see box below). Economic growth has been and is expected to remain volatile and constrained by the countries' small size, remoteness from markets, and limited transportation links. With constrained export and domestic production opportunities and a heavy dependence on imports (almost all fuel and food items are imported), there exists a structural trade deficit and a persistent current account deficit. As is the case with other import-dependent economies, these countries are highly vulnerable to global economic shocks and price spikes. Going forward, given the scheduled decline and end of the Compact grants in FY2024, substantial fiscal adjustment over the medium term is needed to build adequate government deposits and ensure long-term fiscal sustainability.

Recent Economic Developments

The **Republic of Palau** is located in the Western Pacific Ocean and is geographically part of the larger island group of Micronesia. The country's population of around 21,000 is spread across 250 islands forming the western chain of the Caroline Islands. Palau's economy is heavily reliant on tourism and grants. After two years of strong expansion, growth is estimated at around zero in the fiscal year ending September 2013, owing to declines in construction and tourism. Growth is, however, projected to pick up to around 2.5 percent over the medium term, driven by the recovery in tourism and infrastructure developments. The current account deficit deteriorated slightly in FY2013 due to lower tourist arrivals and large reconstruction imports associated with Typhoon Bopha. Inflation moderated to 2.75 percent (annual average) in FY2013, driven by stable international food and fuel prices, and is expected to remain moderate.

The current fiscal deficit excluding grants is estimated to have remained unchanged at 12.25 percent of GDP in FY2013. Tax revenue continued to rise thanks to increases in the rates of tourism-related taxes, higher prices in the tourism industry, and improvement in tax compliance, but current spending was larger than budgeted due to natural disasters. Given the scheduled end of Compact grants in FY2024 (see box below), substantial fiscal adjustment over the medium term is needed to build adequate government deposits and ensure long-term fiscal sustainability.

Box 6. Compact of Free Association

At the end of the original Compact of Free Association, the Republic of the Marshall Islands and the Federated States of Micronesia entered into the Amended Compact of Free Association with the United States, which became effective in FY2004, with the aim of continuing economic assistance during FY2004/23. Under the Amended Compact, the MHL and FSM receive two streams of funds—Compact sector grants and contributions to the Compact Trust Fund—that will total approximately US$3.6 billion over the 20-year Compact period for FSM and MHL.

Sector grants target six specific sectors: education, health care, public infrastructure, the environment, public sector capacity building, and private sector development, with priority for education and health. Sector grants will decline by US$0.5 million per year, while the trust fund contribution is augmented by US$0.5 million per year. These amounts will be partially adjusted for inflation until 2014, after which grant funding will be fully adjusted for inflation.

While the Compact has no specified termination date, the annual fiscal transfers are scheduled to cease in FY2023 to be replaced by disbursements from the Compact Trust Fund from FY2024. According to projections from various sources, income from Compact Trust Fund assets may not be able to fully replace Compact sector grants from FY2024 onward. Eligibility for federal programs, the provision of U.S. services, and the open migration provision will continue beyond FY2023.

The Republic of Palau entered into the Compact of Free Association with the United States in FY1994, which provided for several types of assistance aimed at promoting Palau's self-sufficiency and economic advancement. Included were 15 years of direct assistance to the Palau government, and contributions to a trust fund meant to provide Palau US$15 million each year during FY2010–FY44. In September 2010, the United States and Palau signed an agreement that would, among other things, provide for additional assistance to Palau beginning in FY2011 and modify its trust fund. The agreement would provide steadily decreasing assistance, totaling approximately US$215 million for FY2011–FY24, and modify the trust fund. A bill, now pending, was introduced in the U.S. Senate on February 14, 2011, to approve the agreement and appropriate funds to implement it.

The **Federated States of Micronesia** (FSM) consist of four states—from west to east, Yap, Chuuk, Pohnpei, and Kosrae—that are spread across the Western Pacific Ocean. The country's population of around 102,000 is spread across 607 islands. Economic activity in the FSM consists primarily of subsistence farming and fishing. Real GDP growth was estimated at 0.6 percent in FY2013, and is expected to remain low going forward. Rapid growth in the fishery sector during the year was offset by contraction in the construction and wholesale and retail sectors. The construction sector has ceased to be a source of growth, because the U.S.-funded airport improvement projects have come to an end and other donor-funded planned infrastructure projects are delayed. In the short to medium term, declining public sector demand from Compact sector grant reduction is also expected to reduce economic growth, with limited private sector growth not expected to fully offset this effect. The inflation rate is expected to continue declining from the recent peak in FY2011, since food and fuel prices are contained. Although strong fish exports contributed to the decline in the trade deficit in FY2013, the current account deficit is projected to stay at around 10 percent of GDP, which is financed by the inflow of official transfers.

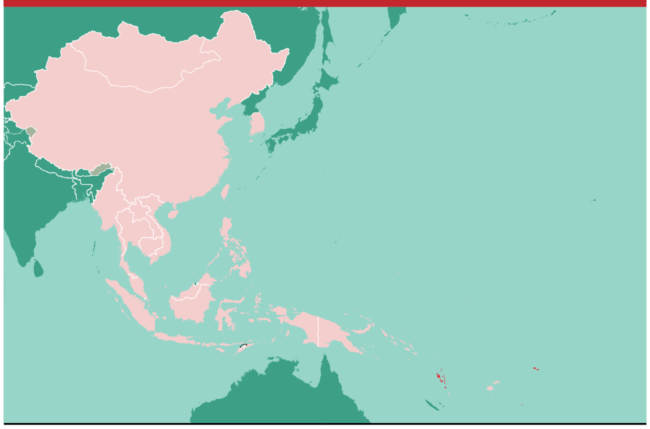
The FSM has been registering small fiscal surpluses in recent years, although the aggregate fiscal outcome masks the large differences among the performances of the various state governments. While the consolidated tax revenue (of all four states and the national government) remains at 11 to 12 percent of GDP, low relative to its Pacific peers, nontax revenue is estimated to have increased by 4 percent of GDP between FY2011 and FY2013 due to strong growth in fishing license fees paid by foreign vessels. However, state government performance varied—the Yap state government recorded a 5.5 percent fiscal deficit, the Chuuk and Pohnpei state governments recorded small deficits of around 1 to 2 percent of local GDP, while the Kosrae state government achieved a small surplus. In addition, the net asset positions of the state governments vary—the Chuuk government has a large debt portfolio, while the Yap government has a large pool of external investments accumulated during the original Compact.

The Republic of the Marshall Islands (MHL) neighbors the FSM, with a population of around 53,000 people spread over 24 low-lying coral atolls comprising 1,156 individual islands and islets. Economic activity in the MHL consists primarily of subsistence farming and fishing. Real GDP growth is estimated at 3 percent in FY2013, supported by increasing fishery output and successful progression in the grant-funded airport project. In FY2014, GDP growth is projected to rebound to 3.2 percent, driven by the resumption of Compact-funded infrastructure projects. In the medium term, however, growth prospects are uncertain and expected to be weighed down by the scheduled reduction in Compact grants and limited private sector growth. Inflation is estimated to have eased from 4.3 percent in FY2012 to 1.9 percent in FY2013, due to subdued global commodity prices. The current account deficit including official transfers remained elevated at an estimated 13.5 percent of GDP in FY2013, because high imports (including construction-related imports for the airport project) more than offset a pickup in exports and an increase in receipts from fishing license fees. The government is estimated to have achieved a small fiscal surplus equivalent to around 0.8 percent of GDP in FY2013, on the back of strong fishing revenues, with large transfers to poorly performing SOEs continuing to be a major drag on public finances.

Outlook and Emerging Challenges

Given the scheduled decline and end of Compact grants in FY2024, substantial fiscal adjustment over the medium term is needed to build adequate government deposits and ensure long-term fiscal sustainability. From a revenue perspective, tax reforms and enhanced compliance efforts already underway have the potential of enhancing fiscal sustainability. Further consideration of reforming taxes on sin goods has the potential of not only improving revenues but also reducing noncommunicable-disease-related expenditures. Expenditure consolidation achieved through the operational efficiency of current and capital expenditure would also support improving fiscal sustainability; however, this will need to be achieved while sustaining service delivery, especially to the poor. Finally, clear fiscal rules to ensure that windfall revenues, such as tourism and fishing, are saved, will also enhance budgetary self-sufficiency after FY2023.

SMALL SOUTH PACIFIC ISLAND COUNTRIES



Kiribati	
Population	102,351
Population growth	1.5 percent
GDP (PPP, int'l US$)	189.9 million
GDP per capita (PPP, int'l US$)	1,855
Surface area	810 sq. km.
Capital	South Tawara
Samoa	
Population	190,372
Population growth	0.8 percent
GDP (PPP, int'l US$)	962.1 million
GDP per capita (PPP, int'l US$)	5,054
Surface area	2,840 sq. km.
Capital	Apia
Tonga	
Population	105,323
Population growth	0.4 percent
GDP (PPP, int'l US$)	558.5 million
GDP per capita (PPP, int'l US$)	5,303
Surface area	750 sq. km.
Capital	Nuku'alofa
Tuvalu	
Population	9,876
Population growth	0.2
GDP (PPP, int'l US$)	35.9 million
GDP per capita (PPP, int'l US$)	3,637
Surface area	30 sq. km.
Capital	Funafuti
Vanuatu	
Population	252,763
Population growth	2.2 percent
GDP (PPP, int'l US$)	756.0 million
GDP per capita (PPP, int'l US$)	2,991
Surface area	12, 190 sq. km.
Capital	Port Vila

Source: World Development Indicators.

Summary

Growth in the small South Pacific Island Countries (Kiribati, Samoa, Tonga, Tuvalu, and Vanuatu) continues to exhibit volatility arising from natural disasters, economic conditions in remittance-sending countries and tourist markets, and the project cycles of donor-funded infrastructure investments. Governments are working to consolidate public expenditure, strengthen revenue, and maintain debt sustainability in order to expand their fiscal space to respond to future shocks.

Recent Economic Developments

Kiribati continues to experience steady moderate growth, driven by large donor-financed infrastructure investment projects (road, airport, and seaport rehabilitation). The economy grew by 2.9 percent in 2013, with growth projected to reach 3.0 percent in 2014. As infrastructure investment spills over into retail and commerce, private sector confidence and investment are expected to support continued moderate growth. Reflecting sustained increases in private sector activity, inflation is expected to reach 2.5 percent in 2014, after deflation in 2012 and 2013 driven by a strengthening Australian dollar and moderate commodity import prices.

Volatile fishing license revenues continue to exert a determining impact on the fiscal balance. Record fishing license fees supported a fiscal surplus of 10.1 percent of GDP in 2013, enabling a substantial replenishment of the Revenue Equalization and Reserve Fund (Kiribati's sovereign wealth fund, used for budget support and intergenerational saving). With moderate fishing license sales in 2014, the fiscal deficit is expected to reach 22.6 percent of GDP, financed by a combination of trust fund drawdowns and concessional borrowing associated with capital projects. Implementation of a value-added tax has been completed, with revenues currently on track to reach budgeted levels. Over the medium term, Kiribati faces significant challenges in restoring fiscal sustainability, with trust fund drawdowns in 2014 expected to significantly exceed sustainable levels.

The current account deficit is expected to grow to 53.4 percent in 2014, from 27.4 percent in 2013. The deterioration is driven by expected moderate license fee receipts in 2014 in the context of continued high levels of imports associated with donor infrastructure projects. Goods exports are expected to increase slightly from 4.1 percent of GDP in 2013 to 4.2 percent of GDP in 2014, driven by strengthening copra prices, while imports increase from 62.3 to 63.0 percent of GDP. Kiribati does not have an independent monetary or exchange rate policy and uses the Australian dollar.

Samoa's economy has been making a solid recovery from the major cyclone that buffeted the country in December 2012, causing damage and losses estimated at 30 percent of GDP. After contracting by 0.4 percent in FY2013, the economy has posted fairly solid growth in the first three quarters of FY2014 and appears to be on track to achieve annual growth of about 2.2 percent. The recovery in FY2014 has been led by the agriculture, commerce, and construction sectors, and reflects the success of Samoa's postcyclone recovery and reconstruction program.

Fiscal stimulus programs and recovery and reconstruction expenditure in the wake of the succession of major external shocks that have hit Samoa in recent years have combined with subdued economic growth to place considerable pressure on the fiscal situation. Budget deficits averaged 6.0 percent of GDP in the five years to FY2013. In FY2014, the deficit is estimated at 4.8 percent of GDP, reflecting high levels of postcyclone recovery and reconstruction expenditure, partially offset by high levels of grants from development partners. The expansion of external borrowing in recent years to finance these fiscal deficits has resulted in the rapid accumulation of external debt, with Samoa now assessed to be at high risk of debt distress.

Primarily as a result of postcyclone reconstruction work, the current account deficit is estimated to have widened to 6.1 percent of GDP in FY2014. Although tourist arrivals were subdued in the 11 months to May 2014 relative to the same period the previous year, total visitor arrivals—which include the large visiting friends and relatives market—and earnings held up well. In the 11 months to May 2014, remittances—which play a critical role in financing Samoa's imports—were 6.9 percent below their level the previous year, probably due mainly to the boost to remittances the previous year as the Samoan Diaspora responded to the cyclone. In the year to June 2014, annual average inflation dropped slightly to -0.5 percent, from -0.2 percent a year earlier.

Cyclone Ian, a level 5 tropical cyclone that hit Tonga in January 2014, has had a manifest impact on the economy in FY2014. Economic growth in Tonga slowed to 0.3 percent over FY2013, partly due to a drop in construction as major public infrastructure works completed. Despite Cyclone Ian, which is estimated to have lowered growth in FY2014 by 0.6 percent, the subsequent recovery program and a modest pickup in both agriculture and tourism are expected to lead to an annual growth rate of 1.4 percent.

Cyclone Ian has somewhat weakened Tonga's fiscal position. The government budget was on track to achieve a small overall surplus in FY2014, but following Cyclone Ian, a drop in tax revenue and increased use of International Development Association credits for reconstruction work led to a small deficit of 0.9 percent of GDP. Over the medium term, Tonga faces known fiscal challenges including the repayment of two large loans, and is likely to experience fiscal shocks arising from continued climatic and economic vulnerability. Continued fiscal prudence and advance planning will help Tonga deal with these challenges.

Inflation reached a historical low of just 0.2 percent yoy in FY2013, with a temporary drop in price of some transportation services, but is estimated to have moved back up to 1.4 percent over FY2014 as activity picked up and the central bank maintained appropriately loose monetary policy. Domestic credit markets finally seem to have turned a corner after a long period of declining credit and balance sheet repair due to a speculative lending bubble in 2008. Data show credit to the household sector grew marginally (by 0.2 percent) to September 2013, and lending is set to increase further now that asset quality has substantially improved. The current account deficit narrowed to 5.5 percent of GDP in FY2013, with declining imports associated with the completion of infrastructure projects. Foreign exchange reserves remain ample, at almost eight months of import cover.

GDP growth in Tuvalu is estimated to have recovered to 1.3 percent in 2013 after being broadly flat in 2012, driven by a thriving fisheries sector. Inflation rose moderately to around 3 percent on a weakening Australian dollar. The balance of payments continued to improve as a result of a large fiscal surplus driven by fishing revenues and foreign aid; reserves have increased to over eight months of imports. Growth is expected to pick up gradually to 2.5 percent in the next few years as a series large donor-financed projects start. Meanwhile, significant growth of public spending and investments in the pipeline could exert upward pressure on prices over the medium term and cause the balance of payments to turn into a moderate deficit.

On the fiscal front, the Government of Tuvalu is estimated to have achieved significant surpluses in 2012 and 2013, owing to higher-than-expected fishing license revenues and grants. The Government of Tuvalu has acted prudently in saving these surpluses, which together with recent distributions from the national Trust Fund has rebuilt buffer assets to a more sustainable level. The 2014 budget is also projected to result in a surplus despite an over 20 percent rise in recurrent expenditures. The rising expenditure is more than offset by rising fishing license fees and one-off grants.

In Vanuatu, the economy is picking up speed and registered 2.8 percent growth over 2013, up from 1.8 percent the year before with tourism growing and several major public construction projects commencing. The outlook for 2014 is for continued expansion of these sectors to increase in growth to around 3.5 percent. Consumer prices registered a modest 1.5 percent inflation in 2013, and inflation is projected to remain low at 2 percent over 2014. The central bank is currently reviewing its monetary policy stance, and stands ready to tighten it should inflationary pressures build further.

The current account deficit narrowed in 2013 for the second successive year, to 4.4 percent of GDP, covered by foreign direct investment and development assistance. Foreign exchange reserves remain ample at just under seven months of import cover. Vanuatu's basket peg exchange rate regime is considered appropriate.

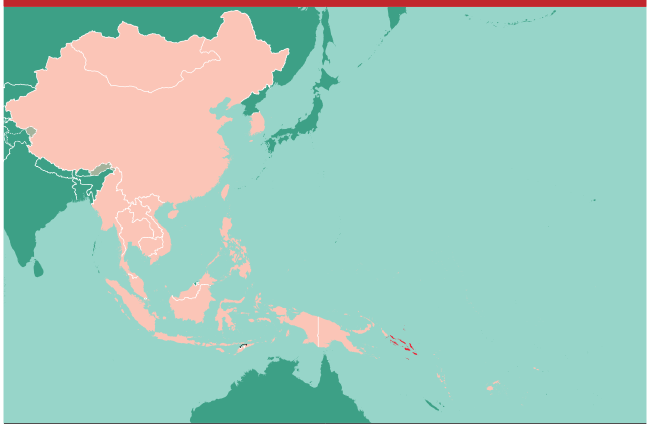
The Government of Vanuatu has maintained a conservative fiscal stance, with negligible budget deficits and low levels of public debt. The overall fiscal deficit in 2013 was just 0.2 percent of GDP. Vanuatu's risk of debt distress is low, with total public external debt standing at 13 percent of GDP. Government revenue, however, has declined from 27.0 percent of GDP in 2008 to 21.4 percent in 2013, posing an increasingly tight constraint on public service delivery.

Outlook and Emerging Challenges

The near-term growth outlook for small Pacific Island Countries is mixed, with postdisaster reconstruction, fisheries, and tourism playing important roles. Over the longer term, recent improvements in the management of regional fisheries resources present important opportunities to increase fishing license fee income in some countries, and—potentially—new opportunities for onshore fisheries development. Small Pacific Island Countries remain vulnerable to any slowdown in nearby larger markets via tourism and remittance channels. The extent of this exposure varies by country, however, with small Pacific Island Countries offering a variety of tourism experiences to different markets, and with remittances from different sources exhibiting varying degrees of volatility.

A common challenge across several countries is ensuring sustainable fiscal management, especially in the context of recent natural disasters. In Tonga and Samoa, authorities are working to balance fiscal sustainability concerns against disaster recovery needs. In Kiribati, deeper structural fiscal imbalances will need to be addressed through further revenue measures and progress in improving fishing license fee arrangements. Ensuring adequate fiscal buffers remains a priority for small Pacific Island Countries in the context of continued exposure to external shocks and natural disasters.

THE SOLOMON ISLANDS



Population	561,231
Population growth	2.1 percent
GDP (PPP, int'l US$)	1.2 billion
GDP per capita (PPP, int'l US$)	2,068
Surface area	28,900 sq. km.
Capital	Honiara

Source: World Development Indicators.

Summary

The Solomon Islands experienced major flooding during April 2014, causing extensive damage and disruption to economic activity. The availability of foreign exchange and fiscal buffers, built up during the preceding period of robust growth, assisted the government in maintaining vital services and effectively implementing disaster response activities. With production at the Gold Ridge mine shut down as the result of flood damage, and exhaustion of natural log stocks expected over the coming years, the medium-term outlook for growth, revenues, and the external position is subject to significant risks, unless new sources of growth can be mobilized, potentially including prospective new mining investments.

Recent Economic Developments

Disruption caused by flooding is expected to have a substantial negative growth impact on the Solomon Islands economy. Following several years of strong growth, the economy expanded by only 3 percent in 2013, reflecting a decline in agricultural output owing to unfavorable weather, lower gold production caused by the restructuring of the Gold Ridge mine in the wake of lower world gold prices, and the ongoing depletion of logging stocks. Growth is now projected at 0.1 percent for 2014 (down from initial projections of 4.0 percent), as a consequence of flash floods affecting areas of Guadalcanal, including the capital Honiara, in April. The flooding severely disrupted commercial and retail activity, as well as cash crop production, and led to the suspension of production at the Gold Ridge Mine.

Cocoa production to the end of Q2 was 58 percent below 2013 production for the same period, reflecting crop damage. Some recovery in cash crop production is expected during the second half of the year, driven by increased copra and cocoa prices. Gold and silver production ceased with the flooding, with annual production 74 percent and 64 percent, respectively, below 2013 levels. Log production, a key driver of growth in 2010, 2011, and 2012, and the Solomon Islands' largest export, is expected to recover to 2013 levels, despite flood disruptions, reflecting some strengthening in log prices. Flood impacts are expected to be partially offset by increased construction activities associated with privately and publicly financed reconstruction during H2 2014. Overall flood-associated damage (that is, capital destruction) is estimated at US$52 million (equivalent to 4.5 percent of GDP), while direct losses in output are estimated at US$55 million (equivalent to 4.7 percent of GDP). Formal employment is expected to remain flat during 2014 due to the impacts of flooding on the formal economy.

The current account deficit is expected to widen to 14.7 percent of GDP in 2014, partly due to the cessation of gold production and lower cash crop exports due to the floods, and partly as a reflection of significantly lower fish exports in the first half of the year. Compared to H2 2013, fish exports have declined by around 50 percent, while log exports, which account for half of all export receipts, declined by 7 percent. Major downside pressures will be partially offset by declines in prices for major imports, including oil and rice and expected increased export prices for logs, palm oil, and coconut oil.

Foreign exchange reserves remain at comfortable levels (US$578 million, or 12.1 months of forward imports in June 2014), supported by donor inflows and fishing license fees. Over the medium term, foreign exchange reserves are expected to decline as the structural deficit of the trade balance widens with cessation of mining activities and exhaustion of natural logging stocks. Growth in the trade deficit would be precipitated by any declines in log demand arising from slower growth in major markets, including China.

Inflation picked up significantly in the first half of 2014, reflecting flood-related supply-side constraints to domestic food production, with provisional figures suggesting a yoy CPI inflation of 7.2 percent in June. By June, the domestic component of the CPI had increased by 12.7 percent yoy, while the import component was negative 1.7 percent. Credit growth continues at moderate levels. Private sector credit grew by 9.8 percent in the year to March 2014, while commercial bank lending increased by 14 percent through 2013. The ratio of credit to GDP remains at around 17 percent, which is still only about half of the average for Pacific Island economies. In March, the Central Bank of Solomon Islands (CBSI) slightly relaxed the monetary policy stance, but it continues to closely monitor price impacts of the recent flooding and may tighten monetary policy again should inflation not abate. Most reconstruction work of flood-damaged infrastructure is unlikely to start before 2015, so some inflationary pressures may persist next year. Given the Solomon Islands' dependence on imports, prices will be substantially driven by international developments, and particularly the prices of rice, wheat, and oil.

Over the last six months, the Solomon Islands dollar (SI$) slightly appreciated against the U.S. dollar to SI$7.30 per U.S. dollar from SI$7.36 at the beginning of the year, while depreciating 5 percent against the Australian dollar. The CBSI recently reviewed its operational implementation of the basket peg, following its introduction in 2012, and now plans further refinements to ensure that the peg is followed more closely. To avoid excessive fluctuations against the U.S. dollar, the CBSI has not allowed the bilateral rate to deviate by more than 1 percent in either direction from a preset "base" rate, but is now moving to widen the band and move the base rate so it is more in line with the basket peg.

Despite a balanced budget, negative revenue impacts of flooding are expected to lead to a fiscal deficit of 1.6 percent of GDP for 2014. Revenue forecasts for 2014 have been revised down by around SI$150 million, primarily due to the closure of the Gold Ridge mine. Preliminary results from the first five months of 2014 showed a deficit of SI$104 million, with expenditures of SI$1.08 billion and revenues of SI$976 million. To June, internal revenue collections were 9 percent lower than forecasted and 3 percent lower than in the equivalent period in 2013. Similarly, customs collections fell by 5.3 percent compared to forecasted growth of 5.4 percent. In the context of revenue declines, the Ministry of Finance is implementing expenditure control measures to ensure that cash reserves remain at comfortable levels, including delaying the processing of payment requests for discretionary items from line ministries. Ministry of Education and Human Resource Development processes have been successfully tightened to control scholarship awards and associated expenditures (a driver for significant overexpenditure of the education budget in 2013), helping to manage the deficit and supporting improved overall budget execution. Fiscal risks remain around additional expenditure pressures in the lead-up to national elections, scheduled for November 2014.

Outlook and Emerging Challenges

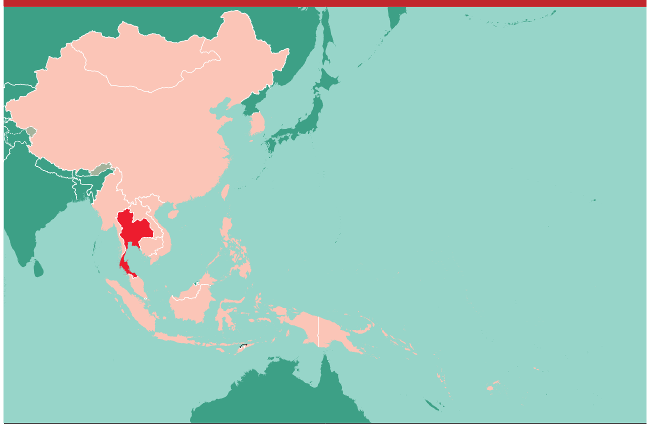
Without the realization of new sources of growth, the Solomon Islands faces significant risks over the medium term. In the short term, growth is expected to pick up, mostly driven by reconstruction-related activities across the public and private sector. Growth of 4 percent is expected in 2015, moderating to 3.5 percent in 2016. In the medium term, the Solomon Islands faces the challenge of developing new sources of growth in light of a forecasted decline in logging and the uncertainty around the exploitation of the country's mining potential. Future mining developments depend on the development of a legal and regulatory framework conducive to mining, and clear procedures for the acquisition of land for the exploration and exploitation of natural resources. The proposed Tina River Hydropower Development Project may provide some short-term boost to growth through construction activities, with possible medium-term impacts from lower electricity prices.

Solomon Islands: Key Indicators

	2012	2013	2014f	2015f	2016f
	Year	Year	Year	Year	Year
Output, Employment, and Prices					
Real GDP (% change yoy)	3.8	3.0	0.1	3.5	3.5
Price index (% change yoy) 1/	5.7	6.0	7.3	5.1	5.5
Consumer price index (% change, period average)	5.9	5.4	7.0	5.5	5.0
Public Sector					
Government revenues and grants (% GDP) 1/	51.8	48.2	50.4	49.3	48.0
Government expenditures (% GDP) 1/	55.9	52.6	48.8	48.5	47.6
Government balance (% GDP)	4.1	4.4	-1.6	-0.8	-0.4
Foreign Trade, BOP, and External Debt					
Trade balance of goods and services (millions US$)	-16	-105	-229	-234	-257
Exports of goods and services (millions US$)	635	574	492	555	543
(% change yoy)	14.1	-9.7	-14.3	12.7	-2.0
Imports of goods (millions US$)	651	679	721	788	800
(% change yoy)	6.7	4.3	6.2	9.3	1.5
Current account balance (millions US$)	2	-90	-169	-194	-201
(% GDP)	0.2	-8.4	-14.7	-15.5	-14.6
Foreign direct investment, net (millions US$)	66	104	70	117	126
Total external debt (millions US$) 2/	132	125	138	162	188
(% GDP)	13.0	11.3	11.5	12.4	13.4
Debt service ratio (% exports of g&s)	20.7	21.7	28.1	29.2	34.5
Foreign exchange reserves, gross (millions US$) 3/	500	531	488	459	420
(months of imports g&s)	8.8	8.8	7.4	6.9	6.5
Financial Markets					
Domestic credit (% change yoy) 4/	4.1	16.0	16.0		
Exchange rate (SI$/US$, eop)	7.30	7.40	7.40	7.40	7.40
Real effective exchange rate (2005=100)	126.2	136.8			
(% change yoy)	9.3	8.4			
Memo: Nominal GDP (millions US$)	997	1.074	1.153	1.254	1.380

Sources: National data sources; IMF; World Bank staff estimates.
e = estimate.
f = forecast.
g&s = goods and services.
1/ GDP deflator.
2/ External public and publicly guaranteed debt.
3/ Includes foreign assets of nonbank financial institutions.
4/ Domestic credit to the private sector.

THAILAND



Population	67.0 million
Population growth	0.3 percent
GDP (PPP, int'l US$)	964.3 billion
GDP per capita (PPP, int'l US$)	14,390
Surface area	513,120 sq. km.
Capital	Bangkok

Source: World Development Indicators.

Summary

The Thai economy is projected to grow by 1.5 percent for the entire year. Real GDP growth in H1 2014 contracted by 0.1 percent, mainly due to the contraction in domestic demand, which has been weak since Q4 2013, and which has continued to be so into the first half of this year. Exports also underperformed since both goods and services exports were weak. As a result, imports had collapsed, leading to a high growth in net exports. In H2 of the year, domestic demand is expected to recover, albeit slowly, as consumer and investor confidence, which have declined since internal conflicts broke out last November, will slowly recover with the stabilization of the political situation after the coup d'état in the latter half of May. Moreover, the B 90 billion (0.8 percent of GDP) arrears of the Paddy Pledging scheme, which was paid in June, will have a positive impact on domestic spending in subsequent months. Exports of goods are also expected to register higher growth in the second half of the year, with the gradual recovery in the economies of Thailand's major markets. Exports of services from tourism, which have contracted sharply in the first half of the year, are also expected to register a lower contraction as the political situation stabilizes.

The economy is expected to grow by 3.5 percent in 2015 as domestic demand, particularly private and public investments, continues to recover as the political situation is expected to be more stable. Public disbursements are expected to speed up from their stagnation in the first half of this year, with a functioning government now in place. The implementation of planned large public transport investment projects will also start next year, although the bulk of them will most likely be implemented starting in 2016. Should the U.S. and Eurozone economies continue to recover, Thai exports would grow at a higher rate than this year. Tourism receipts will also continue to recover should political stability continue throughout the next year. However, household consumption will not recover quickly, because household debt has soared, reaching over 80 percent of GDP in 2014.

Recent Economic Developments

In the first half of the year, real GDP contracted by 0.1 percent yoy. The contraction was mainly driven by the collapse in domestic demand, particularly for private consumption, and both private and public investments. Exports of goods and services have also been weak in the first half of the year. Exports of goods contracted by 0.1 percent yoy in U.S. dollar terms in the first half of the year, while growing by 1.1 percent in volume terms as exports of major products—hard disk drives, metal and steel, petroleum products, chemicals, and agroproducts—slowed. Exports of services, particularly tourism receipts in the first half of the year, also contracted by 6.2 percent yoy as violence in the streets of Bangkok escalated since the beginning of the year. With the contraction in domestic demand and the slow growth of goods exports, imports of goods for production and consumption have also collapsed, contracting by 13.3 percent yoy in U.S. dollar terms and 11.4 percent in volume terms in H1 of the year.

Manufacturing and tourism-related activities have contracted in H1 of the year, along with the fall in domestic demand and exports of goods and services. Manufacturing in the first half of the year contracted by 2.1 percent yoy. Hotel and restaurant activities also contracted, by 3.6 percent. The contraction in manufacturing was mainly the result of the sharp decline in the production of vehicles and parts as domestic demand contracted by 34 percent yoy from a very high base last year. Manufacturing of other key products such as food, hard disk drives, and electrical appliances also contracted, as did exports of rice, fishery, and hard disk drives and domestic demand for electrical appliances.

Capital registered net outflows, especially in Q1 2014, despite the increase in FDI. Net capital outflow was strong at US$6.1 billion in Q1 before easing to US$0.7 billion in Q2. Net outflows in Q1 were mainly for overseas loans, deposits, and portfolio investments by the Thai private sector. In Q2, net outflows for overseas portfolio investments continued, while there were also outflows of trade credits. However, in both quarters, net FDI continued to be strong, totaling US$6.4 billion, exceeding that of H1 2013, despite the political turmoil.

In contrast, the current account was in a large surplus—US$8.8 billion (4.7 percent of GDP)—in the first half of the year. With the collapse in imports, the trade account surplus at US$12.6 billion contributed to the current account surplus, while the services and income account had a net outflow of US$3.8 billion. Taking into account the capital account and the errors and omissions, the overall balance was an outflow of US$1.1 billion in the first half of the year. At end-July, international reserves were US$160.8 billion, or 2.7 times the short-term external debt (compared to US$159 billion at end-2013).

Monetary policy has been accommodative to growth in an environment of low inflation. The policy rate has been reduced to 2.0 percent since March—a 50-basis-point reduction from October last year—as the economy slows. Inflation has been low at 2.2 percent yoy in the first seven months of this year. This is mainly the result of low inflation in nonraw food and energy products—their prices in the consumer price basket rose by only 1.5 percent, while raw food and energy prices in the first seven months rose by 4.1 percent yoy.

In the absence of a functioning government, public investment contracted by 11.3 percent yoy in the first half of the year. Large public investment projects had been put on hold—the B 350 billion water management project has been delayed due to a Constitutional Court ruling that consultations and environmental impact assessments must be completed prior to implementation (so far, only B 21 billion have been disbursed) and the B 2 trillion borrowing bill for transport infrastructure projects was ruled unconstitutional at the beginning of the year. With this borrowing delayed, public debt stood at 46.6 percent of GDP at end-June, a slight increase from 45.7 percent at end-2013.

The Paddy Pledging Programme was discontinued in June. The program has been unable to disburse funds since November 2013, since the government was only an acting one. By May 2014, the program was B 90 billion in arrears (around 0.8 percent of GDP). After the coup in May, the arrears were disbursed to farmers in June and the program was discontinued.

Outlook and Emerging Challenges

Real GDP growth for 2014 is projected at 1.5 percent, with a yoy acceleration in the second half of the year. Real GDP in the second half of the year is projected to grow by around 3 percent yoy. Growth will continue to be supported by net exports as exports of goods and services gradually recover, growing by around 2 percent yoy after contracting by 0.6 percent in the first half of the year. Imports of goods and services, however, will continue to contract at around 1 percent yoy in the second half of the year (after contracting by 8.9 percent in the first half), since recovery in exports and domestic demand will be weak.

Domestic demand in the second half of this year will grow at around 1 percent as private consumption and investments slowly recover. Household consumption growth is constrained by high household debt, which has soared to over 80 percent of GDP at the end of the first half of the year. It is therefore projected to grow by only 2 percent yoy in the second half of the year (after contracting by 1.4 percent in the first half). Private investment will also recover, albeit slowly, at around 1.5 percent yoy (after contracting by 7.2 percent in the first half of the year), as capacity utilization remained low at 60.6 percent in June. Meanwhile, inventories, which were at record-high levels last year (B 91 billion in real terms, or 1.8 percent GDP), will continue to be drawn down. However, the recovery in domestic demand in the second half of the year is partly supported by the disbursement of the paddy pledging arrears of almost 1 percent of GDP since June.

The Thai economy is projected to grow in 2015 by around 3.5 percent. It will be supported by further recovery in exports, and by public and private investments, when compared to their low bases especially in the first half of this year. With the recovery in exports and investments, imports should resume growing after contracting this year. The current account surplus in 2015 is projected to be around US$12.7 billion (3 percent of GDP), compared to US$16.0 billion (4.2 percent of GDP) in 2014. Household consumption will grow by only 1.5 percent in 2015, because it will continue to be constrained by high household debt. Nevertheless, domestic demand should grow by almost 4 percent, after contracting by 2.3 percent in 2014. Net exports, however, would grow by 1.6 percent, compared to 23.8 percent in 2014, as import growth reverses from a contraction in 2014 to growth in 2015.

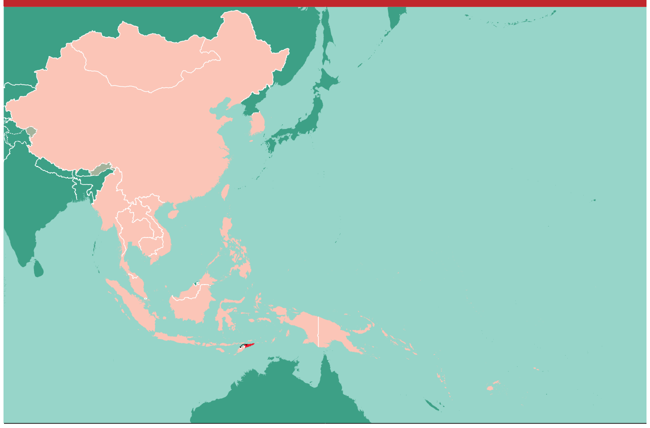
The new government's policies and ability to implement programs and projects are to be closely watched, as will be the performance of Thai exports. A new government was installed in August. Since then, several new policies have been proposed to the Cabinet by the ministries, including tax reform, a new energy policy, and agricultural support programs. Their adoption and implementation, as well as the implementation of the FY2015 budget and the large transport infrastructure projects, are to be closely followed. On the external front, the competitiveness of Thai exports will need to be closely examined as the global economy recovers. So far, Thai export growth (in U.S. dollar terms) has trailed that of its regional neighbors, with key exports such as hard disk drives and rubber products either contracting or growing much slower than in previous years.

Thailand: Key Indicators

	2012	2013	2014f	2015f	2016f	2013		2014					2014
	Year	Year	Year	Year	Year	Q3	Q4	Q1	Q2	Apr	May	Jun	Jul
Output, Employment, and Prices													
Real GDP (% change yoy)	6.5	2.9	1.5	3.5	4.0	2.7	0.6	-0.6	0.4				
Domestic demand (% change yoy)	9.4	1.3	-2.3	3.9	3.0	0.1	-3.2	-6.3	-5.5				
Industrial production index (2000=100) 1/	181.6	175.8	181.1			173.6	170.5	171.7	166.9	156.2	172.0	168.9	165.2
(% change yoy)	2.2	-3.1	2.7			-1.9	-2.5	-4.9	-4.1	-3.9	-4.0	-6.3	-5.2
Unemployment (%)	0.7	0.7	0.7	0.7	0.7	0.8	0.7	0.9	1.0	0.9	0.9	1.2	
Real wages (% change yoy) 2/	19.6	8.0				9.1	7.2	8.9	10.6	14.0	10.3	7.7	8.2
Consumer price index (% change yoy)	3.0	2.6	2.3	2.5	2.7	1.7	1.7	2.0	2.5	2.4	2.6	2.4	2.2
Public Sector													
Government revenues (% GDP) 3/	18.5	19.6				21.2	17.2	15.8	21.7	14.8	29.5	20.8	13.7
Government expenditures (% GDP)	22.8	22.0				20.8	27.7	19.4	17.9	20.1	15.5	18.1	20.6
Government balance (% GDP) 4/	-4.3	-2.4				0.4	-10.5	-3.6	3.8	-5.3	14.0	2.7	-6.9
Public sector debt (% GDP) 5/	43.6	45.7				45.5	45.7	46.5	46.6	46.6	45.9	46.6	46.8
Foreign Trade, BOP, and External Debt													
Trade balance (billions US$) 6/	0.0	6.4	25.7	22.4	18.9	-0.6	-0.9	6.6	6.1	0.6	1.6	3.9	1.5
Exports of goods (billions US$) 7/	225.9	225.4	227.2	239.0	259.4	58.8	56.6	55.6	55.9	17.1	19.3	19.5	18.7
(% change yoy)	3.1	-0.2	0.8	5.2	8.5	-1.7	-1.0	-0.8	0.6	-0.9	-1.2	3.8	-0.6
Key export (% change yoy) 8/	3.4	-2.8				1.1	3.7	8.7	10.3	-6.4	16.1	11.3	3.6
Imports of goods (billions US$) 9/	219.9	218.7	201.2	216.3	240.1	60.7	59.2	48.9	49.8	16.5	17.6	15.7	17.2
(% change yoy)	8.8	-0.5	-8.0	7.5	11.0	-2.0	-7.9	-15.0	-11.8	-13.8	-7.7	-14.1	-7.0
Current account balance (billions US$) 6/	-1.5	-2.5	16.0	12.7	9.2	0.0	3.0	8.2	0.5	-0.6	-0.7	1.8	-0.9
(% GDP)	-0.4	-0.6	4.2	3.2	2.2	0.0	3.1	8.8	0.6	-2.1	-2.1	5.9	-2.7
Foreign direct investment (billions US$) 10/	10.7	12.8				4.3	3.9	3.4	3.4	1.4	1.0	1.0	
External debt (billions US$) 11/	130.7	139.8				139.1	139.8	140.1	143.3	140.9	142.3	143.3	
(% GDP)	35.7	36.1				35.9	36.1	36.6	37.5	36.8	37.2	37.5	
Short-term debt (billions US$) 11/	58.2	59.9				61.5	59.9	60.1	61.4	60.3	62.5	61.4	
Debt service ratio (% exports of g&s)	4.2	4.0				3.7	3.9	3.8					
Foreign exchange reserves, gross (billions US$) 6/	171.1	159.0				163.5	159.0	158.8	159.3	160.2	159.1	159.3	160.8
(months of imports of g&s)	7.5	9.5				9.7	9.7	10.2	10.1	10.2	9.5	10.7	
Financial Markets													
Domestic credit (% change yoy) 12/	15.3	12.5				11.4	9.2	6.3	5.1	6.1	5.6	3.6	
Short-term interest rate (% p.a.) 13/	2.9	2.5	2.0			2.5	2.3	2.2	2.0	2.0	2.0	2.0	2.0
Exchange rate (Baht/US$, ave)	31.1	30.7	32.5	32.5		31.4	31.7	32.6	32.4	32.3	32.5	32.5	32.1
Real effective exchange rate (2012=100) 14/	100.0	106.5				105.1	103.9	101.9	101.9	102.5	101.5	101.7	102.6
(% change yoy)						3.0	0.5	-5.4	-6.8	-8.2	-7.7	-4.6	-3.5
Stock market index (Dec. 1996=100) 15/	1,392	1,299				1,383	1,299	1,376	1,486	1,415	1,416	1,486	1,502
Memo: Nominal GDP (billions US$)	366.4	388.4	379.0	402.9	428.5	93.0	95.2	93.3	93.3				

Sources: National data sources; World Bank staff estimates.
f = forecast.
g&s = goods and services.
1/ Manufacturing Production Index.
2/ Average wage of employed person, using the National Statistical Office Labor Force Survey, deflated by CPI inflation.
3/ Refers to central government only. Fiscal Policy Office data.
4/ Cash balance of central government before financing.
5/ Includes domestic central government debt, domestic debt of nonfinancial state enterprises, and the Financial Institutions Development Fund (FIDF) debt.
6/ Revised from BPM5 to BPM6.
7/ Export figures readjusted to comply with HS2012.
8/ Electronics.
9/ Import figures readjusted to comply with HS2012.
10/ Net FDI of all sectors. Bank of Thailand data, using BPM6.
11/ Bank of Thailand data.
12/ Private credits from domestically registered commercial banks, branches of foreign banks, international banking facilities, finance companies, specialized banks, thrift and credit cooperatives, and money market mutual funds.
13/ Bank of Thailan's one-day repurchase rate, average
14/ Bank of Thailand data.
15/ Stock Exchange of Thailand

TIMOR-LESTE



Population	1.2 million
Population growth	2.5 percent
GDP (PPP, int'l US$) 1/	2.6 billion
GDP per capita (PPP, int'l US$) 2/	2,242
Surface area	14,870 sq. km.
Capital	Dili

Source: World Development Indicators.
1/ The equivalent in 2011 nonoil GDP at current market prices is US$1.128 billion.
2/ The equivalent in 2011 nonoil GDP at current market prices is US$1,007.

Summary

The 2013 and 2014 economic growth estimates for Timor-Leste, and the medium-term forecasts, have been cut, reflecting poor spending performance in 2013, and declining budgets. Prospects for Tibar Bay Port, a cement plant, and a brewery, could have important growth impacts from 2015. Public spending performance is better in 2014 than in 2013, although challenges remain in infrastructure. The 2015 fiscal envelope of US$1.3 billion could result in an FY2015 budget even lower than the FY2014 budget, and closer to spending capacity. Inflation has fallen considerably since 2013, with quarterly average prices contracting for the first time since 2009. Private sector credit fell in Q2 for the first time since 2010. Imports increased relative to 2013, although due, in part, to measurement issues. The Petroleum Fund continues to grow, passing US$16.6 billion in June 2014. The likelihood of the prime minister resigning this year has diminished, but a cabinet downsizing, reshuffle, or both, may occur, possibly triggering an FY2014 rectification budget.

Recent Economic Developments

Both capital and recurrent public spending are improving relative to this time last year, which improves prospects for 2014 growth in nonoil GDP (Timor-Leste's preferred measure of economic activity). This follows the first-ever yoy decline in public spending in 2013, to US$1.1 billion against a US$1.65 billion budget, negatively contributing to nonoil economic growth. The execution law for the US$1.5 billion FY2014[5] budget requires cuts in the third quarter if execution does not pass 80 percent by that time. This incentivizes spending agencies, but also provides the opportunity to improve the 2014 execution rate if spending slows. In May, the Ministry of Finance set an FY2015 fiscal envelope of US$1.3 billion, to return to fiscal sustainability and the level of perceived spending capacity.

Having sharply lowered its 2013 nonoil GDP growth estimate from 10.6 percent to 8.0 percent in the January 2014 budget documents, the government is likely to publish further cuts for 2013 and the medium term, as growth in public spending slows. Long-term petroleum revenue forecasts, and the Estimated Sustainable Income (ESI) Timor-Leste earns on its petroleum wealth, fell as production forecasts from fields currently under development fell. Headline inflation remained low in H1 2014, at an average of 1 percent yoy from January to July, registering quarterly deflation in Q2 for the first time since 2009. This follows a dramatic fall in inflation at end-2013, from over 13 percent yoy as domestic demand pressures eased and adjustments were made to measurement.

Growth

While the 2013, 2014, and medium-term forecasts for real nonoil GDP growth are likely to be revised down in the 2015 budget document as public spending stabilizes, the 2014 estimate could be higher than

5 The fiscal year follows the calendar year in Timor-Leste.

2013 if budget execution improves this year. Vehicle purchases grew 178 percent in Q2 compared to the same period last year (after falling by 6 percent in Q1), the highest rate since 2008, and especially in the heavy vehicle category. Electricity consumption also grew in the first two quarters of 2014, mainly due to rising domestic consumption. On the downside, credit to the private sector contracted for the first time in Q2 relative to trend and relative to Q1 2014. The prospects for 2015 will be lifted with plans for Tibar Bay Port, a cement plant in Baucau, and a brewery under discussion.

In May, the government released its 2000–12 National Accounts, which revised 2011 nonoil real GDP growth up significantly from 12 percent to 14.7 percent, based on definitional adjustments. The Accounts show that 2012 nonoil GDP growth nearly halved from 2011 to 7.8 percent, based on the 2011 revision, but also reconfirming the sensitivity of growth to slowing public spending.

Fiscal

Budget execution was 33 percent (excluding obligations) as of July 31, 2014—42 percent higher than the same period in 2013, and 8 percent lower than in 2012. If spending accelerates in the second half of the year, as in previous years, execution performance is likely to be better than the 66 percent achieved in 2012 and 2013. Capital budget execution, although 90 percent higher than in the same period in 2013 (but 28 percent lower than in 2012), continues to weigh down overall execution, with only 20 percent of the capital and development budget being executed at end-July. The execution for the Infrastructure Fund (a ring-fenced, multiyear part of the budget with dedicated large-project management institutions) was 19 percent, with oil and gas, water and sanitation, and tourism under 5 percent. Constrained execution is mainly a result of delays in procurement (due to incomplete project design documentation) and limited capacity.

While levels of spending have improved relative to last year, execution rates have also improved thanks to the smaller FY2014 budget, which could be cut further by a possible rectification. The US$1.5 billion 2014 budget was US$150 million less than in 2013, which itself was US$200 million less than in 2012. However, only the capital budget was cut in 2014, whereas the recurrent budget has risen by 18 percent in relation to 2013, driven by a 40 percent increase in transfers, some of which are new, and possibly one-off. These include the Oecusse development project (US$20 million), school rehabilitation (US$25 million), additional capital for the central bank to on-lend through commercial banks (US$20 million), and official development assistance to Guinea Bissau (US$7.5 million).

The FY2015 budget ceiling set in May cuts the budget by a further US$200 million to US$1.3 billion, with the first cut to the recurrent budget (20 percent) since 2010, returning to 2012 levels. The reduction is both a step toward greater fiscal sustainability and budget credibility, and an attempt to reduce demand-driven inflationary pressures and improve public productive investment. Focus in the final stages of preparation will be on whether the recurrent and overall ceilings hold, and whether the medium-term spending path rises as in 2013 and 2014, requiring excess withdrawals from the Petroleum Fund.

The FY2014 budget reduced projections for petroleum production, since fields currently under development are now forecasted to end by 2021 rather than 2025. This has reduced the ESI from petroleum wealth by 19 percent to US$632 million in 2014 from an estimated US$787 million in 2013. ESI and domestic revenues together indicate a level of public spending that does not reduce the petroleum fund for future generations. Falling ESI emphasizes the importance of improving the domestic tax effort with both policy reform (a value-added tax is being discussed) and administrative reform. Audits of the taxpayer database have recently been completed, and the new one-stop shop for business registration can provide a more orderly registration process, also for tax purposes. It also underscores the imperative that public resources are spent in projects with high economic return.

In FY2014, the nonoil fiscal deficit (domestic revenue less total spending) is projected to be 75 percent of nonoil GDP. Domestic revenue performance has improved relative to last year, with 53 percent of the projected full-year target of US$166.1 million collected by July 31, 2014. When including petroleum revenues, the government's overall fiscal surplus target is US$1,609 million, or 91 percent of nonoil GDP. The 2013 nonoil fiscal deficit was 61 percent of nonoil GDP. The overall surplus was 138 percent of estimated 2013 nonoil GDP, well above the original 54 percent forecasted, since petroleum revenues significantly exceeded forecasts.

Inflation and Financial Sector Issues

Inflation continued to fall in the first half of 2014 from 2.7 percent yoy in January to 0.7 percent deflation in June. This was the first monthly price contraction since July 2013, resulting in the first quarterly deflation in Q2 (-0.3 percent qoq) since 2009. This follows the dramatic drop in inflation in Q4 2013 from over 13 percent yoy. Part of the fall is due to an increased weight (now 64 percent) attributed to food in the CPI consumption basket, much of which is imported. Global food prices have fallen, and domestic supply has improved. Additional factors include slower public spending and hence domestic demand pressures. The real effective exchange rate has also appreciated. The U.S. dollar (Timor-Leste's official currency) has appreciated since January 2013 relative to major trading partners. And in 2013, inflation was for the first time since 2009 lower in Timor-Leste than in Indonesia, a trend that has continued in 2014.

Credit to the private sector contracted by nearly 5 percent in Q2 relative to Q1, following an uninterrupted period of growth since 2010. At 10 percent of nonoil GDP, the level of lending to the private sector as a share of GDP remains the lowest in the region (140 percent in East Asia and Pacific, and 21 percent in Lao PDR, the second lowest).

Interest rate spreads widened, as lending rates rose from 12.48 percent in December 2013 to 12.87 in June 2014, while deposit rates lowered from 0.56 to 0.52 percent.

The share of nonperforming loans (NPLs) has been declining since a peak of 50 percent in 2010. This reflects an expansion in credit, with a stable value of nonperforming loans. The share of NPLs has been 27 percent since 2013, down from a 33 percent average in 2012. Loan loss provisions were US$57.7 million in July 2014, or 119 percent of the value of nonperforming loans, effectively mitigating the risk to the banking system.

External Balance

The trade deficit continued to deteriorate in the first five months of 2014 to US$459 million, widening slightly in relation to the same period in 2013, although there may be data errors in May. Coffee exports improved relative to the same period last year. However, monthly imports have been increasing. Imports in May alone were bigger than combined Q1 2014 imports, due to US$208 million worth of metals and semiprecious metals. However, this is likely to be incorrect recording of the receipt of centavos coins, minted in Portugal, for circulation as currency in Timor-Leste.

The main harvest of coffee began in August, and with global Arabica prices rising since the beginning of the year (a 42 percent yoy rise in July 2014), a better export performance relative to 2013 can be expected in the second semester. The impact on the trade balance will depend on whether imports will accelerate from the third quarter onward, in line with public spending. One positive factor is that World Bank forecasts show diminishing prices for cereals, which compose a significant part of the import basket.

The Petroleum Fund, Timor-Leste's Sovereign Wealth Fund, reached US$16.6 billion in value at end-June 2014, nine times the estimated 2014 nonoil GDP, which together with official central bank reserves is capable of covering over 200 months of imports.

Total petroleum receipts from taxes and royalties in the first semester were US$1.1 billion, or 78 percent of the FY2014 target of US$1.4 billion. Interest earnings were US$597 million, or 78 percent of the US$770 million forecast net investment income for 2014. The fund is again on track to exceed its annual target (US$2.2 billion in total petroleum revenues in 2014). Forecasts for 2015 to 2018 show relatively constant petroleum revenue (US$2,458 million average), but with an increasing contribution from net interest income from investments, from 34 percent in 2015 to 49 percent in 2018.

Outlook and Emerging Challenges

Prime Minister Kay Rala Xanana Gusmão did not step down in September as originally announced in his January 2014 budget speech, and may reduce and reshuffle the cabinet, increasing the likelihood of a rectification budget. At a convention of the prime minister's main ruling party, the Conselho Nacional da Resistência Timorense (CNRT), the prime minister was encouraged to stay in office with a mandate to cut and reshuffle ministerial posts. A 2014 rectification budget may be issued if spending is too low by the end of Q3, or if cabinet seats are cut.

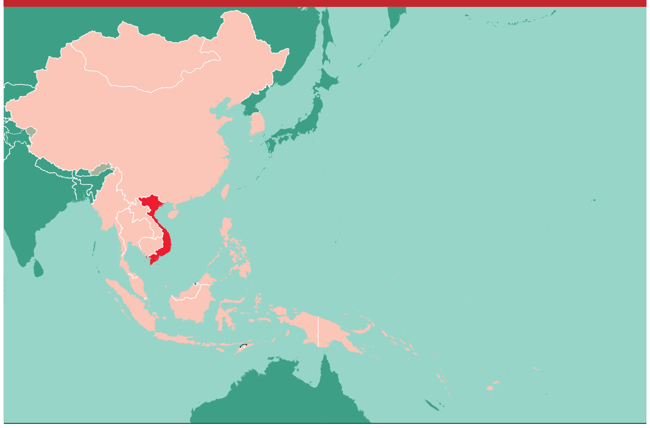
Plans for developing the district enclave of Oecusse as a special economic zone for social markets are advancing rapidly, with the leader of the main opposition party appointed in August as head of an authority undertaking the effort. In July, legislation was passed providing significant autonomy to the authority over the region's management of legislation relating to land use, public finances, and investor incentives.

Timor-Leste: Key Indicators

	2012	2013e	2014f	2015f	2016f
	Year	Year	Year	Year	Year
Output, Employment, and Prices					
Real GDP (% change yoy)	5.7	-3.2	-6.9	1.7	-2.1
Real nonoil GDP (% change yoy)	8.3	8.1	8.0	7.7	8.6
Consumer price index (% change yoy, annual average)	11.8	11.3	7.7	7.7	7.7
Public Sector					
Government revenues (% GDP)	69.1	59.7	63.6	60.9	63.4
Government expenditures (% GDP)	22.1	23.5	26.5	27.5	27.5
Government balance (% GDP)	47.0	36.2	37.1	33.4	35.9
Nonoil government balance (% GDP)	-15.8	-17.2	-19.0	-19.6	-19.1
Nonoil government balance (% nonoil GDP)	-73.7	-65.2	-56.7	-51.8	-43.5
Public sector debt (% GDP) /1	0.0	0.7	5.6	11.1	16
Foreign Trade, BOP, and External Debt					
Trade balance (millions US$)	-639	-826	-829	-904	-976
Exports of goods (millions US$)	33	16	42	46	57
(% change yoy)	32.0	-51.5	162.5	9.5	23.9
Imports of goods (millions US$)	672	843	871	950	1,033
(% change yoy)	79.7	25.4	3.3	9.1	8.7
Current account balance (millions US$)	2,738	2,105	1,819	1,551	1,588
(% GDP)	43.5	34.3	32.1	27.0	27.7
Foreign direct investment (millions US$)	6	53	116	139	182
External debt (millions US$)	8	44	275	319	278
(% GDP)	0.1	0.7	4.8	5.5	4.9
Debt service ratio (% exports of g&s)	0.0	0.0	0.1	0.2	0.3
Public foreign assets, gross (millions US$) 2/	12,659	14,419	16,543	18,526	20,644
(months of imports of g&s)	91	93	95	98	103
Foreign exchange reserves, gross (millions US$)	884	213	213	213	213
(months of imports of g&s)	15.8	3.0	2.9	2.7	2.5
Petroleum Fund, closing balance (millions US$)	11,775	14,952	16,330	18,313	20,431
Financial Markets					
Domestic credit (% change yoy)	20.5	21.2	21.7		
Short-term interest rate (% p.a.)	12.20				
Real effective exchange rate (2005=100) (period average)	118.1	134.5			
(% change yoy)	11.8	13.9			
Memorandum items:					
Memo: Nominal GDP (millions US$)	6,300	6,129	5,673	5,748	5,730

Sources: National data sources; IMF; World Bank staff estimates.
e = estimate.
f = forecast.
g&s = goods and services.
1/ External debt.
2/ Central bank foreign exchange reserves + Petroleum Fund balance.

VIETNAM



Population	89.7 million
Population growth	1.1 percent
GDP (PPP, int'l US$)	474.8 billion
GDP per capita (PPP, int'l US$)	5,293
Surface area	330,957 sq. km.
Capital	Hanoi

Source: World Development Indicators.

Summary

Vietnam further consolidated macroeconomic stability in 2014, with continued low inflation and strengthened external accounts. Slower economic growth has prompted an easing of monetary policy, but lending has been constrained by weaknesses in bank balance sheets and subdued private sector demand. GDP growth is forecasted to flatten this year and slightly edge up in 2015, with inflation remaining in single digits. Regaining growth momentum, sustaining strong export performance and FDI inflows, and otherwise strengthening competitiveness requires intensified efforts to reform the banking sector and state-owned enterprises, and to improve the business environment.

Recent Economic Developments

Vietnam has maintained macroeconomic stability, with easing inflation, strengthening external accounts, and stable foreign exchange markets. Headline inflation fell from a peak of 23 percent in August 2011 to about 4.2 percent in August 2014, as a result of benign supply-side pressures (especially on account of soft energy and food prices) and continuing subdued domestic demand. Stronger trade and capital accounts on the balance of payments have enabled foreign exchange reserves to build up to an import cover of about 3.1 months in May 2014, up from 2.4 months in December 2013. Recent tensions with China in the East Sea have added some turmoil in the financial and foreign exchange markets, although these pressures appear to be abating. The State Bank of Vietnam adjusted downward the reference rate for the dong (effective June 19, 2014) by 1 percent, to 21,246 per dollar, its first adjustment in 12 months. Macroeconomic stability has helped Vietnam improve its sovereign risk ratings despite regional tensions.

Vietnam's economic growth, however, remains sluggish and continues to come in below its long-term potential. Growth picked up at 5.1 percent in Q1 2014 and 5.25 percent in Q2, remaining well below the precrisis peak rate of 7 percent. The economy is projected to grow at 5.4 percent in 2014—the same pace as 2013—before picking up slightly to 5.5 percent in 2015. In the short run, this is linked to slow domestic demand. Growth in retail sales—a proxy for private consumption—eased to 5.7 percent in real terms in June due to weak consumer confidence. FDI remained substantial, but private domestic investment remains dampened by weak credit growth and low business sentiment. The share of domestic private investment in GDP stood at only 10.7 percent in H1 2014, well below the level of 13.9 percent in 2010. A growing number of domestically owned businesses have been closing or suspending operations. Sixty-one thousand firms closed or suspended business in 2013 compared to 47,000 in 2010; a further 37,600 were added to this list in the first seven months of 2014—a 10 percent increase over the same period last year. Difficulties in finding suitable markets, limited access to financial resources, and the high costs of inputs for production were among the main reasons behind enterprise liquidations or suspensions.

Longer-term growth potential remains hampered by a web of structural problems in state-owned enterprises and the banking sector, policy weaknesses that continue to thwart domestic private investment and competition in key sectors, a widening skills gap, constrained access to finance, and relatively high trade logistics costs.

Although FDI has leveled off in recent months (albeit at high levels), the foreign-invested sector remains an important engine of economic development in Vietnam. By end-July 2014, Vietnam had investments from more than 100 countries and territories, with total accumulated FDI commitment of around US$242 billion in a broad and diversified range of business activities. The foreign-invested sector contributes to almost 20 percent of Vietnam's GDP, 25 percent of total investment, two-thirds of total exports and, directly and indirectly, millions of jobs. Foreign investors have generally held a positive view of Vietnam's investment climate, appreciating the country's political stability, improving macroeconomic stability, a motivated and educated workforce, and proximity to Chinese supply chains. Nonetheless, some key issues need closer attention.

More immediately, this would require assuaging investor concerns regarding safety and security arising from the recent riots that followed the East Sea stand-off with China. Decisive measures by the Vietnamese government to prevent further rioting and help victims cope with the recent damage have been well received by the investor community. Beyond that, foreign investors' confidence hinges on preserving macroeconomic stability, and accelerating structural reform to create a level playing field for all enterprises and businesses. More efforts are also needed to strengthen market mechanisms, accelerate administrative reforms, and strengthen human-resource training. Vietnam also needs to upgrade its infrastructure services, especially in areas such as transport, ports, and power, which investors have often cited as constraints.

A widening fiscal deficit presents growing macro challenges. The deficit target of 4.8 percent of GDP was overshot by 0.5 percentage points in 2013, with a similar outcome expected in 2014, largely due to declining tax revenues. In response, the government is seeking to strengthen tax administration and broaden the tax base, and to require state-owned enterprises (SOEs) to pay dividends to the State Budget. Efforts are also afoot to rein in growth of recurrent spending and tighten controls over new capital investment projects. The proposed revisions to the State Budget Law (expected to be discussed in the National Assembly in November 2014) offer important opportunities to further strengthen fiscal management. The public debt situation remains sustainable, although susceptible to systemic shocks—such as lower GDP growth, recapitalization of banks by the government, or fiscal costs arising from accelerated SOE restructuring.

Despite high labor force participation and a low official unemployment rate, labor market trends give some cause for concern. In particular, the unemployment rate is considerably higher among skilled workers, reflecting a skills gap that is acute among applicants for jobs in technical, professional, and managerial occupations. Employers continue to report availability of skilled workers as a more severe binding constraint than labor market regulations or taxes. Moreover, in 2013, 63 percent of workers were in the informal sector, a majority of them women.

The banking sector is tenuously stable. With a focus on addressing NPLs, banks remain cautious in expanding lending despite strong growth in deposits. Authorities have successfully tackled short-run liquidity pressures, but structural reforms to address more fundamental weaknesses (related to poor asset quality, inadequate capital, and weak governance) have moved at a slow pace. The central bank's Circular 02, on loan classification and provisioning, is a step in the right direction, but its full enforcement has been delayed until April 2015.[6] The Vietnam Asset Management Company has

6 Issued in January 2013, the State Bank of Vietnam's Circular 02 sets standards for asset classification, risk provisioning, and the utilization of provisioning by domestic credit institutions and by foreign bank branches, consistent with international best practices. It implements the country's 2010 Law on Credit Institutions.

assumed a growing share of bad assets, but is yet to develop a clear strategy to resolve them. Progress is partially hampered by gaps in the existing State Bank of Vietnam regulation and the corporate restructuring framework. Although the cap for total foreign holdings remains unchanged at 30 percent (consistent with Vietnam's World Trade Organization commitments), Decree 01, issued in January 2014, now allows higher ownership in special cases subject to prime ministerial approval. The State Bank of Vietnam has targeted six to seven mergers and acquisitions in the banking sector in 2014, and a 50 percent reduction in the number of commercial banks in the next three years.

The pace of SOE reforms appears to have picked up. The recently issued Resolution 15 contains a comprehensive action plan to step up SOE divestment. Two related laws—on Management of State Capital Invested in Enterprises and on the Enterprise Law—are expected to be approved by end-2014. The government equitized 74 SOEs in 2013 (triple the number in 2011 and 2012), and the momentum continued in 2014. By the end of June 2014, about 40 enterprises were equitized, and the evaluation of enterprise values has been conducted for another 160 SOEs. A new feature of the recent equitization process is that it increasingly involves large SOEs such as Vietnam Airlines and Vietnam Textiles & Garments. Some progress has been made against Decree 71, requiring all nonbank SOEs to fully divest from five noncore risky areas by 2015. Future progress will require strengthened information disclosure, performance monitoring, and corporate governance; transparency of the divestment process; and clearer lines of accountability in SOE oversight.

Outlook and Emerging Challenges

Economic growth remains moderate and continues to come in below its potential. GDP growth, estimated at 5.4 percent in 2014, is projected not to exceed 5.5 percent before 2016. In the short run, this is linked to weakness in domestic demand. Longer-term (or trend) growth remains subdued due to a web of structural problems in SOEs and the banking sector, policy distortions that continue to thwart domestic private investment, skills shortages, and gaps in infrastructure and trade logistical services. Nonetheless, the improved global prospects bode well for Vietnam, given its close trade and investment linkages with the global economy.

The medium-term outlook presents the following potential macroeconomic risks: (a) domestic private sector demand remains sluggish and susceptible to negative news; (b) with elevated NPL ratios and balance sheet positions intertwined with the SOE sector, the banking sector remains susceptible to sudden shifts in depositor confidence and unexpected news on SOE performance or asset price movements. Restructuring and reform of the SOEs and the financial sector should help Vietnam return to a more sustainable macroeconomic environment while laying the foundation for greater efficiency and productivity to drive medium- and longer-term growth; and (c) prolonged tensions over territorial disputes present risks to the baseline growth forecast.

Vietnam: Key Indicators

	2012	2013	2014f	2015f	2016f
	Year	Year	Year	Year	Year
Output, Employment, and Prices					
Real GDP (% change yoy) [1/]	5.2	5.4	5.4	5.5	5.8
Domestic demand (% change yoy)	4.3	5.4	5.4	5.5	5.7
Industrial production index					
(% change yoy)	4.7	5.9	6.0	6.2	6.5
Unemployment (%) [2/]	3.2	3.5			
Consumer price index (% change yoy)	9.1	6.6	4.5	5.0	5.0
Public Sector					
Government revenues (% GDP)	22.7	22.9	20.3	20.1	20.1
Government expenditures (% GDP)	27.4	28.5	27.0	26.1	25.8
Government balance, general (% GDP) [3/]	-4.8	-5.6	-6.6	-6.0	-5.7
Public sector debt (% GDP) [4/]	48.5	51.6	54.7	56.9	59.1
Foreign Trade, BOP, and External Debt					
Trade balance (billions US$)	0.7	0.0	-0.2	-3.3	-7.3
Exports of goods (billions US$)	114.5	132.1	149.7	168.1	188.8
(% change yoy)	18.2	15.4	13.3	12.3	12.4
Imports of goods (billions US$)	113.8	132.1	149.9	171.4	196.2
(% change yoy)	6.6	16.1	13.5	14.3	14.5
Current account balance (billions US$)	9.3	9.5	7.8	6.8	5.3
(% GDP)	6.0	5.6	4.1	3.3	2.4
Foreign direct investment (billions US$)	8.4	8.9	9.5	10.1	11.2
External debt (billions US$)	43.6	48.5	51.7	55.2	59.4
(% GDP)	28.0	28.5	27.7	27.3	26.9
Debt service ratio (% exports of g&s)	3.7	2.8	3.1	2.8	2.8
Foreign exchange reserves, gross (billions US$) [5/]	25.4	28.5	35.7		
(months of imports of g&s)	2.7	2.4	3.1		
Financial Markets					
Domestic credit (% change yoy)	8.7	12.7	10.0	12.0	13.0
Short-term interest rate (% p.a.) [6/]	9.0	6.5	6.0		
Exchange rate (Dong/US$, eop) [7/]	20,828	21,036	21,246		
Real effective exchange rate (2000=100)	127.5	136.1			
(% change yoy)	4.1	6.7			
Stock market index (Jul. 2000=100) [8/]	414	506	625		
Memo: Nominal GDP (billions US$)	155.6	170.6	187.8	204.5	219.4

Sources: Vietnam Government Statistics Office; State Bank of Vietnam; IMF; World Bank staff estimates.
e = estimate.
f = forecast.
g&s = goods and services.
1/ The national accounts have been rebased to 2010 from 1994 by General Statistical Office.
2/ Urban areas.
3/ Includes off-budget items.
4/ Public and public guaranteed debt. Forecast by the latest Debt Sustainability Analysis 2014.
5/ Foreign exchange reserves for 2014 is as of May 30.
6/ Three-month deposit, end-of-period, is as of May 30.
7/ Central Bank's interbank exchange rate for 2014 is as of September 17.
8/ Ho Chi Minh Stock Exchange Index (VN index) for 2014 is as of September 17.

WORLD BANK **EAST ASIA AND PACIFIC ECONOMIC UPDATE** OCTOBER 2014

Enhancing Competitiveness in an Uncertain World

WORLD BANK GROUP