AMRO Annual Consultation Report

Brunei Darussalam - 2018

The ASEAN+3 Macroeconomic Research Office (AMRO)

March 2019

Acknowledgements

1. This Annual Consultation Report on Brunei Darussalam has been prepared in accordance with the functions of AMRO to monitor, assess and report to members on macroeconomic status and financial soundness and to identify the relevant risks and vulnerabilities, and assist them, if requested, in the timely formulation of policy to mitigate such risks (Article 3 (a) and (b) of AMRO Agreement).

2. This Report is drafted on the basis of AMRO's Annual Consultation Visit to Brunei Darussalam from 13-19 November 2018 (Article 5 (b) of AMRO Agreement). The AMRO Mission team was headed by Dr. Siu Fung (Matthew) Yiu, Group Head and Lead Specialist. The team members also included Mr. Muhammad Firdauz Muttaqin (Desk Economist), Ms. Siti Athirah Ali (Economist), Ms. Wanwisa Vorranikulkij (Economist), Ms. Laura Grace Gabriella (Researcher) and Ms. Le Phuong Thao (Associate). AMRO Director Dr. Chang Junhong and AMRO Chief Economist Dr. Hoe Ee Khor also participated in key policy meetings with authorities. This AMRO Annual Consultation Report on Brunei Darussalam for 2018 was peer reviewed by Dr. Seung Hyun (Luke) Hong (Group Head and Lead Economist) and Dr. Abdurohman (Specialist); and approved by Dr. Hoe Ee Khor.

3. The analysis in this Report is based on information available up to 31 January 2019.

4. By making any designation of or reference to a particular territory or geographical area, or by using the term "member" or "country" in this Report, AMRO does not intend to make any judgements as to the legal or other status of any territory or area.

5. No part of this material may be disclosed unless so approved under the AMRO Agreement.

6. On behalf of AMRO, the Mission team wishes to thank the Brunei Darussalam authorities for their comments on this Report, as well as their excellent meeting arrangements and hospitality during our visit.

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Executive Summary

1. **After recording a strong rebound in 2017 following four consecutive years of contractions since 2013, Brunei's economic recovery lost momentum in the first three quarters of 2018.** In 2017, the economy saw positive growth, mainly driven by a gradual recovery in LNG production. However, the decline in oil and LNG production in the first three quarters of 2018, despite the rising trend in global oil and gas prices in that period, resulted in a slowdown in growth. The economic slowdown was also attributable to a contraction in the financial sector. With lower oil and LNG production, GDP growth is expected to decline in 2018 before picking up in 2019, led by stronger FDI inflows and the commencement of production in downstream petroleum industries.

2. **Consumer price inflation has returned to positive territory since the beginning of 2018.** The rise in inflation in 2018 was mainly driven by supply side factors partly because of the increase of excise tax on food and beverage. Inflation is anticipated to increase further in 2019, led by an expected strengthening of domestic demand.

3. **On the external side, the current account surplus is expected to narrow slightly in 2018 and rebound to a higher level in 2019.** The current account surplus widened in 2017, on account of an increase in oil and LNG exports, boosted by higher LNG production and crude oil and LNG prices. However, the current account surplus is expected to narrow slightly in 2018, reflecting lower oil and LNG exports and a large increase in the imports of capital goods. From 2019 onwards, the current account is expected to improve.

4. **The banking sector remains sound and well capitalized.** Banks continue to be well-capitalized and their risk exposure is relatively well-managed. The capital adequacy ratio (regulatory capital to risk-weighted assets) is well above the 10 percent minimum requirement. However, the growth of non-performing loans (NPL) rose in 2018 due to the still weak overall economic conditions.

5. **The government budget improved in fiscal year 2017/18 but remained in substantial deficit.** The budget deficit has improved due to a significant increase in oil and gas revenue, as well as the continuing prudence in total fiscal spending. The FY2018/19 budget targets a smaller deficit and, based on the realization in the first half of the fiscal year, AMRO staff project an even smaller deficit.

6. **The major risks are mainly from domestic factors as a result of the high reliance on the oil and gas sector.** Brunei's government has enhanced its efforts to develop other industries besides oil and gas, and the economy has made significant progress as reflected in the big improvement in its ranking in World Bank's Doing Business Report and higher FDI inflows. However, the oil and gas sector is still dominant in Brunei's GDP growth, exports and fiscal revenue. Amid the price recovery since 2016, an unexpectedly large shortfall in oil and LNG production in the first three quarters of 2018 has affected economic growth. It will potentially hamper the government's ability to support the economy.

7. **A delay in the ongoing structural reforms and economic diversification will diminish the long-term prospects of the economy.** With the maturing of the oil and gas fields, it is important that momentum is maintained in pursuing structural reforms that aim at diversifying the economy into new industries and away from high reliance on the oil and gas sector in the medium-term.

8. **The banking sector remains sound with excess liquidity and rising NPL ratio, possibly leading to potential vulnerabilities in the medium-term.** Banks channels their excess liquidity in interbank market and their network abroad with minimal foreign currency risk exposure and low counterparty risks. In addition, the rising NPL ratios in the recent quarters suggest that the banking sector is also facing a higher credit risk. Although, some measures have been introduced by the authorities to counteract such risks, these could affect banks' profitability in the medium term and need close monitoring.

9. **On the external side, the major risk mainly stems from the possibility of a sharp decline in global oil and gas prices, while other external risks are expected to have a smaller impact on the economy.** Brunei has a relatively low engagement in global value chains (GVCs), so it is less susceptible to spillovers from global trade tensions. However, with the growth in manufacturing and other industries, Brunei's participation in GVCs will increase over time**.**

10. **Regarding structural policy, the government should continue to accelerate economic reforms in order to enhance economic diversification.** The economy is still heavily reliant on oil and LNG production, while the non-oil and gas sector's role is relatively small. Given the natural declining trend in oil and gas production in the maturing fields, it is critical to diversify the growth drivers of the economy in the medium to long term into manufacturing, tourism and other non-traditional industries in order to enhance the growth potential of the economy.

11. **On fiscal policy, efforts to diversify revenue sources and enhance the efficiency and effectiveness of fiscal spending should be continued.** The uncertainty of oil and gas revenue, particularly considering the maturing oil and gas fields, reinforces the need to broaden fiscal reforms in order to diversify revenue sources away from oil and gas. To strengthen the fiscal position, the government should continue to reprioritize expenditure and further enhance budget efficiency. Moreover, given the current low inflation environment, the authorities should take this opportunity to reform subsidies and make them more targeted, particularly the energy subsidy.

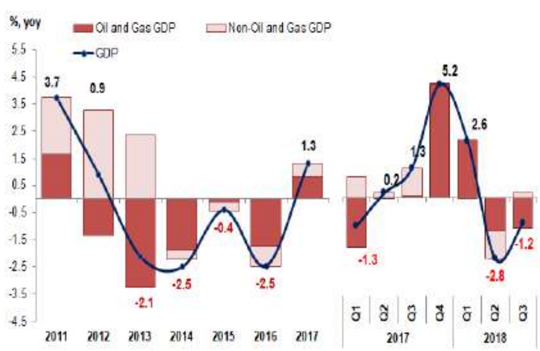
12. **The financial sector can be made more inclusive and diversified by developing new products to improve the private sector's access to financing.** Although the financial sector remains sound and stable, it is still narrowly based on the banking sector. The monetary authority should continue to take measures to improve the private sector's access to finance by establishing new institutions, encouraging the development of various financial products, and improving financial literacy.

A. Recent Developments and Outlook

A.1. Real Sector Developments and Outlook

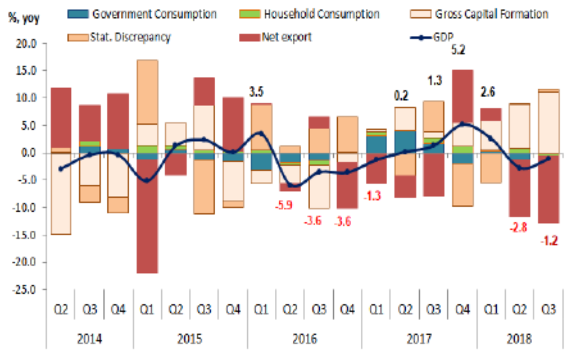
1. **After recording four consecutive years of contraction since 2013, Brunei's economy recorded positive growth in 2017.** The economy started to recover in Q2 2017 and grew strongly by 5.2 percent yoy in Q4 2017 for an overall growth of 1.3 percent in 2017 (Figure 1). This improvement was mainly driven by the gradual recovery in LNG production and the expansion of the construction sector. On average, LNG production improved from 923,739 Million British Thermal Units (MMBtu) per day in 2016 to 975,272 MMBtu per day in 2017[1]. On the expenditure side, GDP growth in 2017 was mainly driven by an increase in gross private investments as implementation progress of infrastructure and FDI projects picked up (Figure 2). In Q4 2017, economic growth was also supported by an improvement in net exports, which was in line with the increase in LNG production.

Figure 1. GDP Growth



Source: DEPD; AMRO staff calculations

Figure 2. GDP Growth by Expenditure



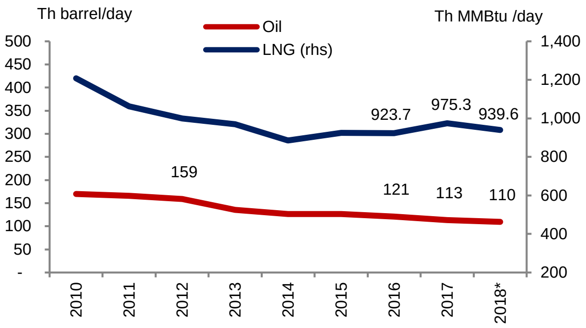
Source: DEPD; AMRO staff calculations

2. **Brunei's economic growth was sluggish in the first three quarters of 2018 and is expected to decline for the whole of 2018, but is expected to pick up in 2019.** Real GDP growth slowed to 2.6 percent in Q1 2018 and contracted by 2.8 percent and 1.2 percent in Q2 and Q3 2018 respectively, which resulted in GDP growth of -0.4 percent for the first three quarters of the year. Despite higher oil and LNG prices, the average oil and LNG production in the first three quarters of the year decreased by 1.9 percent to 110,000 bpd and 1.7 percent to 939.600 MMBtu respectively, compare to the same period last year (Figure 3). The low economic growth was also partly caused by a contraction in the financial sector (Figure 4), explained by a decline in investment income and loss in foreign currencies' revaluation in the banking industry. On the expenditure side, the decrease in oil and LNG production resulted in negative net export growth in Q2 and Q3 2018. However, capital expenditure by the private sector continued to grow significantly reflecting mainly the construction of the Hengyi Refinery project and Brunei Fertilizer project. With the assumption that the oil and LNG production in the fourth quarter is similar to that in the same period of last year, GDP growth is expected to decelerate to -0.5 percent in 2018 before picking up to 2.1 percent in 2019, led by stronger

[1] The LNG production in 2017 was equivalent with 245.000 barrel of oil equivalent per day (boepd), which increases from 238.000 boepd in 2016, while average oil production declined from 121,000 bpd in 2016 to 113.200 bpd in 2017.

FDI inflows and the commencement of Hengyi's refinery operations. However, there is a downside risk in the growth forecast because oil and LNG production is still susceptible to sudden disruptions.

Figure 3. Oil and LNG Production



Note: *) up to Q3 2018
Source: DEPD; AMRO staff calculations

Figure 4. Non-Oil and Gas Sector

Source: DEPD; AMRO staff calculations

3. **The government's efforts to diversify the economy away from the oil and gas sector are gaining traction, and that has improved the longer term outlook for the economy.** With maturing oil and gas fields, the government has stepped up efforts to develop other industries to provide alternative growth engines to the economy. In particular, it has made efforts to improve the business environment and attract FDI into manufacturing and services (See Box A. Economic Diversification from the Upstream Oil and Gas Industry). These efforts have paid off with FDI projects such as Hengyi Industries' investment of USD3.4 billion in the construction of an integrated oil refinery that is projected to start its operations in the second half of 2019. Another major project is Brunei Fertilizer Industries, a USD1.3 billion investment project that is currently under construction and is expected to commence ammonia and urea production in 2021. The completion of the Temburong Bridge will shorten the travel time from the capital city of Brunei (Bandar Seri Begawan) to Temburong district[2], an underdeveloped area across the bay, significantly, from 1.5 hours to 20 minutes. Furthermore, Brunei has improved in World Bank's Doing Business ranking for the fourth consecutive year, jumping from the 105th position in 2015 to the 55th in 2019, fourth among ASEAN countries after Singapore, Malaysia and Thailand (See Selected Issue on Developing Businesses in Brunei Darussalam: a Brief Assessment of Brunei's Reforms to Improve SMEs' Access to Credit).

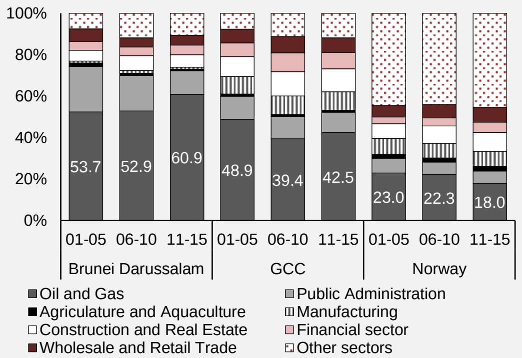
[2] At present, commuters traveling from Brunei Muara to Temburong district have to pass through Limbang (Malaysian territory) and four immigration checkpoints, which are frequently congested

Box A. Economic Diversification from the Upstream Oil and Gas Industry[3]

Brunei's economy has relied heavily on the upstream oil and gas industry. As with the Gulf Cooperation Council (GCC) countries and Norway, Brunei's economy is mainly driven by the production of crude oil and liquefied natural gas (LNG), which accounts for more than 50 percent of GDP (Figure A1). The oil and gas industry also contributes more than 90 percent of total exports and more than 70 percent of government revenue. However, Brunei's oil and LNG production activities are still concentrated in upstream activities[4], with expected increase in contribution from downstream activities once the refinery in PMB becomes operational late 2019. Relative to other oil-rich economies, the GDP contribution of the oil and gas industry in Brunei has been stable at a high level over the past two decades.

Given its less-diversified structure, Brunei's economy is sensitive to oil production disruptions and fluctuations in global oil prices. Given its maturing oil fields, oil production in Brunei has occasionally encountered unplanned disruptions and delayed maintenance. Because of its high reliance on the sector, economic growth is more volatile compared to other regional economies that are more diversified across the agriculture, manufacturing and services sectors (Figure A2). Non-oil and gas sectors in Brunei are less capable of shoring up growth when the hydrocarbon business is disrupted. This vulnerability that stems from low diversification will be more pronounced with declining oil production and depleted oil and gas reserves. According to the U.S. Energy Information Administration, Brunei's oil reserves declined to 1.1 billion barrels in 2015 from 1.8 billion barrels in 1980. Due to maturing fields and the recent episode of plummeting global energy prices, the Brunei economy went into recession from 2013-2016.

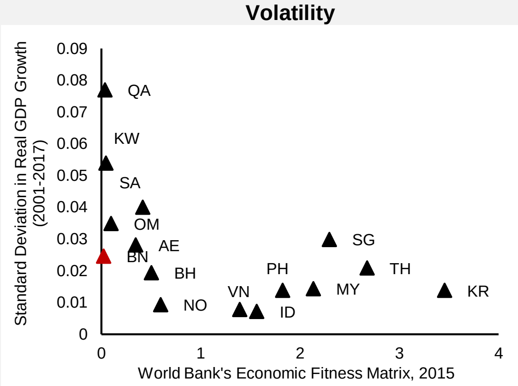
Figure A1. Economic Structure of Oil-rich Countries



Note: GCC numbers are an average for Bahrain, Kuwait, Oman, Qatar, Saudi Arabia and United Arab Emirates

Source: National authorities; AMRO staff calculations

Figure A2. Economic Diversification and Growth Volatility

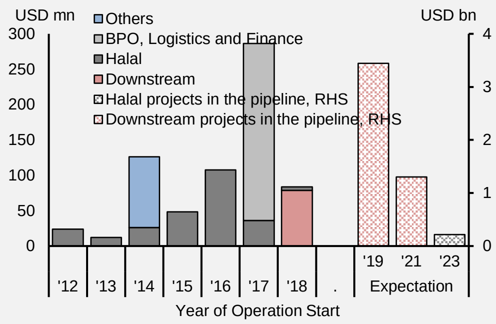


Note: 1/ Economic Fitness (EF) is both a measure of a country's diversification and ability to produce complex goods on a globally competitive basis. Countries with the highest levels of EF have the capability to produce a diverse portfolio of products, ability to upgrade into ever-increasing complex goods, tend to have more predictable long-term growth, and to attain good competitive positions relative to other countries. 2/ GDP growth in 2009-2010 were excluded to avoid noise caused by the Global Financial Crisis.
Source: The World Bank; Department of Economic Planning and Development; AMRO staff calculations

In order to pursue more sustainable growth, the Brunei government has stepped up efforts since 2006 to diversify the economy. Although economic diversification was first highlighted in the Seventh National Development Plan (1996-2000), this was pushed further in 2006 after the commencement of Wawasan Brunei 2035[5]. The economic strategy formulated in the Wawasan Brunei 2035 aims to promote local employment and business opportunities in non-traditional industries. Five priority investment clusters were accordingly designated as new sources for growth, namely Food (Processed, Aquaculture and Poultry), Finance, Information Communication Technology (ICT), and Tourism as well as Downstream Oil & Gas.

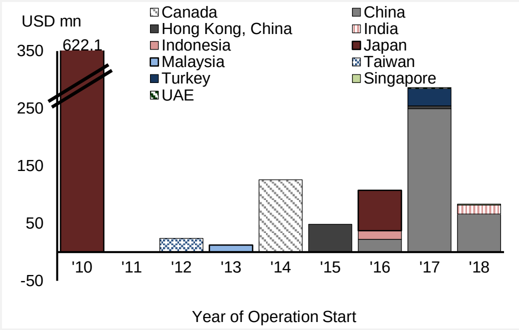
As in other oil-rich countries, FDI is expected to help broaden growth in the early stages of diversification. The role of the Brunei Economic Development Board was expanded in 2012, and the FDI Action and Support Center (FAST) was established in November 2015 to facilitate FDI in setting up their facilities in Brunei Darussalam. To add more value, FAST also works closely with other relevant agencies to ensure FDI companies meet their export requirements and provide support on their export activities. Moreover, the government has made efforts to improve the investment environment, reflected by the country's improvement in the World Bank's Doing Business ranking in 2018 (Selected Issue on Developing Businesses in Brunei Darussalam). Given the small domestic market, foreign investors are encouraged to help Brunei in growing its export markets. This initiative will not only increase Brunei's production capacity, it will also deepen the integration of the Brunei economy with the global value chains in the region. As a result of the government's efforts, the amount of FDI has trended upward since 2014 of which most projects are in halal and petrochemical industries which Brunei is specialized in. The top investors are from Japan and China (Figure A3 and A4). The Hengyi refinery project (Phase I) as well as the ammonia and urea fertilizer plant [6] are the most sizable with the investment equivalent to 31.7 percent and 11.4 percent of GDP in 2017 respectively.

Figure A3. The Size of FDI Projects That Started or Will Start Its Operation by Year



Note: Total investment of each project was used to represent the size.
Source: FAST; AMRO staff calculations

Figure A4. The Size of FDI Projects Classified by Country of Origin



Note: Total investment of each project was used to represent the size.
Source: FAST; AMRO staff calculations

Fostering the growth of local private firms is another policy to transition the economy from its traditional sectors. The public sector is a dominant growth driver in Brunei. Besides providing public services, the government was also a key player in many sectors in the past through direct ownership of businesses[7] via government-linked companies (GLCs). However, following the establishment of Darussalam Assets[8] in 2012, the government's direct influence in the businesses hitherto directly owned by Government has declined. Darussalam Assets was set up with the following aims: (i) consolidating the oversight of the GLCs away from the line ministries, leaving the ministries to regulatory roles; (ii) owning and actively managing GLCs on a commercial basis in accordance with good corporate governance principles and with a view to promoting measurable performance improvement; (iii) improving GLCs' administration to meet international standards; (iv) spurring development in non-hydrocarbon sectors; (v) reducing their reliance on the government; and (vi) paving the way for possible privatization of infrastructure projects, government agencies and services in the future. In addition to the reforms at the corporate level, the government also set up Darussalam Enterprise in 2016 to promote local entrepreneurship for SMEs. The administrative procedures for businesses have been streamlined, while capacity-building programs were provided for local start-

[3] Prepared by Wanwisa Vorranikulkij (Economist)

[4] The upstream industry finds and produces crude oil and natural gas, sometimes known as the exploration and production sector. The midstream industry focuses on processing, storing and transporting commodities. Meanwhile, the downstream industry includes oil refineries, petrochemical plants, petroleum products distributors, retail outlets and natural gas distribution companies. (Source: The Petroleum Services Association of Canada)

[5] Wawasan Brunei 2035 is a long-term development plan. It aims at having well-educated and highly-skilled people, improving Bruneians' quality of life, and enabling Brunei to be a dynamic and sustainable economy with per capita income among the top countries in the world. The plan consists of eight socioeconomic development strategies, namely education, economic, security, institutional development, local business development, infrastructure, natural environment and cultural habitat. The action plans for Wawasan Brunei 2035 were included in the Ninth National Development Plan (2007-2012), while the following national development plans were formulated to align with the long-term goals of Wawasan Brunei 2035.

[6] *Hengyi Industries SdnBhd* is a joint venture between the Brunei government and Zhejiang Hengyi Group. *Brunei Fertilizer Industries* is a joint venture between Brunei Fertilizer Industries Sdn Bhd and ThyssenKrupp Industrial Solutions AG.

[7] Consisting of aviation, telecommunications, power utilities, logistics, agribusiness, food and beverage, leisure and tourism, medical, education, hospitality, and real estate.

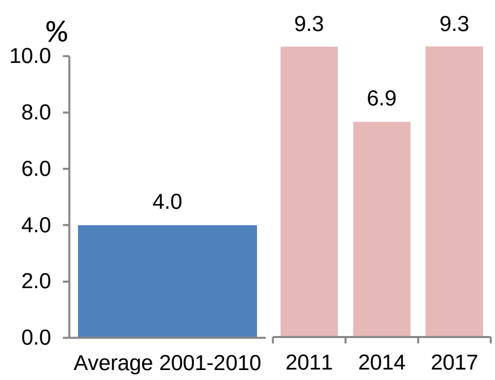
[8] Darussalam Assets SdnBhd is a private limited company that owns Brunei's GLCs. It is wholly-owned by the Ministry of Finance Corporation

ups. Bank Usahawan was also set up to provide financing and business consultancy services to SMEs which have limited access to bank financing.

Physical infrastructure and logistics networks have been upgraded as well. The conditions and operations of the Muara Port[9] were upgraded in 2017. Moreover, the transportation network have been expanded with the aim of facilitating commute in the country and promoting tourism. The Temburong Bridge is under construction to provide access between the main part of Brunei Muara and Temburong districts. Royal Brunei Airlines has also recently increased the number of routes between Brunei and other regional economies such as China, Japan and Taiwan.

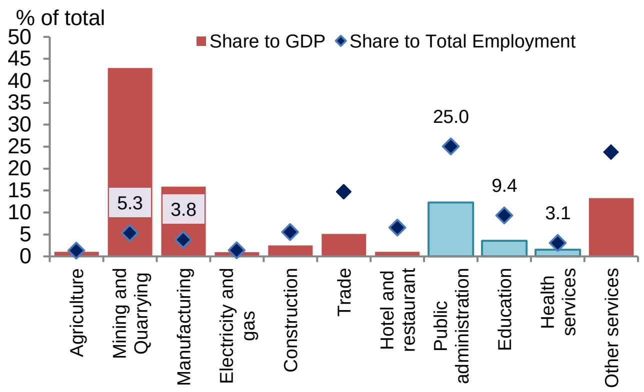
4. **As a result of the relatively weak economic activities, the unemployment rate increased in recent years.** The unemployment rate in Brunei increased from 6.9 percent in 2014 to 9.3 percent in 2017[10] (Figure 5). Based on the latest survey in 2017, the increase of unemployment rate was driven by the rise in the number of total unemployment from 14,078 person in 2014 to 19,199 person in 2017. Although the private sector created about 12,000 jobs in the period, it was not sufficient to offset the increase in working age population and the reduction of public sector recruitment. Moreover, according to the survey, the unemployment rate among the youth (aged between 15 and 24 years) increased from 25.3 percent in 2014 to 28.9 percent in 2017, accounted for about 44.2 percent of the total unemployment in the latest survey. The high unemployment rate is partly a result of structural issues such as a skills mismatch and a strong preference to work in the government, at GLCs or oil and gas companies (Figure 6).

Figure 5. Unemployment Rate



Notes: The latest available unemployment data is based on the 2017 Labour Force Survey.
Source: DEPD: AMRO staff calculations

Figure 6. Employment by Sector



Source: DEPD; AMRO staff calculations

5. **The authorities have continued to take various measures to tackle the structural challenges in the labor market.** To address manpower planning at a national level, the government has established the Manpower Planning Council (MPC) in April 2016, with the objective to formulate policies to ensure sufficient skilled labor is supplied to match demand in the labor market. The working secretariat of the MPC is the Manpower Policy and Planning

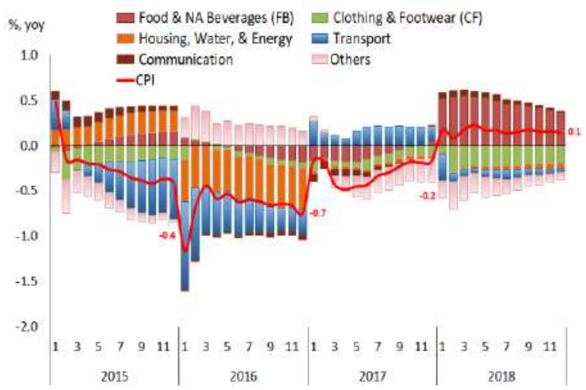
[9] As a part of the port upgrade, the port operations were transferred from the government authorities to Muara Port Company SdnBhd. which is a joint venture between Guangxi Beibu Gulf Port Group and Darussalam Assets.
[10] The latest available data on unemployment is based on the Labour Force Survey (LFS) data in 2017 which include both local and foreigner.

Unit (MPPU). Since early 2017, the MPPU has introduced a few initiatives such as the i-Ready Apprenticeship Program[11], setting up of the JobCentre Brunei (JCB)[12] and also the 11th HRD National Development Fund. Additionally, in order to address skills mismatch, the MPPU, in collaboration with the Ministry of Education and relevant industries, is also working to improve the education curriculum and provide job training programs to address the needs of the private sector. This is done via the setting up of the Industry Steering Committee (ISC) of which one of its objectives is to improve employability of local jobseekers by equipping them with education and skills which suits the industries' needs.

A.2. Inflation

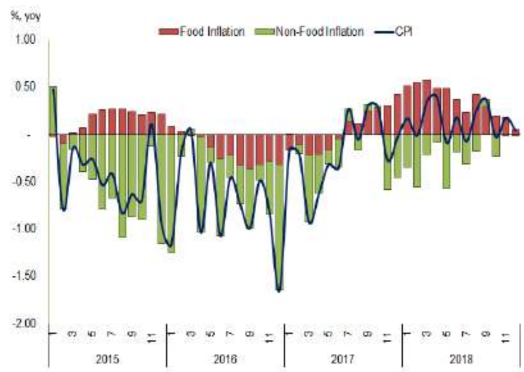
6. **The consumer price inflation returned to positive territory in 2018, mainly driven by rising food prices.** On average, CPI inflation rose from -0.7 percent in 2016 and -0.2 percent in 2017 to 0.1 percent in 2018 (Figure 7). The rise in inflation in 2018 was mainly driven by supply side factors especially in food prices since July 2017 (Figure 8). This is in line with changes in customs and excise duties on several food products such as beverages with high sugar and monosodium glutamate levels, in April 2017. Inflation is expected to increase further at around 0.4 percent in 2019 in line with the expected strengthening of domestic demand.

Figure 7. Average Inflation Rate (ytd)



Source: DEPD; AMRO staff calculations

Figure 8. Food and Non-Food Inflation (yoy)



Source: DEPD; AMRO staff calculations

A.3. External Sector

7. **The trade balance surplus is expected to narrow slightly reflecting a sharp increase in imports of capital goods for infrastructure and FDI projects.** The trade surplus

[11] The i-Ready Apprenticeship Program is a three-year program aimed to equip graduates (bachelor degree and above) with work experience in their respective industries both in the private and public sector. The program's objective is to increase graduates' employability and marketability in the job market. The i-Ready apprenticeship program is also an avenue to re-skill graduates to become new professionals outside their field of education, whereby 18% of the active apprentices are currently undergoing re-skilling on the job. There are two requirements for companies wanting to join The i-Ready program; (i) to disburse minimum salary at certain amounts a month for employees participating in the program; and (ii) to offer permanent a position after an employee finishes the 18-month training program.

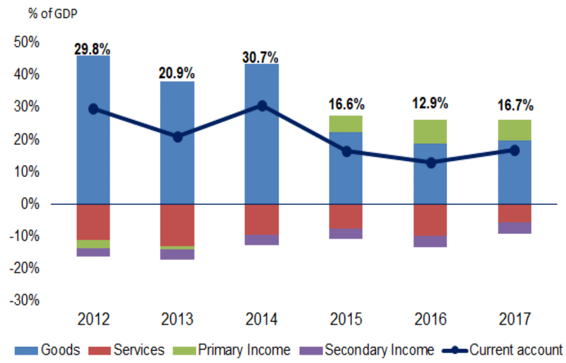
[12] JobCentre Brunei was established on 11 January 2017, whereby it aims to be a one stop career centre and acts as a bridge between employers and local jobseekers. It is a center that provide services to multi-stakeholders including companies in their efforts to recruit locals, local communities such NGOs and local jobseekers towards increasing their employability and marketability in the job market. JCB also conducts outreach programs to ensure its services reaches to multiple stakeholders including districts, villages, higher education institutions and the general public. In 2017, JCB have achieved 2,494 local recruitment and in 2018, it has achieved 2,764 local recruitment.

increased in Q4 2017 as exports rebounded sharply by 36.2 percent on the back of large increases in LNG exports and oil and LNG prices (Figure 9). In Q2 2018, the trade surplus narrowed significantly when unexpected maintenance activities in the oil fields resulted in a decline in oil and LNG exports. However, the trade balance is expected to have improved slightly in the rest of the year with a moderate recovery in oil and LNG exports. Import growth continued to increase in Q2 2018, and was expected to maintain its pace in the second half of the year with the ongoing progress of several infrastructure and FDI construction projects. For the whole of 2018, the trade surplus is estimated to be slightly smaller than in 2017 as import growth exceeded export growth.

Figure 9. The Trade Balance

Source: DEPD; AMRO staff calculations

Figure 10. Current Account Balance



Source: DEPD; AMRO staff calculations

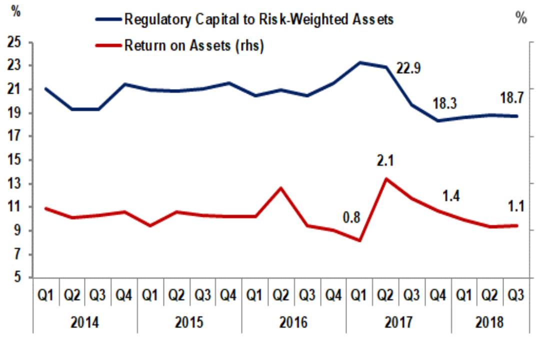
8. **On the back of a smaller trade surplus, the current account surplus is expected to narrow in 2018, but will rebound to a somewhat higher level in 2019.** The current account surplus, which reached its lowest level at 12.9 percent of GDP in 2016, improved to around 16.7 percent of GDP in 2017, in line with the increase in trade surplus (Figure 10). As a consequence of the expected decline in oil and LNG production in the whole year as well as rising imports, the current account surplus is projected to be smaller in 2018. From 2019 onwards, it will strengthen further as capital goods imports are expected to decline with the starting of Phase I operations of the Hengyi project. In addition, the Hengyi refinery project is also expected to start exporting products in the second half of 2019. Overall, the external position remains strong with ample official reserves and foreign assets.

A.4. Financial Sector

9. **The banking sector remains sound.** Banks continue to be well-capitalized and their risk exposure is relatively well-managed. The capital adequacy ratio (CAR) declined from 22.9 percent in Q3 2017 to 18.7 percent of risk-weighted assets as of Q3 2018 (Figure 11). The decline in the CAR was mainly due to the capital reduction by one major bank, which reduced its Tier 1 capital. Despite this drop, the CAR remained well above the minimum regulatory requirement of 10 percent. Gross non-performing loans (NPL) ratio, which was trending down, increased from 4.4 percent in Q4 2017 to 5.8 percent in Q3 2018 (Figure 12), while the net NPL ratio increased from 1.6 percent to 3.0 percent over the same period. The increase in the NPL ratio was mainly driven by rising NPL in residential housing sector, which rose from 4.0

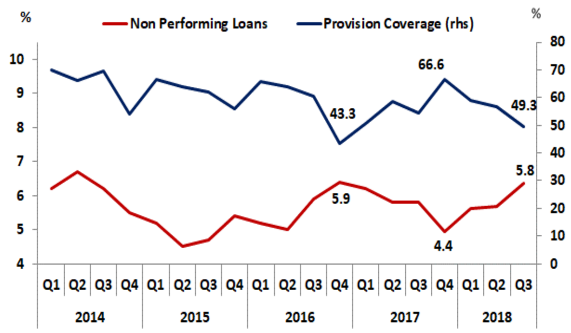
percent in Q4 2017 to 5.5 percent in Q2 2018 due to the still weak overall economic conditions. As part of the credit risk management, banks tend to restructure or write-off their NPLs, supported by sufficient provisioning which shows an increase since Q1 2017. The fragile economic recovery also resulted in a decrease of profitability in the banking sector as reflected in the decline in Return on Assets (ROA) ratio from 1.4 percent in Q4 2017 to 1.1 percent in Q3 2018.

Figure 11. Capital Adequacy Ratio and Return on Assets



Source: AMBD; AMRO staff calculations

Figure 12. Non-performing Loans Ratio and Provision Coverage



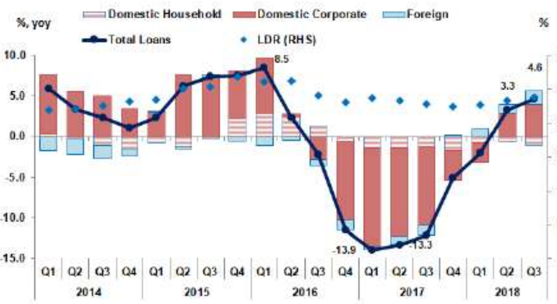
Source: AMBD; AMRO staff calculations

10. **Since the second quarter of 2018, bank loan growth has turned positive but remained moderate.** The 3.3 percent loan growth in Q2 2018 and 4.6 percent in Q3 2018 were mainly contributed by corporate loans (Figure 13), which recorded a 7.1 percent and 9.8 percent increase respectively (Figure 14), while the growth of household loans was still negative. There is reason for banks to be more cautious in extending loans to the household sector given the higher NPLs in that sector. However, to encourage more borrowing while maintaining the quality of loan, the Monetary Authority of Brunei Darussalam (AMBD) has raised the total debt service ratio (TDSR)[13] limit from 60 percent to 70 percent in August 2017 for residential property financing given the low riskiness of this subsector and the regulatory framework in place, and implemented the national credit scoring system in April 2018, known as Bureau Credit Score.[14] The implementation of the Bureau Credit Score and the establishment of Bank Usahawan are aimed at facilitating easier access to credit for both individuals and businesses, particularly for micro, small and medium enterprises (MSMEs).

[13] The TDSR measures the monthly total debt obligation as a proportion of monthly income. The policy was introduced in June 2015, where the maximum TDSR set at 60 percent for borrowers with minimum monthly income above BND1,750. Borrowers with monthly income below BND1,750 are subjected to financial institutions' internal policies. AMBD increased the TDSR to a maximum of 70 percent in August 2017 and allowed bank flexibility to exceed the TDSR limit for certain credit facilities in November 2017. In addition, the TDSR for individual with net monthly income of BND10,000 and above will be subject to the banks' and finance companies' internal credit policies.

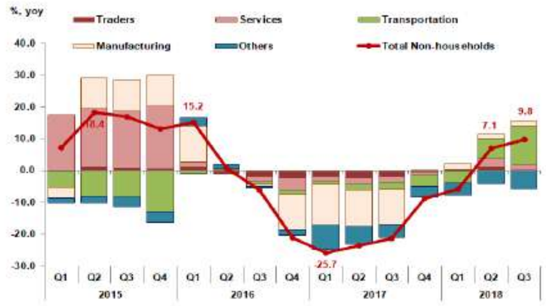
[14] A Bureau Credit Score is a numerical expression which range between 215 and 570 to represent the probability that a borrower has low (a debtor with high credit score) or high (a debtor with low credit score) credit risk. The calculation of the Bureau Credit Score is primarily derived from an analysis of the borrower's historical credit performance, which consist of five factors, such as (i) length of credit history, (ii) amount owed (measures the percentage of total available credit facility being used), (iii) payment history, (iv) number of new credit, and (v) types of credit in use.

Figure 13. Bank Loan Growth



Source: AMBD; AMRO staff calculations

Figure 14. Corporate Loan Growth



Source: AMBD; AMRO staff calculations

11. **AMBD continues to enhance the regulatory framework to maintain financial stability and to ensure the implementation of international standards in Brunei's financial system.** These include corporate governance requirements for banks, insurance companies and takaful operators. Currently, the AMBD has implemented the Basel II Pillar I Capital Adequacy framework and will be implementing Pillar II by Q4 2018. In order to mitigate higher credit risk, the AMBD has issued the Notice on Classification of Impaired Credit/Financing and Financial Asset for Provision purposes, which set up the minimum level of provisioning required for banks and financial institutions. The AMBD has also issued a consultation notice on Prudential Treatment of Problem Assets and Accounting for Expected Credit Losses on 20th July 2018 to integrate with key features of IFRS 9 in the regulatory definitions of non-performing, forborne and classified exposure. This measure is aimed at getting an earlier identification of NPLs, the timely execution of remedial measures, and recognition of appropriate level of loss allowances. In January 2018, AMBD also issued Guidelines on Credit Risk Management, Internal Audit Function, Compliance and Compliance Function, and Internal Control Systems.

A.5. Fiscal Sector

12. **Despite some improvements, the government budget remains in substantial deficit.** The budget deficit improved from 16.6 percent of GDP in FY2016/17 to 12.7 percent of GDP in FY2017/18, due to a significant increase in oil and gas revenue, as well as the continuing restraint in total fiscal spending (Table 1 and Figure 15). The FY2018/19 budget targets a smaller deficit at around 9.0 percent of GDP[15]. In this fiscal year, the government places emphasis on 5 policy focuses[16] in order to promote economic growth while maintaining fiscal sustainability. These policy focuses are in line with the government efforts to diversify revenue sources and enhance the efficiency and effectiveness of fiscal spending (See Box B

[15] The GDP is based on AMRO staff estimates.

[16] The 5 policy focuses can be elaborated as: (i) **prudent spending**, government institutions are required to ensure their expenditures are implemented efficiently, cost effectively and value for money, (ii) **job creation opportunity**, the government continued a graduate apprenticeship scheme such as I-Ready program to provide job exposure and experience to unemployed graduates, (iii) **enhance nation's productivity through innovation**, that emphasizes on the use of technology and innovative technology, such as e-Invoice portal to collect tax and One Common Billing System, (iv) **trade activities easing**, the government through The FDI Action Support Centre (FAST) facilitates some FDI projects to activate their operation, creates job opportunity to locals, and set up institution to provide financing to SME, and (v) **sustaining the national welfare**, by providing allowances for disabled citizen and permanent residents aged below 15.

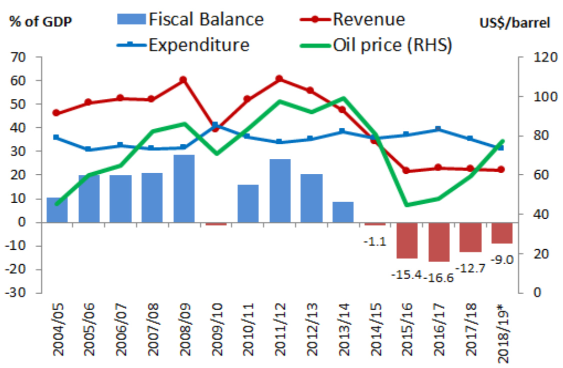
Fiscal Policy to Maintain Fiscal Consolidation while Supporting Economic Growth). Based on the budget realization in the first half of the fiscal year, AMRO projects an even smaller deficit of 7.5 percent of GDP in FY2018/19 due to higher than budgeted oil and LNG prices.

Table 1. Fiscal Development

Items	Nominal Value (BND millions)			
	2016/17	2017/18[B]	2017/18	2018/19[B]
Total Government Revenue	**3,616**	**3,451**	**3,830**	**3,761**
Oil and Gas Revenue	2,584	2,510	2,976	2,840
Non-oil and gas Rrevenue	1,032	938	855	922
Taxes	346	479	309	427
Fees, Charges, Rent, and Others	417	429	321	390
Total Expenditure	**6,252**	**5,300**	**5,997**	**5,300**
Current Expenditure	*4,965*	*4,300*	*5,117*	*4,400*
Charged Expenditure	1,101	700	1,104	700
Personal Emoluments	1,978	1,925	1,856	1,995
Other Charges Annually Recurrent	1,887	1,675	2,156	1,705
Capital Expenditure	*1,287*	*1,000*	*880*	*900*
Budget Deficit/Surplus	**-2,636**	**-1,849**	**-2,166**	**-1,539**
Budget Deficit/Surplus (% to GDP)	-16.6	-10.8	-12.7	-9.0

Notes: *) Budget data
Source: MOFE; AMRO staff calculations

Figure 15. Oil Price and Fiscal Position



Notes: *) Budget Data
Source: MOFE; AMRO staff calculations

13. **On the revenue side, oil and gas-related revenues increased in the last fiscal year on account of higher oil prices.** With the recovery of oil prices in FY2017/18, oil and gas revenue increased by 15.2 percent, or from BND2.6 billion in the previous fiscal year to BND3.0 billion. For FY2018/19, the government budgeted a lower oil and gas revenue than the actual outturn in the previous year. However, according to latest data, the government has already achieved 85.9 percent of its budgeted revenue in the first two quarters (Table 2). This was explained by higher-than-budgeted oil and LNG prices in that period. Based on these developments, AMRO projects total revenue to be higher by 17.6 percent in FY2018/19 compared to last year.

Table 2. Fiscal Budget and Realization

Items	2017/18					2018/19		
	Budget	Realization Q1 & Q2	% of Budget	Realization Total	% of Budget	Budget	Realization Q1 & Q2	% of Budget
Total Government Revenue	**3,451**	**1,676**	**48.6%**	**3,830**	**111.0%**	**3,761**	**2,798**	**74.4%**
Oil and Gas Revenue	2,510	1,301	51.8%	2,976	118.6%	2,840	2,440	85.9%
Non-Oil and Gas Revenue	941	375	39.8%	855	90.8%	922	358	38.8%
- Tax	479	150	31.3%	309	64.5%	427	157	36.7%
- Fee Charges and Rent	429	166	38.7%	321	74.9%	390	160	41.0%
- Others	33	59	179.3%	224	678.4%	104	41	39.4%
Total Expenditure	**5,300**	**2,822**	**53.3%**	**5,997**	**113.1%**	**5,300**	**2,564**	**48.4%**
Current Expenditure	4,300	2,378	55.3%	5,117	119.0%	4,400	2,331	53.0%
- Charged Expenditure	700	526	75.1%	1,104	157.8%	700	591	84.4%
- Personal Emoluments	1,925	860	44.7%	1,856	96.4%	1,995	906	45.4%
- Other Charges Annually Recurrent (OCAR)	1,675	993	59.3%	2,156	128.7%	1,705	833	48.9%
Capital Expenditure	1,000	444	44.4%	880	88.0%	900	233	25.9%
Budget Deficit/Surplus	**(1,849)**	**(1,146)**		**(2,166)**		**(1,539)**	**234**	

Source: MOFE; AMRO staff calculations

14. **On the expenditure side, the government is still facing challenges in its efforts to improve spending efficiency**. In order to narrow the fiscal deficit, the government attempted to cut total expenditure by 15.2 percent in the budget of FY2017/18. However, it

was only able to cut expenditure by 4.1 percent, mostly from the capital spending, while current spending was higher than its budgeted value. While capital spending was significantly reduced by 31.6 percent to BND0.9 billion from BND1.3 billion in FY2016/17, current spending was increased by 3.1 percent from the previous fiscal year, above its budgeted value by 19 percent. The government, however, succeeded in cutting its wage bill by reducing personal emolument expenditures. The efforts to enhance spending efficiency need to be strengthened. The charged expenditure[17] and other charges annually recurrent (OCAR)[18] in FY2017/18 were much higher than the budgeted values by around 58 percent and 29 percent respectively. In FY2018/19, the government has budgeted further cuts in its spending by 11.3 percent compared to its actual outturn in the last fiscal year. To improve efficiency and to mitigate fiscal pressures, the government has adopted a Program and Performance Budgeting (PPB) system[19] and initiated government organizational restructuring since FY2016/17. In the last two years, there has also been a civil service reform, which is an exercise in rationalizing resources by removing job positions that have been vacant for a long time and also reducing certain support-level positions.

Box B. Fiscal Policy to Maintain Fiscal Consolidation while Supporting Economic Growth[20]

The Brunei authorities have continued their efforts to strengthen the fiscal position. Starting with a deficit of 2.7 percent of GDP in FY2014/15, the budget deficit widened sharply to 15.4 percent of GDP in FY2015/16 and further to 16.6 percent of GDP in FY2016/17, in line with declining oil and gas revenues. In response to this, the government has taken efforts to diversify revenue sources and to enhance the efficiency and effectiveness of fiscal spending through the Program and Performance Budgeting (PPB) system, which was implemented in FY2016/17. In August 2018, the Ministry of Finance and Economy (MOFE) introduced the Fiscal Consolidation Program, which is aimed at restructuring line ministries' revenue and expenditures to put the fiscal position at a sustainable path.

Separately, the government has taken steps to diversify its revenue sources. While the government has studied possible options to broaden the tax base, it is currently focusing its efforts on increasing compliance and enforcement of corporate tax payments by companies. This is conducted through the implementation of System of Tax Administration and Revenue Services (STARS)[21] monthly tax awareness workshops held for newly incorporated companies and tax non-filers companies. Moreover, the government also continues to encourage other government institutions to find ways to increase revenue through fees and charges. However, authorities need to be careful in balancing the need to increase revenue without placing unnecessary burden on the population, which may have an adverse impact on the business environment. To improve the management and collection of these fees, the MOFE has introduced the One Common Billing System which is aimed at improving efficiency and reducing defaults on bills and charges.

[17] Charged expenditure refers to payments for the civil list, pensions, gratuities and grants, debt charges, salaries of the Auditor General and members of the Public Service Commission.
[18] Other charges annual recurrent (OCAR) refers to maintenance of public facilities and infrastructures, ICT expenditures, utilities, rent, and operational expenditure and allowances.
[19] Programme and Performance Budgeting (PPB) is a multi-year budgeting plan and a top-down process that places budget in a sustainable fiscal framework. Streamlining of virement rule and procedure has been implemented and the MOFE has established an improved fiscal reporting and monitoring process.
[20] Prepared by Muhammad Firdauz Muttaqin (Economist)
[21] STARS is an electronic tax system which was introduced in 2012 in order to make it easier for taxpayers to file their tax payments or returns.

Table B1. Capital Allowances and Exemptions on Investment

Allowances and Exemption		Rate	Effective	
1	**Capital Allowances (CA) for Investment**			
	a. Industrial Building	Increase the rate of CA from 20% to 40% and annual CA from 4% to 20%	**2015**	All the CA rate to be a common rate of 25% since 2017
	b. Plant and machinery	Increase the rate of CA from 20% to 40%	**2009**	
	c. Plant and machinery for Manufacturing Industries	Increase the rate of CA from 100% to 150%	**2015**	
2	**Exporter can opt for special regime**	fixed taxation at 1% of export proceed	2012	

Source: MOFE; AMRO staff compilations

Table B2. Exemptions for SMEs

Description		Criteria and Tax Rate	Effective
1	**Tax Threshold for SME**		
	a. Chargeable income (CI) ≤ BND100.000	25% of CI is charged to tax	**2011**
	b. BND 100.000< CI ≤ BND150.000	50% of CI is charged to tax	
	c. Above BND 150.000	100% of CI is charged to tax	
2	**Excemption**		
	SMEs with Gross sale or turn over <BND 1 million	tax rate 0%	**2016**
	New companies are exempted on CI for the First $100.000 for 3 years	tax rate 0%	**2008**

Source: MOFE; AMRO staff compilations

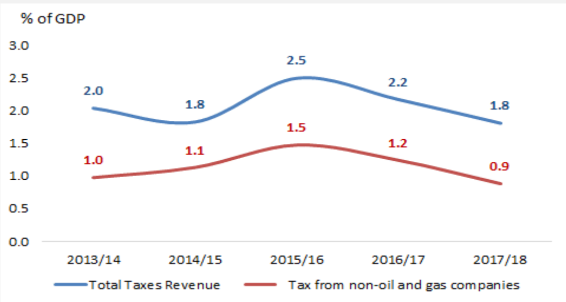
Table B3. Withholding Tax Rate

	Nature of Payment	Tax Rate Effective		
		2008	**1 January 2016**	**1 April 2017**
1	Interest, commision, fee or other payment in loan	15%	no change	2.5%
2	Royalties, lump sum payments for the use of movabe properties	10%	no change	no change
3	Payment for the use of scientific, technical, industrial or commercial knowledge	10%	no change	no change
4	Payment for rendering assistance or service of scientific, technical, industrial or com. knowledge	20%	10%	no change
5	Payment for the management or assistance in the management of any business	20%	15%	10%
6	Rent or other payment for the use of movable property	10%	no change	no change
7	Non-resident directors' remuneration	20%	10%	no change

Source: MOFE; AMRO staff compilations

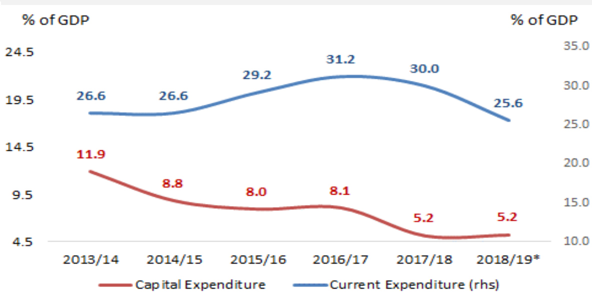
On the other hand, the government has also been using tax policy to stimulate economic activities. In just a decade, the government has reduced the corporate tax rate several times, from 30 percent in 2007 to 20 percent in 2012, and further to 18.5 percent in 2015. In addition to this, the MOFE has increased the rates of capital allowances and reduced Withholding Tax rates as a measure to encourage investment and FDI inflows and to assist SMEs (Tables B1-B3). These allowances and exemptions are currently being reviewed by the Revenue Division, Ministry of Finance & Economy to ensure that the government can still collect income tax from non-oil and gas companies (Figure B1), while still providing a conducive business and investment environment, which in turn will expand the revenue base and increase government ability to support growth in the medium-term.

Figure B1. Tax Revenue Development



Source: MOFE; AMRO staff compilations

Figure B2. Government Spending



Source: MOFE; AMRO staff compilations

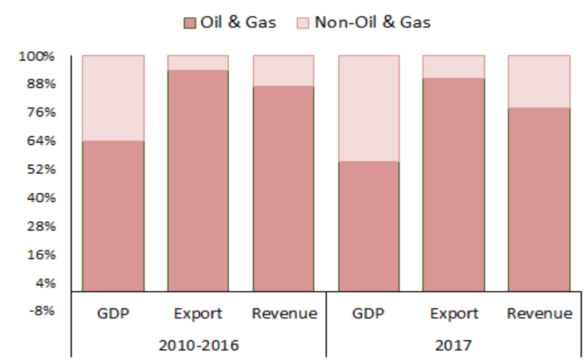
On the expenditure side, the government has taken the opportunity to implement fiscal consolidation, focusing pro-growth and efficient spending. Despite expenditure remaining high and often over budget, the MOFE has been able to limit the current expenditure as a percentage of GDP, especially for personal emolument (Figure B2). Other expenditure components such as charged expenditure and OCAR, however, have remained high and tended to increase. Based on the Fiscal Consolidation Programme, the government has encouraged line ministries and departments to restructure their expenditures, through reviewing their existing policies, undertaking structural reforms and streamlining administrative processes and also promoting efficiency.

B. Risks, Vulnerabilities and Challenges

B.1. Oil and Gas-Related Risks

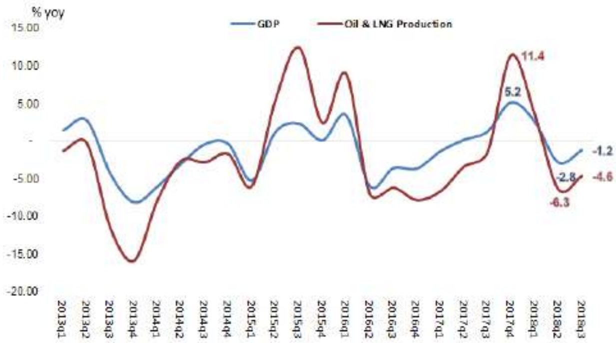
15. **The economy's high reliance on the oil and gas sector remains the main risk in the medium to long term.** Despite a decrease in its share in recent years, the oil and gas sector still contributed a significant 55 percent of GDP, 90 percent of exports and 78 percent of government revenue in 2017 (Figure 16). Amid an oil price recovery since early 2016, an unexpected decline in oil and LNG production in the first half of 2018 has affected economic growth and exports. Therefore, as GDP growth is closely related to oil and LNG production (Figure 17), a sharp decline in this sector is considered the main risk to the growth outlook in the near- to medium-term. Hence, in addition to being susceptible to unexpected changes in oil and LNG prices, delays and sudden disruptions in the maintenance of oil fields also do not bode well for the country's oil and LNG production and exports, as well as economic growth.

Figure 16. Role of the Energy Sector in the Economy



Source: DEPD; AMRO staff calculations

Figure 17. GDP Vs Oil and LNG Production Growth



Source: DEPD; AMRO staff calculations

B.2. Spillover Effects from a Weakening Fiscal Position

16. **The oil and gas sector is still the major source for government revenue.** Seventy-eight percent of the government's revenue is derived from the oil and gas sector through royalties, dividends and taxes. Because of this lack of diversity in revenue sources, an unexpectedly large shortfall in oil and gas revenue would hamper the government's ability to support the economy through its fiscal policy. As such, this poses a challenge to the government's decision to spend on capital expenditure and providing resources for structural reforms, which are important to enhance long-term growth.

B.3. Risk of a Slower Momentum in Ongoing Economic Diversification Efforts

17. **A slackening in the pace of structural reforms and economic diversification would dampen the long-term prospects of the economy.** In light of the maturing oil and gas fields, it is important not to lose momentum in pursuing structural reforms to diversify the economy into new industries and away from the high reliance on the oil and gas sector in the medium to long term.

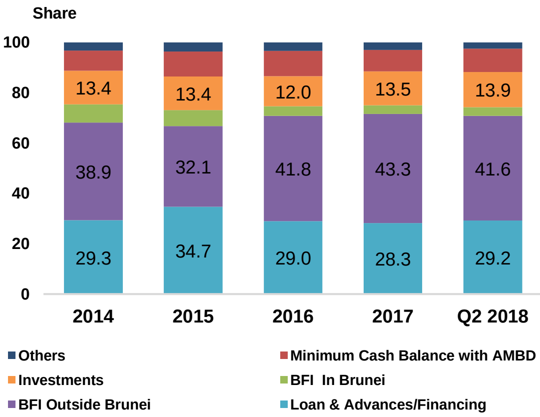
B.4. Structural Challenges in the Labor Market

18. **Failure to address the labor constraint in the non-oil and gas sector will slow down the economic diversification.** Skills mismatch between industry needs and labor supply, and a strong preference to work in the public sector and oil and gas related industries among Bruneians, remain a challenge which can be an important constraint to the diversification of the economy. In response to this, the authorities have set up some job creation and training and apprenticeship programs, in particular the “i-Ready” and the “Center for Capacity Building (CCB)”. However the effectiveness of the two initiatives in mitigating the labor issues in the medium-term need to be carefully assessed, since some public agencies or private companies could not provide a permanent position for all participants after the programs.

B.5. Potential Vulnerabilities in the Banking System

19. **The excess liquidity and rising NPL ratios in the banking system could lead to potential vulnerabilities in the medium term.** The banking sector generally has remained sound with a high capital adequacy ratio, well above the minimum requirement. However, with the considerable excess liquidity in banking system as reflected in the low loan-to-deposit ratio, banks channel their excess liquidity in interbank market and their network abroad (Figure 18), with minimal foreign currency risk exposure and low counterparty risks. In addition, the rising NPL ratios in the recent quarters suggest that the banking sector is also facing a higher credit risk. Although some measures have been introduced to mitigate such risks, these warrant close monitoring because they could hurt the profitability and undermine the soundness of banking sector in the medium term (Table 3).

Figure 18. Bank’s Asset Composition



Source: AMBD; AMRO staff calculations

Table 3. Financial Stability Indicators

Indicator	2013	2014	2015	2016	2017	2018 Q3	Average (2013-2017)	ASEAN5	CLMV
Capital Adequacy									
Regulatory Capital to Risk-Weighted Assets	19.4	21.4	21.5	21.5	18.3	18.7	20.4	17.9	17.2
Regulatory Tier 1 Capital to Risk-Weighted Assets	20.4	21.4	22.8	23.2	18.1	19.44	21.2	15.6	14.7
Asset Quality									
Non-performing Loans to Total Gross Loans	5.7	5.0	4.9	5.9	4.4	5.8	5.2	2.1	2.7
Net NPL/Financing (net of Provision) to Gross loans	1.6	2.3	2.2	3.3	1.4	3.0	2.2		
Profitability									
Return on Assets	1.4	1.4	1.3	1.0	1.4	1.1	1.3	1.6	0.6
Return on Equity	10.2	10.1	8.7	6.4	9.5	7.6	9.0	13.6	5.7
Net Interest margin to gross income	73.2	76.4	71.8	66.7	71.8	86.0	72.0	65.4	54.8
Liquidity									
Liquid Assets to Total Assets	56.2	53.9	45.5	50.4	51.0	50.1	53.4	33.2	32.2
Liquid Assets to Short Term Liabilities	113.1	121.9	93.0	105.1	106.4	99.8	109.7	68.2	46.1

Source: AMBD; AMRO staff calculations

B.6. External Risks

20. **Besides a sharp decline in global oil and gas prices, other external risks including escalating US-China trade tensions, sharper than expected economic slowdown among major trading partners, and heightened global uncertainties triggered**

by EM crises or geopolitical tensions, are expected to have a low impact on the economy. The declining global oil prices are not only adversely affecting the Brunei economy, but could also affect the commercial viability of Brunei to increase oil production, especially in deep-water fields where the development costs are high. On the other hand, the relatively low engagement in the global value chain (GVC) made Brunei less susceptible to spill overs from the global trade conflicts. However, with the growth of manufacturing and other industries in the medium term, Brunei's participation in GVC will increase over time and its economy will become more exposed to the shocks in the non-oil sector.

Table 4. Key Risks by Source

Risks		Likelihood			Potential Impact
		2016	2017	2018-19	
Domestic	A sharper than trend decline in oil and LNG production	3	2	2	High
	The unexpected shortfall in oil and gas revenue limits the government's ability to support the economy	3	2	2	Medium
	Slower momentum in ongoing economic diversification efforts	2	1	1	Medium
External	A sharp decline in global oil and gas prices	2	2	3	High
	Escalating U.S.-China trade tensions	1	2	3	Low
	Sharper-than-expected economic slowdown among major trading partners	1	1	3	Low
	Heightened global uncertainties triggered by EM crises or geopolitical tensions	1	2	2	Low

1	2	3	4
Low likelihood	Low to Medium	Medium	High likelihood

Source: AMRO staff assessment

C. Policy Recommendations

21. **The government should remain steadfast in pursuing economic reforms in order to enhance the diversification of the economy and its long-term growth prospects.** Although Brunei has made significant gains in its efforts to diversify the economy, as reflected in its success in attracting FDIs into the refinery and other mega projects, the economy is still heavily reliant on oil and LNG production. GDP, exports and government revenue are dominated by the oil and gas sector performance, while the non-oil and gas sector's role is relatively small. In view of the declining trend in oil and LNG production, it is critical to diversify the growth drivers of the economy in the medium to long term into the manufacturing, tourism, and other non-traditional industries in order to enhance the growth potential of the economy.

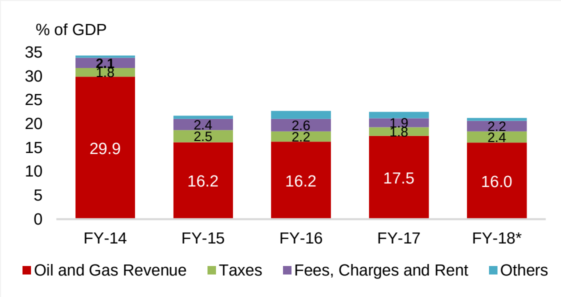
22. **On fiscal policy, efforts to diversify the revenue sources should be continued.** The uncertainty of oil and gas revenue reinforces the need to broaden fiscal reforms to ensure sustainability over not only the short term but also the medium term (see Box C Medium-term Fiscal Consolidation). The One Common Billing System to consolidate fee incomes from various government agencies is commendable and expected to increase revenue. From the experience of other oil exporting countries, such as those in the Gulf region, consideration should also be given to how to broaden tax bases, such as to recalibrate the rates for corporate

income and property taxes as well as to expand excise taxes. Furthermore, increasing compliance and strengthening enforcement of corporate tax payments by companies are also worth considering.

Box C. Medium-term Fiscal Consolidation[22]

The government budget position has improved in recent years, but efforts to strengthen and consolidate the fiscal position should be continued. The current budget improvement mainly comes from a significant increase in oil and gas revenue (Figure C1), while efforts to diversify revenue sources and to constrain spending **have** proven to be difficult. These are the areas that need to be worked on as the budget is still susceptible to disruptions in oil and LNG production and fluctuations in global oil prices.

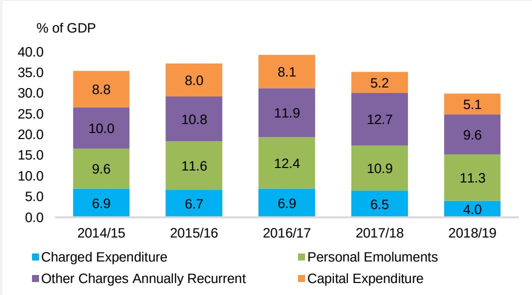
Figure C1. Government Revenue Structure



Notes: *) Budget data

Source: MOFE; AMRO staff calculations

Figure C2. Government Expenditure Structure



Source: MOFE; AMRO staff calculations

Medium-term Fiscal Outlook and Policy Adjustment

The fiscal outlook remains challenging over the medium-term. The budget deficit narrowed in the last two fiscal years in line with significant increases in oil and gas revenues. Although oil and LNG production declined in the first half of 2018, the moderate increase in oil and LNG prices has resulted in higher oil and gas revenues and improved the fiscal position for FY2018/19 so far. However, over the medium-term, oil prices are expected to decline slightly, while the oil and LNG production is estimated to increase in line with the rejuvenation of some oil and gas fields. With limited room for further expenditure cuts at this stage, the fiscal balance is expected to improve gradually but will remain in deficit over the next few years until 2023, assuming no substantial policy changes are made and with a modest recovery in oil production (Table C1).

Table C1. Medium-term Fiscal Outlook[23]

	Actual			Projection					
	FY2015	FY2016	FY2017	FY2018	FY2019	FY2020	FY2021	FY2022	FY2023
				In millions of BND					
Revenue	3,709	3,133	3,830	4,567	4,786	4,956	5,182	5,425	5,670
Expenditure	6,338	6,182	5,997	5,860	5,902	5,959	6,017	6,077	6,138
Fiscal blance	-2,630	-3,049	-2,166	-1,293	-1,117	-1,003	-835	-652	-468
				In percent of GDP					
Revenue	21.7	19.9	22.5	26.6	27.2	27.1	27.3	27.5	27.7
Expenditure	37.1	39.2	35.2	34.2	33.6	32.6	31.7	30.8	29.9
Fiscal blance	-15.4	-19.3	-12.7	-7.5	-6.3	-5.5	-4.4	-3.3	-2.3
Previous projection				-8.1	-5.1	-3.3	-1.4	0.7	1.7

Note : Fiscal year is from April to March
Source : National authorities, AMRO staff projections

[22] Prepared by Muhammad Firdauz Muttaqin (Economist)

[23] The base line scenario is using some assumption, such as: (i) the average of oil price declines slightly until 2023, while the LNG price stays at a similar with current average of 2018, (ii) total oil production increases by 2.0 percent every year, while LNG production remains the same, and (iii) the total expenditure as percentage of GDP declines until 2023.

Over the medium-term, the fiscal position still remains dependent on global oil price movements and domestic oil production. To illustrate the impact of oil and LNG prices and production, a fiscal stress test was conducted using different scenarios (Table C2) to assess the medium-term fiscal outlook. In the upside scenario, the fiscal balance will recover faster than in the baseline scenario and is expected to yield a surplus by 2021 (Table C3). In case of the downside scenario, the fiscal balance recovery will take longer, where the budget deficit will widen due to lower oil and LNG production as well as low oil prices. Therefore, the authorities still need to increase efforts to diversify revenue sources and reprioritize spending.

Table C2. Fiscal Balances - Stress Test Scenarios

Indicators	Baseline	Upside scenario	Downside Scenario	
			Oil Price Decline	Oil Production Decline
Oil and LNG Price	Oil price declines slightly, while the LNG price stays at a similar level until 2023.	Oil price increases by 10% in 2019 and 2020, and remains the same in 2021-2023"	Oil price decline by 10% in 2019 and 2020, and remain the same in 2021-2023	Similar to the baseline scenario
Oil and LNG production	Total oil production increases by 2%, while LNG production remain the same from 2019 to 2023	Similar to the baseline scenario	Similar to the baseline scenario	Oil and LNG production decline by 10% and 5% in 2019 and 2020, and remain the same in 2021-2023

Source: AMRO staff estimation

Table C3. Fiscal Balances - Stress Test Results

	Projections					
	FY2018	FY2019	FY2020	FY2021	FY2022	FY2023
Fiscal balance Under:	*(In percent of GDP)*					
Baseline[1)]	-7.5	-6.3	-5.5	-4.4	-3.3	-2.3
Upside[2)]	-7.2	-3.5	-1.2	0.0	1.3	2.5
Downside[3)]						
- Oil price decline	-8.1	-7.8	-6.8	-5.9	-5.1	-4.3
- Oil production decline	-7.5	-8.2	-8.8	-7.9	-6.9	-6.0
Memorandum items:						
Baseline oil price (US$/barrel)	73.2	72.0	71.0	70.1	69.1	68.1
Baseline LNG price (US$/MBTU)	9.8	9.7	9.5	9.5	9.5	9.5
Baseline oil production (bpd)	115	117	120	122	124	127
Baseline LNG production (boepd)	240	245	245	245	245	245

Source: AMRO staff estimation
Note: Baseline oil and LNG production and prices are the fiscal year

23. **Efforts to enhance the efficiency and effectiveness of fiscal spending should be continued, particularly prioritizing the budget for capital expenditure.** To strengthen the fiscal position, the government should continue to reprioritize expenditure and further enhance the budget efficiency. At the same time, Brunei's potential growth could benefit from increasing capital spending on infrastructure to support industries which are potential growth drivers such as manufacturing, tourism, agriculture and aquaculture. In addition, the current low inflation environment provides an opportunity for the government to reform subsidies, particularly energy subsidy, to make them more targeted.

24. **Further initiatives to resolve unemployment and structural issues in the labour market are welcome.** The government initiatives to narrow the skills mismatch, to improve employability, and to encourage entrepreneurship among the youth are commendable and should be further enhanced. The retraining programs provided by the Centre of Capacity Building should be continued in order to upgrade the skill sets of the Brunei workforce. Inter-agency collaboration between Ministry of Education, MPPU and the private sector to align higher-education curriculums with the needs of the industries, is commendable as it will reduce the skills mismatch in the long term.

25. **Although the financial sector remains sound and stable, it is narrowly based on the banking industry, and there is scope to make it more inclusive and diversified.** It can be achieved by increasing the contribution and activities of the asset management industry in the economy and developing more financial instruments to meet the needs of the business community. The AMBD should continue to take measures to improve the access of the private sector and households to credit and improving financial literacy of the general public. From a

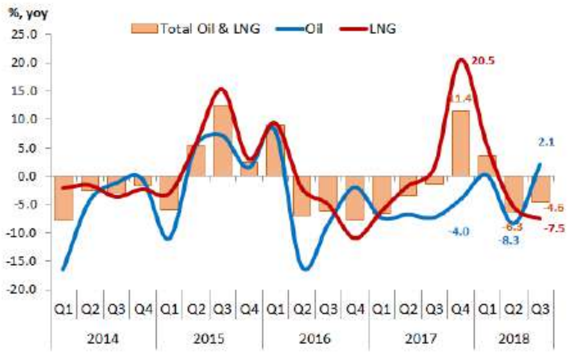
development perspective, the issuance of longer-term Sukuk will help extend the yield curve and encourage the development of other financial products which will provide more investment opportunities to Brunei investors.

26. **The availability of key economic and financial data has improved and is greatly welcome.** Further efforts to provide important economic data such as balance of payments, GDP, household income and spending, as well as labour market data in a timely manner, are necessary for effective surveillance, offering a better understanding of the current conditions of the economy for policy making. The authorities' plan to enhance data provision and dissemination in the short term is commendable.

Appendix 1. Major Economic Indicators for Brunei Darussalam

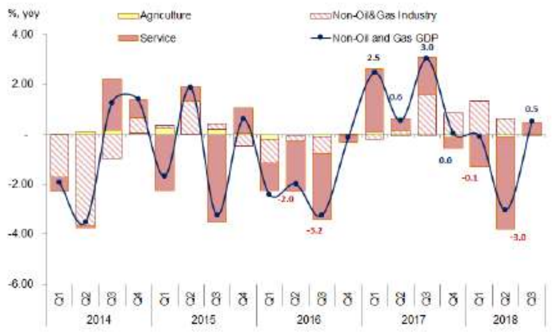
Figure 1.1. Real Sector, GDP Growth and Prices

Oil and LNG production growth is slower in 2018



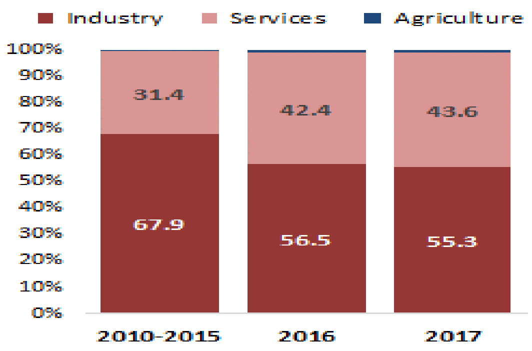
Source: DEPD; AMRO staff calculations

The slower GDP growth in the first half of 2018 was also contributed by non-oil and gas sector especially the financial sub sector in service sector.



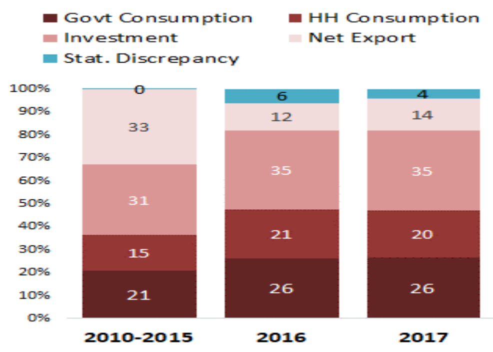
Source: DEPD; AMRO staff calculations

The contribution of the industry sector, which includes oil and gas mining and manufacturing, to GDP declined since 2016, mainly due to the slumping oil and gas sector.



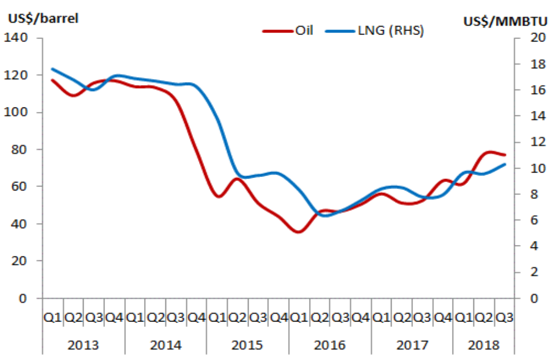
Source: DEPD; AMRO staff calculations

On the expenditure side, the largest contribution to GDP moved from net export to investment and government consumption, which was in line with the oil and gas sector declining.



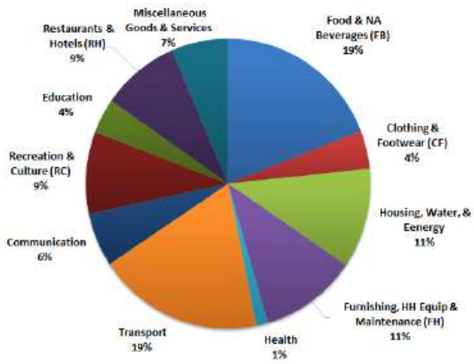
Source: DEPD; AMRO staff calculations

After falling significantly since 2H 2014, oil and LNG prices have shown a modest recovery from 2H2016.



Source: DEPD; AMRO staff calculations

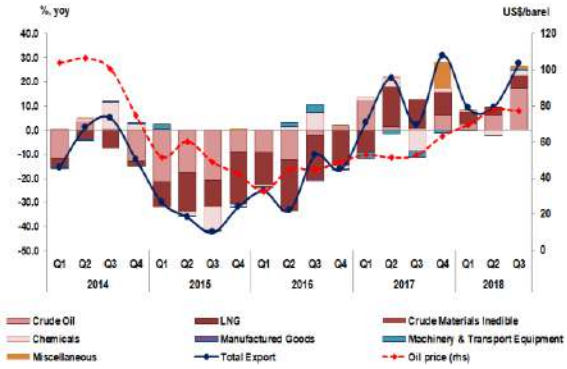
Transport and food and beverages are the two biggest component on the CPI basket in Brunei.



Source: DEPD; AMRO staff calculations

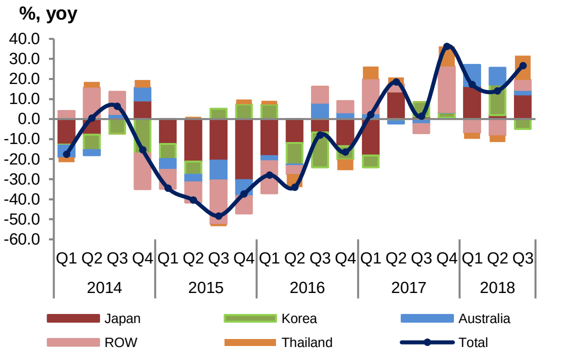
Figure 1.2. External Sector

The improvement in exports was mainly due to higher oil prices in 2017 and a gradual recovery in production.



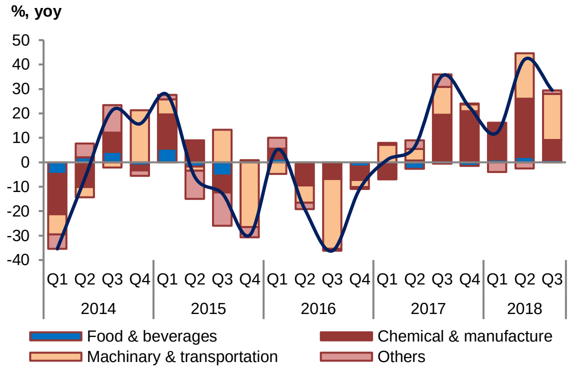
Source: DEPD; AMRO staff calculations

Based on destination countries, most of Brunei's exports went to Japan and Korea as the biggest importer of Brunei's oil and LNG production.



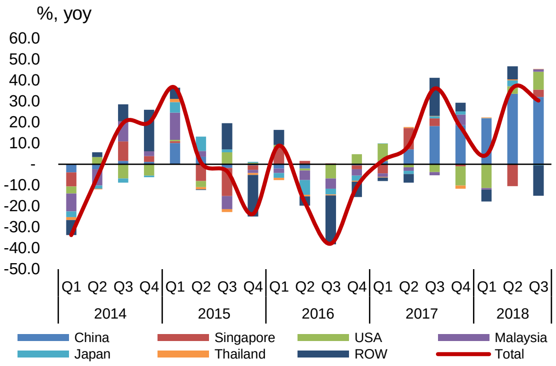
Note: ROW refers to Rest of the world.
Source: DEPD; AMRO staff calculations

Imports increased since 2017, driven by intermediate and capital goods, as investment increased.



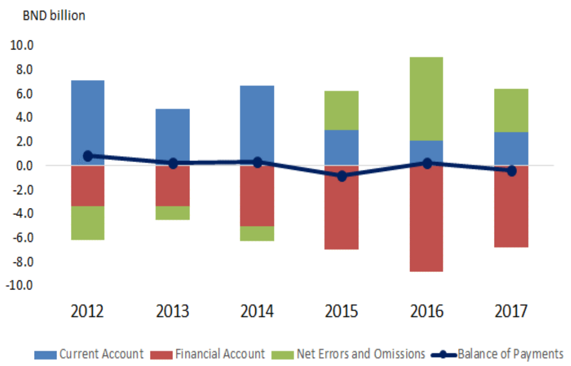
Source: DEPD; AMRO staff calculations

In line with some infrastructure and FDI project, the current import increase mostly came from China.



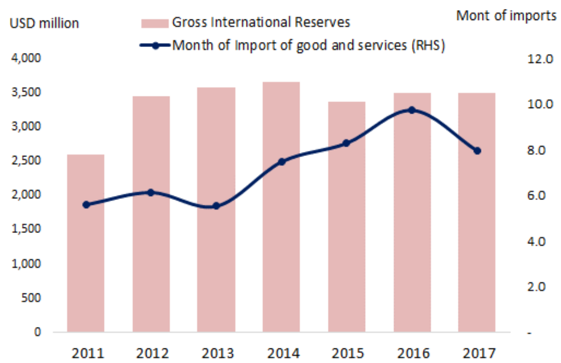
Note: ROW refers to rest of the world
Source: DEPD; AMRO staff calculations

The overall balance of payment in 2017 is slightly negative and projected to be relatively similar in 2018.



Source: DEPD: AMRO staff calculations

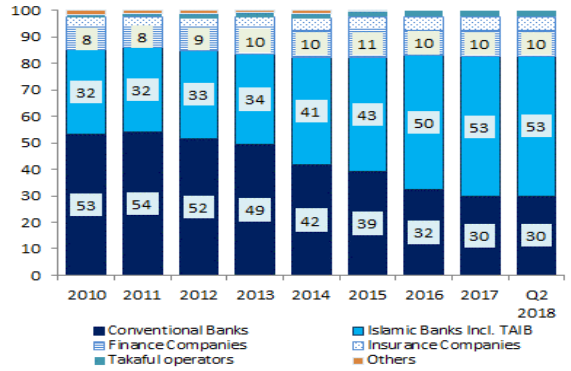
The overall external position remained well-buffered as Brunei's international reserves cover around 8 months of merchandise imports.



Source: DEPD, AMBD; AMRO staff calculations

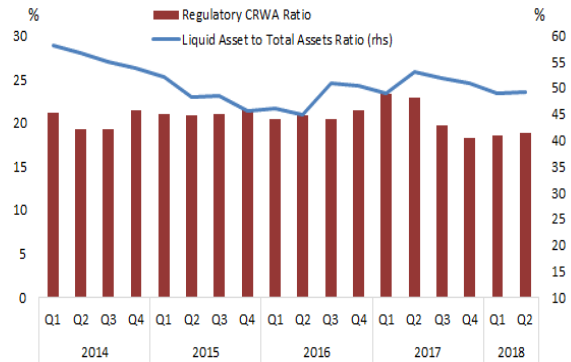
Figure 1.3. Financial Sector

Islamic banks (including Perbadanan Tabungan Amanah Islam Brunei (TAIB)) increasingly dominate the financial sector structure in Brunei.



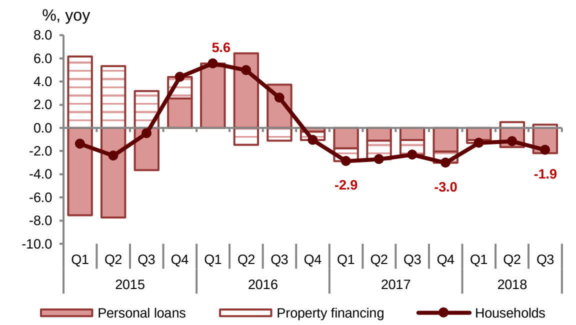
Source: AMBD, AMRO staff calculations

Banking sector remains sound with a high regulatory capital and supported by a high liquidity.



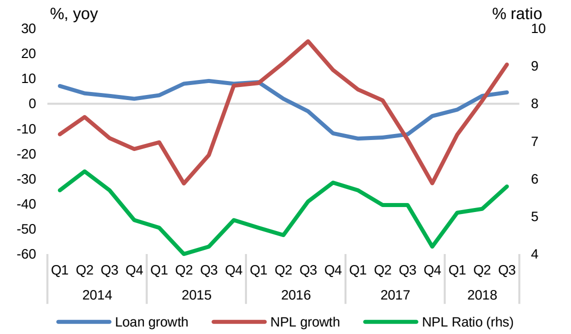
Source: AMBD, AMRO staff calculations

Different from corporate loan, credit to households still sluggish since the end of 2016



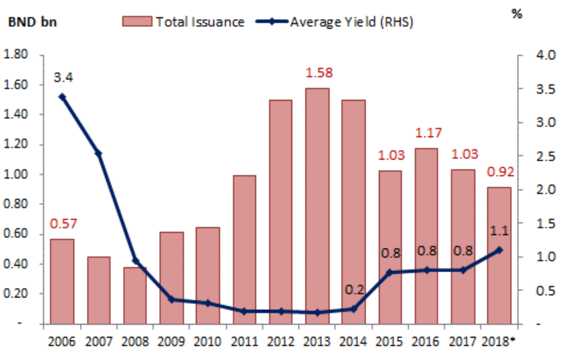
Source: AMBD, AMRO staff calculations

The improvement of loan growth was followed by the increase of the non-performing loans.



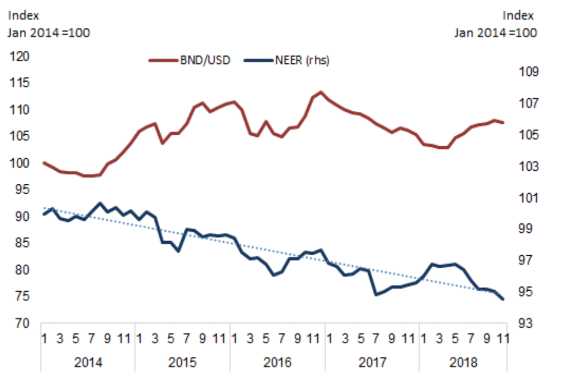
Source: AMBD, AMRO staff calculations

Total of Sukuk issuance continued decline from BND1,032 million in 2017 to BND948 million in 2018, with its outstanding was BND347.5 million.



Note: The issuance of Sukuk in Brunei is mainly to build the Government Securities yield curve as a benchmark for corporate sukuk.
Source: AMBD, AMRO staff calculations

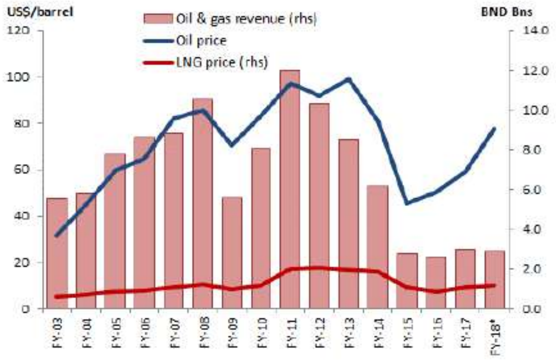
The BND appreciated against a basket of its main trading partners' currencies.



Notes: Currency basket calculated based on importing countries' weight to Brunei
Source: CEIC, AMRO staff calculations

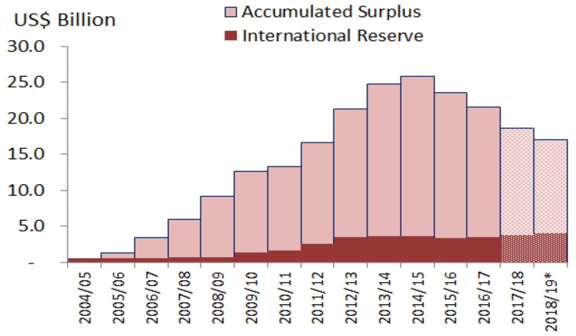
Figure 1.4. Fiscal Sector and Others

Oil-related revenue dropped sharply as oil and LNG prices plummeted; but it is expected to pick up in FY2018/19 as oil and LNG prices increase.



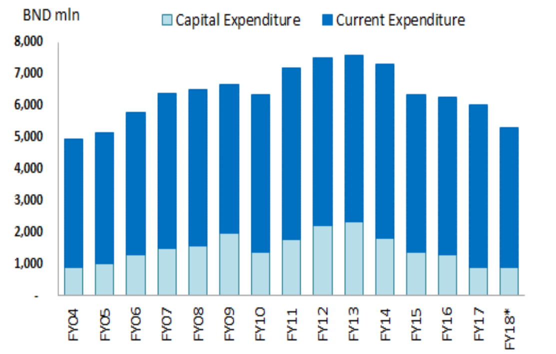
Notes: *) Based on the government budget. Fiscal year: April to March
Source: MOFE, AMRO staff calculations

The fiscal buffer measured in accumulated surpluses remains ample, but it has been declining with a deficit fiscal position



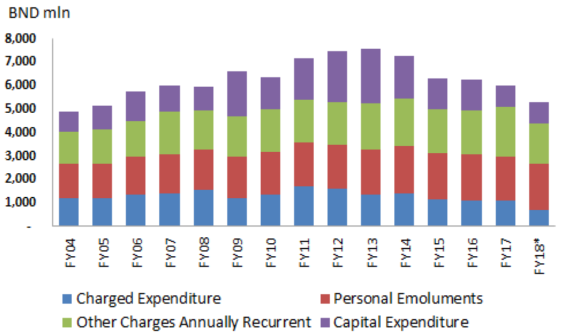
Notes: *) Based on the government budget. The gross international reserves position is as of June 2017.
Source: MOFE, AMRO staff calculations

The government has restrained spending amid declining trend of oil and gas revenue.



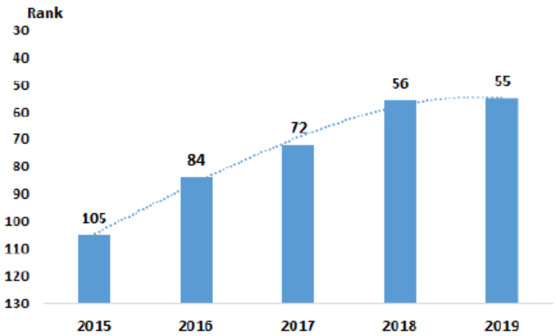
Note: Fiscal year: April/March
Source: MOFE, AMRO Staff calculation

Personal emoluments and other charges annually recurrent (OCAR) take up the biggest portion of the government spending.



Note: Fiscal year: April/March
Source: MOFE, AMRO Staff calculation

Brunei is the most improved countries globally in terms of ease of doing business



Source: World Bank's ease of doing business ranking

Brunei ease of doing business is the fourth among ASEAN countries,

	2017	2018	2019
Singapore	2	2	2
Malaysia	23	24	15
Thailand	46	26	27
Brunei Darussalam	**72**	**56**	**55**
Vietnam	82	68	69
Indonesia	91	72	73
Philippines	99	113	124
Cambodia	131	135	138
Laos	139	141	154
Myanmar	170	171	171

Source: World Bank's ease of doing business ranking

Appendix 2. Selected Economic Indicators for Brunei Darussalam: 2014-2019

	2014	2015	2016	2017	Projection[1)] 2018	Projection[1)] 2019
National Income and Prices						
Real GDP	-2.5	-0.4	-2.5	1.3	-0.5	2.1
Consumer price inflation (average)	-0.2	-0.4	-0.7	-0.2	0.1	0.4
Balance of Payments [2)]	(In millions of US dollars unless otherwise specified)					
Trade balance	7,444	2,910	2,153	2,403	2,028	2,660
Exports	11,111	6,126	4,812	5,474	5,787	6,994
Imports	3,668	3,216	2,659	3,072	3,759	4,335
Current account balance	5,251	2,157	1,470	2,020	1,559	1,664
In percent of GDP	30.7	16.6	12.9	16.7	12.6	13.1
Overall balance	252	72	144	-282	74	49
Gross international reserves	3,648	3,367	3,489	3,488	3,562	3,611
In months of imports of goods & services	7.5	8.3	9.8	7.4	6.4	6.3
	(in annual percentage change, unless otherwise specified)					
Export value	-7.3	-40.2	-22.4	13.6	17.8	6.3
Oil and gas	-11.1	-39.9	-24.8	13.2	19.2	6.5
Crude Oil	-13.3	-46.6	-16.6	16.6	28.7	11.9
LNG	-9.2	-34.4	-30.3	14.6	22.1	2.0
Others	99.6	-44.6	9.4	4.2	5.0	5.0
Export volume	-2.5	0.6	-1.9	0.2	-4.9	11.7
Import value	-0.5	-10.0	-17.4	15.4	35.2	4.0
Import volume	0.1	-4.7	-16.0	14.2	33.9	4.0
Terms of trade	-3.2	-34.7	-25.0	12.5	28.9	-5.2
Government1 [3)]	(In percent of GDP)					
Revenue and grants	34.3	21.7	22.7	22.5	26.6	27.2
Oil and gas revenue	29.9	16.2	16.2	17.5	21.3	21.7
Non-Oil and Gas Revenue	4.1	5.2	5.1	5.0	5.3	5.5
Expenditure	35.4	37.1	39.3	35.2	34.2	33.6
Current Spending	26.6	29.2	31.2	30.0	29.0	28.4
Capital Spending	8.8	8.0	8.1	5.2	5.2	5.2
Budget Balance	-1.1	-15.4	-16.6	-12.7	-7.5	-6.3
Monetary Sector	(in annual percentage change, unless otherwise specified)					
Domestic credit	32.9	28.5	-21.3	-14.2	5.0	6.8
of which: private sector	1.1	4.9	-8.4	-3.3	2.0	5.0
Broad money	3.2	-1.8	1.5	-1.8	3.2	5.2
Memorandum items:						
Exchange rate (BND/US$) period avg	1.27	1.37	1.38	1.38	1.35	1.35
Exchange rate end of period (BN$/US$)	1.33	1.42	1.45	1.34	1.37	1.37
GDP in millions of US$	17,098	12,930	11,400	12,136	12,372	12,682
GDP in millions of BN$	21,664	17,778	15,748	16,747	16,689	17,124

Note:
1) Figure for 2018 and 2019 are based on AMRO staff projection except for inflation and trade
2) BOP Data from DEPD and IMF
3) Fiscal Year April/March

Source: National authorities, IMF, AMRO staff projections

Appendix 3. Data Adequacy for Surveillance Purposes

Surveillance Areas	Data Availability[i]	Reporting Frequency/Timelines[ii]	Data Quality[iii]	Consistency[iv]	Others, if Any[v]
National Accounts	Yearly GDP data is available for both all expenditure, production and income sides. Quarterly GDP data is also available both expenditure and production side.	Quarterly GDP data comes with a 4 to 6 month lag with an unclear schedule. For example the Q4 GDP 2017 was released in late April 2018 and Q1 GDP 2018 was in late July 2018, while Q2 GDP 2018 was released in the early November 2018.	In some occasion, statistical discrepancy remains relatively high. For example, in 2017, statistical discrepancy accounted more than 4.3 percent of total GDP. On the expenditure side, since Q1 2017, gross fixed capital formation has been broken down into government and private headers separately.	Historical GDP data using the new base of 2010 have not been made available, making comparisons over time difficult.	
CPI Inflation	CPI inflation is available publicly in monthly bases.	CPI data is released regularly with a lag of 1-2 months	Data quality is fairly good and quite detailed.		
Balance of Payments (BOP) and External Position	Yearly and quarterly BOP data is available publicly on the DEPD website	Yearly BOP data is available up to 2017 Quarterly balance of payments data is compiled by JPKE and available upon request.	Net errors and omissions are frequently quite large (in 2016 around 44% of GDP and in 2017 around 21%). It make the analysis and interpretation of the data difficult. Data on the financial and capital accounts is relatively difficult to understand as more detailed data is not available and difficult to trace.	Due to relatively large statistical discrepancy, it is difficult to match the current account data with the saving-investment gap derived from the national account.	
State Budget and Government/ External Debt	Annual budget data is available yearly in government publications such as the Brunei Darussalam Statistical yearbook. The quarterly budget data is only available upon request to the authorities.	Annual government revenue and expenditure data are released with a time lag of more than one year. More recent data is available upon request.	-	-	-
Money Supply and Credit Growth	Money supply and domestic credit data are available at the AMBD website	Monthly data are released with a time lag of 3 months	Data quality is fairly good and quite detail		
Financial Sector Soundness Indicators	Financial soundness indicators are available in quarterly bases	The data is released with a time lag of 3 to 4 months	Data quality is fairly good but need more detail such as NPL for each sector		
Labor Market	The last available data up to 2017	The data is released with unclear schedule			

Notes: (i) Data availability refers to whether the official data are available for public access by any means, (ii) Reporting frequency refers to the periodicity of the published data, (iii) Timeliness refers to how up-to-date the published data are relative to the publication date, (iv) Data quality refers to the accuracy and reliability of the available data given the data methodologies, (v) Consistency refers to both internal consistencies within the data series itself and its horizontal consistency with other data series of either the same or different categories, and (vi) Other criteria might also apply, if relevant. Examples include, but are not limited to, potential areas of improvement for data adequacy.
Source: AMRO staff compilation. This preliminary assessment will form the "Supplementary Data Adequacy Assessment" in the EPRD Matrix.

Annexes Selected Issues

Annex 1. Developing Businesses in Brunei Darussalam: A Brief Assessment of Brunei's Reforms towards Improving SMEs' Access to Credit[24]

The Brunei authorities place emphasis on improving the overall business environment for domestic businesses and local entrepreneurs. According to the World Bank Doing Business Report, Brunei has made significant improvement in business environment. However, access to finance was recognized as a constraint to the SME development in Brunei. The authorities have implemented some initiatives to improve the credit access for SMEs such as the implementation of the Bureau Credit Score and the establishment of Bank Usahawan (SME Bank). These efforts come with opportunities and potential vulnerabilities.

1. **Reducing the Brunei economy's reliance on the oil and gas sector has increasingly become a priority for the government.** The oil and gas sector currently contributes 60 percent of GDP and employs 10 percent of the workforce. However, in recent years, after being hit by sudden oil price shocks as well as disruptions in oil and LNG production, the government has taken more steps to support non-oil and gas sectors. Other than economic diversification efforts by attracting and facilitating FDIs to operate in the country, (elaborated in Box A), the authorities have also placed emphasis on improving the overall business environment for domestic businesses and local entrepreneurs. This selected issue will first briefly introduce Brunei's overall position in its journey to improve the business environment. Then it will discuss the SME environment in Brunei and certain literature surrounding SME financing before delving into the reforms Brunei has implemented to address SME financing and development issues.

2. **Supporting and developing a conducive business environment was one of the main thrusts of Brunei's 10th National Development Plan (2012-2017).** To this end, the government has established the Ease of Doing Business (EODB) Steering Committee under the Ministry of Energy, Manpower and Industry. Its role is to foster a pro-business ecosystem by developing clear strategies and programs to improve the business environment and to improve the quality and efficiency of government procedures. This role is shared by champion groups within the government and also other supporting agencies such as Darussalam Enterprise (DARe). DARe was also established with the aim of developing MSMEs through capacity building, facilitating market access and providing industry-ready sites and complexes to operate from.

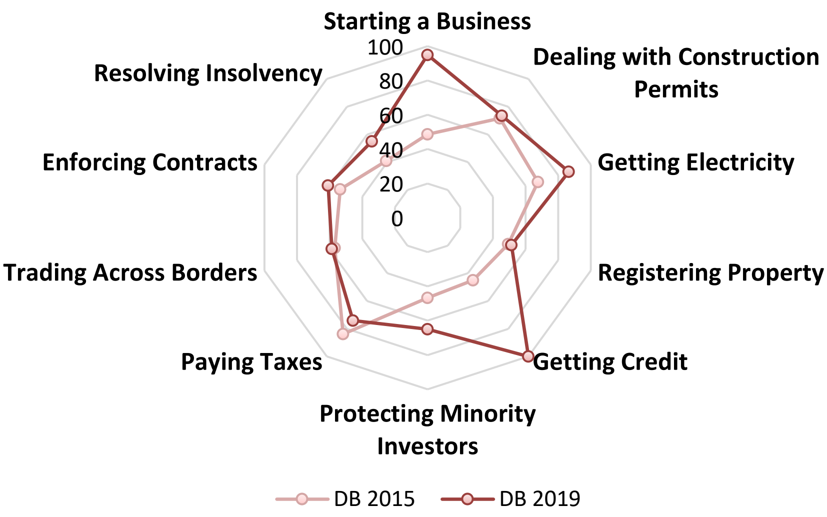
3. **According to the Doing Business Report published by the World Bank in November 2018, Brunei has made significant strides to improve its business environment.** The reforms implemented by government ministries and other relevant agencies have resulted in Brunei's overall ranking climbing to 55th in 2019 from the 105th in 2015. Brunei's rankings for all individual indicators assessed in the World Bank survey have improved remarkably since the Doing Business Report 2015,[25] especially in the areas of starting a business and securing credit

[24] Prepared by Siti Athirah Ali (Economist)

[25] The World Bank has updated its methodology to assess these indicators on a regular basis. Due to these changes, Brunei Darussalam's ranking for Paying Taxes in DB2016 was adjusted from 89.05 to 66.79.

(Figure A1.1). Within the region, Brunei Darussalam is ranked eighth behind Singapore (2), Hong Kong (4), Korea (5), Malaysia (15), Thailand (27), Japan (39) and China (46). In addition to the 10 indicators included in the World Bank survey, the Ministry of Energy, Manpower and Industry also uses other indicators to assess its business environment, which are deemed to be country-specific. These include assessing the efficiency of procuring halal certification and labor permits, effectiveness of enterprise development, handling procurement and late payments, as well as following up on procedures after incorporation of businesses. These non-World Bank indicators, while not assessed using scores, are monitored based on the action plans set out by respective government ministries and agencies.

Figure A1.1. Brunei Darussalam Scores for Doing Business (November 2018)



Source: World Bank Doing Business Report

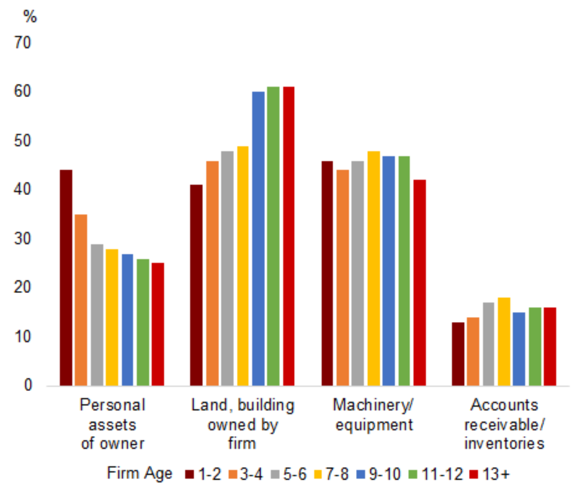
SMEs and Access to Financing in Brunei

4. **The current composition of the corporate sector in Brunei, other than the major oil and gas companies and government-linked companies, is dominated by MSMEs.** According to the Report of Economic Census of Enterprises 2016, 96.5 percent of active enterprises in Brunei are MSMEs, and they employ four out of every 10 members of the working population. Their contribution to the economy is expected to increase as the economy recovers and continues its diversification efforts. According to statistics compiled by the AMBD, lending to the corporate sector has also seen a slight increase in recent months and is expected to expand further as benefits from large government projects and FDI activities start spilling over to the SME sector.

5. **For a long time, access to finance was deemed to be the main factor inhibiting SME development in Brunei.** This is also in line with global findings where a World Bank Enterprise Survey, in which 31 percent of firm owners report access to finance as a major constraint to current operations of the firm. Furthermore, this figure is 40 percent for firms that are less than three years old. As SMEs tend to be small, have very limited market access, and

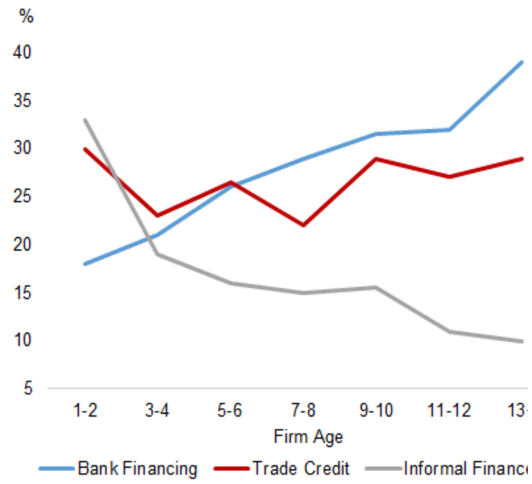
poor financial management and book keeping, SMEs' access to financing from external lenders such as banks tends to be limited. The lack of collateral accepted by banks also means that these SMEs may be subjected to very high interest rates. The enterprise survey shows that while the value of collateral required to secure financing does not vary significantly with firm age, there are differences in the sources of collateral used across age categories (Figure A1.2). In this regard, new firms are almost twice as likely as older firms to use personal assets of the owner as collateral. The survey also shows that the percentage of firms using bank financing increases as firms mature and almost doubles by the time firms become 13 years old, relative to new firms (Figure A1.3). The relationship between age and informal financing[26] runs in the opposite direction. These results are unquestionable because as a firm matures and is able to stay in the industry for an increasing amount of time, it is also able to build its assets, collateral, expand its consumer base and improve its credit worthiness.

Figure A1.2. Sources of Collateral



Source: World Bank Group Enterprises Survey

Figure A1.3. Percentage of Firms Using Financing Types by Firm Age



Note: Firms chose multiple sources where applicable. This figure represents the percentage of firms reporting.

Source: World Bank Group Enterprises Survey

6. **The Brunei government has tried to step in with programs that provide loans or grants to SMEs. However, as with many other countries' experiences, these initiatives to increase financing by the government have been ineffective.** Previous initiatives such as the SME Financing Scheme provided by the MIPR,[27] which involved subsidized interest rates to SMEs, were found to be ineffective. Previous regulations, where the AMBD set a cap on effective interest rates charged by banks at 8 percent on SME loans, did not prove conducive to the business environment. Historically, financial institutions in Brunei have recorded low loan-to-

[26] In addition to family and friends who provide a large percentage of the loans, informal finance consists of professional moneylenders, pawnbrokers, tradespeople and associations of acquaintances.

[27] After some restructuring within the government, all matters pertaining to 'industry' are under the purview of the Ministry of Energy, Manpower and Industry. The Ministry of Industry and Primary Resources (MIPR) is now known as the Ministry of Primary Resources and Tourism (MPRT). In this particular SME financing scheme, funds were provided by the government and channelled through the two local banks, Bank Islam Brunei Darussalam and Baiduri Bank. The interest/ profit rate for these loans was set at 4 percent, which was then split equally between the government and the respective bank.

deposit ratios of around 40 percent. While high liquidity in the banking system could be directed towards development and growth of the domestic private sector, considering the majority of corporates are MSMEs and the credit risk attached to lending to MSMEs is rather high, banks may be reluctant to provide such lending. In addition, while the increased risk attached to SME lending may warrant higher interest rates, this could, in turn, lead to an increase in the likelihood of borrowers unable to pay due to a high repayment burden. Hence, banks and other financial institutions might ration their loans at a lower interest rate than the market equilibrium rate and impose high transaction costs. This not only increases the cost of borrowing, but also can restrict access to finance for some borrowers.

Brunei's Reforms to Improve Access to Credit

7. **From the figure 1.1 above, it is evident that Brunei has been quite successful in addressing the challenge of increasing SME access to credit.** Due to this, Brunei is ranked first globally in terms of SME's ease of securing credit. This is because of a number of initiatives spearheaded by the AMBD. Amongst the reforms set out by the central bank was the adoption of the Secured Transactions Order (STO) 2016 and the accompanying Secured Transactions Regulations (STR). This provides the framework that enables personal movable assets to be pledged as collateral for financing. Under this framework, the AMBD has also established a Collateral Registry, a national electronic register that lists out the security interests over said personal properties as well as flags the parties that have claimed the security interests. The Collateral Registry is a credit management tool that can be used by lenders to identify any potential competing security interests in the same collateral. Allowing personal moveable assets such as cars, other machinery or inventory to be used as collateral increases the credit access of MSMEs, which otherwise have a hard time securing loans.

8. **The AMBD Credit Bureau has also implemented the Bureau Credit Score.** Following the implementation of the Credit Bureau and availability of credit reports, the Bureau Credit Score, introduced in November 2018, provides a numerical value to represent the probability that a borrower will become a 'bad debtor' at a particular point in time. The score is calculated based on five components: length of credit history, amount of debt outstanding, payment history, new credit and types of credit in use. The increased transparency provided by these facilities will allow financial institutions to better assess borrowers and manage their credit risk. From a borrowers' perspective, having access to their credit information would provide them with an incentive to improve their financial management and potentially negotiate better loan rates.

9. **A more recent initiative by the government to improve credit access for SMEs is the establishment of Bank Usahawan (SME Bank).** Funded entirely by the MOFE, it is hoped the bank can fill gaps and provide lending to SMEs that may not have been served by other financial institutions in Brunei. Since its establishment in May 2017, the bank has provided loans ranging from BND3,000 in size to BND750,000, depending on the needs of the business. Because the average loan amount is around BND50,000, Bank Usahawan is not seen as a major competitor to other financial institutions that may not find these loan amounts be attractive.

10. **However, there are potential opportunities and vulnerabilities that come with an SME bank.** While Bank Usahawan may be more equipped to take on an SME portfolio, the credit risks are no different to those faced by other commercial banks. In fact, the bank may be exposed to higher risks since it is only in the business of providing lending to SMEs and is not able to spread the risk across different customers. This may warrant higher rates charged by the bank, which is counterproductive, as this again will limit the bank's desire to lend and customers' access to financing. However, contrary to other commercial banks, Bank Usahawan's mandate focuses on the long-term sustainable growth of firms rather than profitability of the bank. Hence, it is possible the bank can still charge market rates for the loans provided to these SMEs without compromising on its performance. How Bank Usahawan can differentiate itself from other banks is through its close relationship with DARe. While DARe's role focuses on strengthening the foundations of SMEs through product development and market access, Bank Usahawan's role does not end at providing financing. With its expertise in working with SMEs, the bank-client relationship extends to site visits and problem solving in order to avoid issues in the long run.

11. **Having the government fully capitalize the bank may also pose a threat to the success of Bank Usahawan.** As mentioned earlier, previous government attempts to subsidize or provide financing to SMEs have been ineffective. The reason for that is that the government, while capable of providing social services, does not have the capacity to provide such financial services more efficiently than a licensed financial institution, and nor does it have the capacity to provide business advice better than a venture capitalist or angel investor. In Bank Usahawan's case, however, the bank has autonomy to make managerial decisions that best fit the interests of the banks and its clients, as long as there is no loss of the capital provided by the government. Another issue that often arises is the agency problem. With the bank fully backed by the government, empirical evidence would suggest that incentives to perform may be reduced. Hence, putting in additional resources to monitor progress is needed.

12. **In general, Brunei's commitment to improve access to financing to support businesses is commendable. However, while it was initially deemed to be the main issues for Brunei, empirical evidence has shown that there are many other factors that can hinder SMEs' ability to thrive (Table A1.1).** In fact, an evaluation conducted by the Asian Development Bank found that their operations for improving the enabling business environment performed well and helped ease the cost of doing business were more effective than their support programs to increase SME's access to financing. To support this, a workshop conducted by the Centre for Strategic and Policy Studies (CSPS) as part of its Financial Literacy study also found that constraints in the general business environment and access to markets were as important in supporting SMEs.

13. **Overall, the Brunei government is committed to continuing reforms not only to improve the business environment but also to diversify the economy as a whole.** This dedication is commendable and should be continued. Empirical research has concluded that reforms are less likely in countries that have a greater abundance of natural resources because governments in natural resource-rich countries are less dependent on public taxation for their

revenue, which makes them less accountable to the people and less interested in reform. Second, the availability of large rents from the extraction of natural resources encourages rent-seeking activity at the cost of reform efforts. Third, the greater concentration of wealth that tends to accompany an abundance of natural resources works to erode social capital, a necessary ingredient for generating consensus on reform. Hence, it is important that Brunei remains consistent in its efforts and continues to be clear about its long-term economic and development goals.

Table A1.1. Major Constraints Facing Small and Medium-Sized Enterprises in Asia and the Pacific

Business Environment Constraints	Access to Finance Constraints	Access to Markets Constraints
Weak Policy and Legal Framework • Lack of unified and integrated national policy and strategy for SMEs • Lack of institutional framework for coordination and implementation • Lack of secured transactions legal framework	**Limited Access to Bank Credit** • Lack of suitable collateral • Limited capacity of SME to prepare loan documents • Banks perceive SMEs as high-risk, high-cost clients • Banks lack risk-based lending products • Restrictive lending policies (e.g. resulting from Basel III)	**Limited Access to Domestic Markets** • Market fragmentation resulting from sector and geographical disparities and segregation • Large informal sector imposing unfair competition • Unfavorable policy environment with unpredictable changes and unclear regulations
Inefficient Regulatory and Administrative Framework • Burdensome regulatory processes and procedures • High tax compliance cost (poor tax administration) • Weak governance (corruption, lack of transparency and accountability) • Poor trade facilitation (restrictive trade regulations, cumbersome custom procedures)	**Limited Alternative Funding Sources** • Lack of equity funding • Lack of risk-sharing mechanisms • Under developed leasing sector • Small non-bank financial institutions sector • Limited availability of special capital markets for SMEs	**Low Capacity to Innovate and Develop New Products** • Limited financing capacity to invest in R&D and new product development • Skills constraints (technical and managerial skills needed to manage the innovation process) • Lack of market information on customers, products, prices, and market opportunities
Weak Support Institutions • Inadequate business development services • Lack of secured transactions or collateral registry • Inadequate credit information sharing system	**Limited Financing for SMEs in Rural Areas** • Banks and financial services focus on capital cities and major urban areas	**Inability to Participate in International Markets** • Limited capacity to comply with international standards (technical, environmental, and labor standards) • Poor trade facilitation • Lack of knowledge of international markets

Source: ADB Thematic Evaluation on Support for Small and Medium Sized Enterprises, 2005-2017

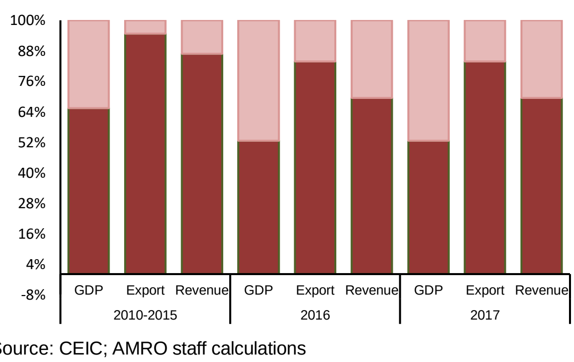
Annex 2. Potential Financial Instability amid Oil Price Fluctuations[28]

Despite its strong performance, Brunei's banking sector shows potential vulnerabilities to the fluctuations of oil and LNG prices. The analysis shows that NPLs increase when the oil price growth and credit growth decline. Based on our assessment, Brunei should consider the implementation of countercyclical macroprudential policy as a means to mitigate adverse shocks to the financial system.

1. **Brunei's macro-financial stability is highly susceptible to changes in oil prices.** As the oil sector contributes more than 60 percent of GDP, the drop in crude oil prices by over 50 percent in 2015 led to a considerable drop in Brunei's GDP, lower government revenues from oil production and lower oil export revenues. The contraction in the oil and gas sector as well as the adverse effect on the government's fiscal position also negatively affected other sectors in the economy. On the other hand, the recent oil price upturn has led to higher oil revenues and stronger fiscal and external positions. In this regard, it is important to assess the significance of oil price macro-financial linkages as it suggests that asset quality and liquidity in the financial system may deteriorate in a low oil price environment and owing to which, financial stress may emerge.

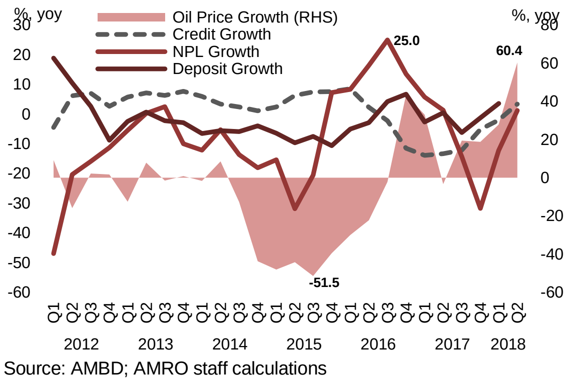
2. **The implications of the significant oil price drop in mid-2014 through macro-financial linkages have been discussed in many studies.** Earlier literature, especially that centered on the Gulf Cooperation Council (GCC) region, has argued that oil price macro-financial linkages boost corporate profitability and strengthen bank balance sheets, but can also lead to the build-up of systemic vulnerabilities in the private sector (Callen, et al, 2015). Most of this is because oil revenues influence the size of businesses and the banking system's depth. Moreover, other research showed oil prices, non-oil GDP, interest rates, stock prices and housing prices are the major determinants of NPLs across GCC banks and the overall regional financial stability (Alodayni, 2016).

Figure A2.1. Brunei GDP, Export and Revenue (2010-2017)



Source: CEIC; AMRO staff calculations

Figure A2.2. Development of Oil Price and Financial Sector in Brunei



Source: AMBD; AMRO staff calculations

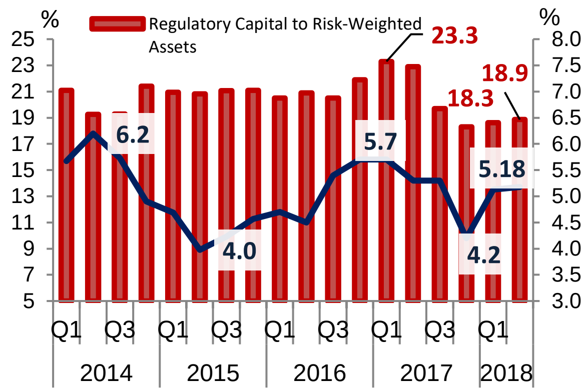
3. **A similar trend was seen in the Brunei economy and its banking system when international oil prices were fluctuating.** Figure A2.2 shows the period of falling oil prices was followed by a decrease in deposit growth, a decrease in credit growth after some lags,

[28] Prepared by Laura Grace Gabriella (Researcher)

and an increase in NPLs. In contrast, the recent increase in oil prices was followed by higher growth in deposits and credit. This implies the financial sector's procyclicality to oil prices - where a sustained decline in oil prices leads to a decline in liquidity and deposits in the Brunei banking system.

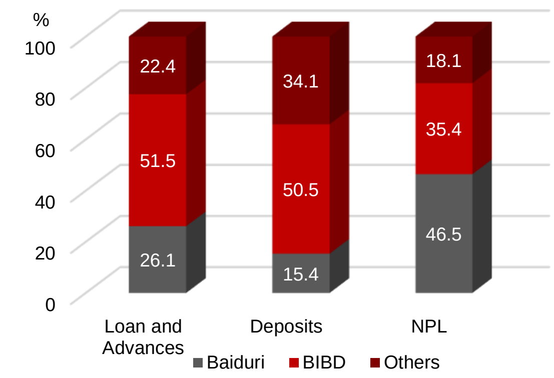
4. **Despite its strong performance, Brunei's banking sector shows potential vulnerabilities.** Brunei's banking system has remained sound, well-capitalized and liquid for a long time. However, its CAR declined from 23 percent in Q1 2017 to 18.9 percent in Q2 2018 after an increase in NPL in the previous period (Figure A2.3). In this regard, banks need to be well aware of the current increase in NPLs in 2018 that could potentially affect their capital further. However, Brunei's banking sector is still dominated by the two biggest banks, both in terms of assets as well as liquidity (Figure A2.4). In terms of deposits, Bank Islam Brunei Darussalam (BIBD) and Baiduri Bank have already accounted for 65 percent of the total deposits. Their share of credit is more than 75 percent, and their loans are mostly loans for personal consumption financing and residential property financing which also account for the highest sector for the NPL. Therefore, the authorities need to be mindful of any potential systemic risks in Brunei's banking system.

Figure A2.3. Brunei Banking Performance in NPLs and Capital to RWA (2014-2018)



Source: AMBD; AMRO staff calculations

Figure A2.4. Size Comparison of Banks in Brunei in terms FSI



Source: Banks Financial Statement; AMRO staff calculations

5. **This selected issue analyzes the impact of oil price drop to the financial sector in Brunei.** It uses a simple Vector Auto Regression (VAR) framework to assess the feedback effects among oil prices and banking variables. The results suggest that oil price-macro-financial linkages exist in Brunei.

Analysis on Oil Prices, NPLs and Credit Risk

6. **In order to analyze the oil price-financial linkage, a VAR model is implemented to assess the feedback effects between oil prices and financial variables.** The data that is used in this analysis are the oil price, NPL, and bank credit from 2011 to 2018 in quarterly frequency. The model is as follows:

$$Y_{i,t} = \Sigma\, A\, Y_{i,t-i} + c_{i,t} + u_{it}$$

where $Y_{i,t}$ is a vector of endogenous variables at time t, where $i = 1, \dots, 5$; and $t = 1, \dots, T$, $c_{i,t}$ is a constant, and u_{it} are i.i.d residuals. The endogenous variables are oil price growth, NPL growth and credit growth. Moreover, a simple cross correlation shows that there is a negative correlation of 0.408 between oil price growth and NPL growth in the lag 4 quarter, and positive correlation 0.206 between oil price growth and credit growth in lag 5 quarter.

7. **The VAR results reveal that NPLs increase when oil price growth and credit growth decline.** As oil price growth decreases by one percentage point, it results in an increase of 0.367 percentage points in NPL growth. In contrast, a one percent decrease in oil price growth will decrease credit growth by 0.046 percentage points.[29] When oil prices are elevated, with better revenues, higher government spending stimulates the economy, leading to greater banking sector liquidity and credit growth because of a positive wealth effect. However, when oil prices drop, the reverse happens. The results indicate the need for macroprudential policy as a means to mitigate the adverse shocks, in addition to other policy options. This result is consistent with the results seen in GCC countries.

Table A2.1. Financial Linkages between Oil Prices, NPL, and Credit Growth

Adverse Shock to	Oil Price Growth	NPL Growth	Credit Growth	R-squared	Adj R-squared
Response of					
NPL Growth	↑ 0.367			0.705	0.152
Credit Growth	↓ -0.046	↑ 0.156		0.791	0.399

Note: Model uses VAR with five lags. Data is using quarterly data 2011-2017. Bank level data for NPL and credit. Numbers represent a percentage response to a 1 percent decline of oil shocks.
Source: AMRO staff calculations

8. **However, there are a few caveats in interpreting these results.** There are limitations because the 2011–2018 time frame may not be sufficiently long enough for oil price and financial cycles. With current data, only correlations between oil price and NPL ratio growth and real credit growth can be seen. As more data is collected, correlations between oil price and deposit growth and housing prices can be analyzed.

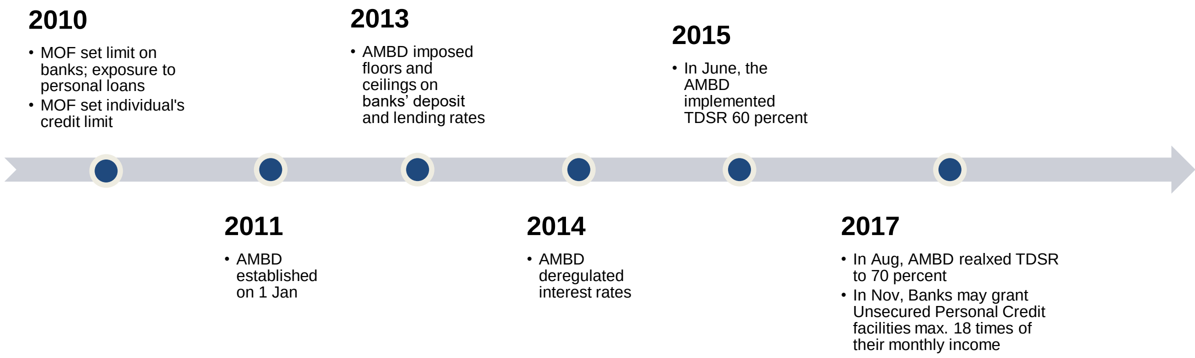
Implementation of Macroprudential Policy in Brunei Darussalam

9. **Brunei has been using macroprudential instruments in the past few years to address personal indebtedness in the country.** This started in 2010 when the Ministry of Finance set the 30 percent credit limit for personal loans. In March 2013, the AMBD imposed floors and ceilings on banks' deposit and lending rates.[30] Banks could not charge more than 4.5 percent on residential property loans, 5 percent on consumer loans (excluding credit cards), 6

[29] Detailed information on the model estimation is available upon request.
[30] Credit floors/ ceilings are not a traditional macroprudential policy, but can be regarded macroprudential tools in Brunei's case.

percent on corporate loans, and 7.5 percent on salary and pension loans. The minimum rates on savings deposits were set at 0.15 percent and between 0.20 percent and 0.75 percent for 1-month and 12-month time deposits respectively. During that time, the AMBD did not specify loan-to-value (LTV) ratios or debt-to-income (DTI) rules, nor did it mandate collateral values for mortgages, preferring to merely monitor these matters. Onsite and offsite monitoring is done on a regular basis; a complete onsite examination, lasting 3–6 months has just been completed.

Figure A2.5. Timeline of Macroprudential Policy in Brunei



Source: AMRO staff compilation

10. **More recently, Brunei has set up the macroprudential surveillance unit with as an ad hoc group called financial stability committee.** Previously, Brunei only used the CAMEL framework to regulate banks. More recently, the AMBD implemented a Total Debt Service Ratio (TDSR) on 8 June 2015 to limit borrowers' monthly total debt obligation as a proportion of monthly income. The maximum TDSR is set at 60 percent for borrowers with minimum monthly income of BND1,750, while borrowers with monthly income below BND1,750 are subjected to financial institutions' internal policies. The AMBD also amended the Notice of the Regulation of Interest/ Profit Rates and Deposit Rates issued to all licensed banks and Perbadanan Tabungan Amanah Islam Brunei (TAIB), which allows banks to price their lending/ financing rates based on their internal risk appetites and borrowers' creditworthiness, as well as to price their deposit rates according to their funding needs.

Policy Discussions

11. **Brunei should consider implementing countercyclical macroprudential policy because results from the analysis show procyclicality between credit growth and oil prices as well as increasing liquidity risk if the oil shock is persistent.** The countercyclical macroprudential policy instrument is expected to slow credit growth in the boom periods and to reverse during busts. Since the economy is still heavily dependent on the oil sector, the recovery in oil prices will be followed by higher credit growth. Therefore, the current implementation of the maximum loan to limit the size of unsecured personal loan (18 times of net monthly income) is followed with the regulation on the Minimum Cash Balance (MCB) in order to stimulate the domestic property market through bank lending that also enables banks to smoothen the temporary liquidity fluctuations at the same time. By implementing countercyclical macroprudential tools, Brunei can also supplement its monetary and fiscal policies to prevent oil price booms and busts from causing serious harm to the overall economy. In view of more economic diversification in the near future, vulnerabilities to external

shocks with widespread effects on the domestic financial system highlight the usefulness of macroprudential instruments.

12. **Brunei's pegged exchange rate regime through the currency board system makes macroprudential policy the main countercyclical tool to support fiscal policy.** Research has argued macro-financial linkages can amplify the effect of oil price movements over a financial cycle, showing the importance of macroprudential policy in supporting macroeconomic stability. In other words, macroprudential policy and strong supervision of the financial sector are necessary to complement fiscal and monetary policy frameworks, especially because of the Brunei dollar's peg to the Singapore dollar. In countries with a fixed exchange rate, macroprudential policy has a more important role to play in managing financial stability risks, given the volatility of the economic and credit cycles and the limited scope for an independent interest rate policy (Arvai, et al, 2014). In recent years, fiscal policy has been Brunei's main tool in managing the economy through the ups and downs of the business cycle. However, given the time lag in implementation and stickiness in expenditure, fiscal policy may not be flexible enough to prevent credit booms and the buildup of systemic risk in the financial sector. In this regard, macroprudential policy needs to play a much bigger role in supporting fiscal policy in managing financial cycles associated with oil prices.

13. **Moving forward, efforts to diversify the economy and reduce its high dependence on oil and gas sector will affect the implementation of macroprudential policy.** As most countries have experienced, macroprudential policies evolve depending on the particular circumstances faced by the country, such as shock type, the structure of the economy and the institutional set up. Along with the evolution of the financial system and overall economic environment, the AMBD might require tighter prudential regulation. Therefore, the diversification strategy that is actively undergoing reforms in line with Wawasan 2035 is expected to significantly change the macro-prudential policy direction.

Table A2.2. Countercyclical Macroprudential Policy in Oil-exporting Countries

Country	Capital	Liquidity	Sectoral	Exposure
Saudi Arabia	X			
Kuwait			X	
Algeria		X	X	
Azerbaijan	X	X	X	
Brunei			X	
Canada		X		
Chile		X	X	
Indonesia			X	
Kazakhstan	X			
Malaysia			X	X
Mexico			X	
Norway			X	

Notes: Capital tools: Leverage ratio; Liquidity tools: Loan to Deposit Ratio, Liquidity Requirements; Sectoral Tools: Concentration Limit, Loan-to-Value Ratio, Debt-to-Income Ratio
Source: Al-Darwish, et al (2015)

14. **In addition, Brunei could learn from the implementation of countercyclical macroprudential policy in other oil producing countries.** As macroprudential policy instruments are used to mitigate systemic risks, previous research, such as by Lim, et al (2011) argues the effectiveness of instruments does not depend on the exchange rate regime or the size of the financial sector, but rather, the types of shocks. In the empirical experience, most oil exporting countries usually use sectoral macroprudential instruments- which could be more targeted towards specific sectors that become sources of risk. This is in line with the TDSR and credit limits that the AMDB has already put in place.

15. **Brunei has taken forward-looking steps by enhancing its macroprudential policies.** Based on sectoral tools, the vulnerabilities from excessive credit to the household sector and procyclical feedback between credit and asset price can be addressed through sectoral capital requirements, LTV and DTI limits. Despite the banking sector already having strong capital and abundant liquidity, the authorities have taken initiatives to prevent systemic risks. Going forward, the AMBD should continue to monitor the performance of the financial sector closely to enable further growth and development of the sector while maintaining financial stability by working with relevant stakeholders.

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