2018/SVL/BN/01

AMRO Annual Consultation Report

Brunei Darussalam - 2017

The ASEAN+3 Macroeconomic Research Office (AMRO)

January 2018

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 its members on their 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 the Annual Consultation Visit of AMRO to Brunei Darussalam from October 30 to November 3, 2017 (Article 5 (b) of AMRO Agreement). The AMRO Mission team was headed by Dr Seung Hyun (Luke) Hong, Group Head and Lead Specialist. The team members also included Dr. Abdurohman (Specialist), Dr. Xianguo Huang (Economist), Ms. Siti Athirah Ali (Economist), and Ms. Thanh Ha Truong (Associate). AMRO Chief Economist Dr. Hoe Ee Khor also participated in key policy meetings with authorities. This AMRO Annual Consultation Report on Brunei Darussalam for 2017 was prepared by Dr Seung Hyun (Luke) Hong, Dr. Abdurohman, Dr. Xianguo Huang, Ms. Siti Athirah Ali; peer reviewed by Dr. Chaipat Poonpatpibul (Group Head and Lead Economist) and Ms. Wanwisa Vorranikulkij (Specialist); and approved by Dr Hoe Ee Khor, AMRO Chief Economist.

3. The analysis in this Report is based on information available up to 31 December 2017.

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

In the 2016 AMRO annual consultation report on Brunei, AMRO staff were of the view that the risk to economic growth emanated mainly from the oil and gas-related factors: unexpected disruption in oil and gas production due to matured oil fields and the prolonged-period of low oil prices. The disruption in oil and gas production in H2 2016 had led to a sharp contraction of the economy. Since the 2016 report, the economy has shown signs of improvement as GDP growth has been trending up with a gradual recovery in oil and gas production and the progress in the implementation of major infrastructure and FDI construction projects. On the external side, despite an improvement in exports, the trade surplus has continued to shrink on account of stronger imports as major construction projects are progressing. The fiscal position is expected to improve markedly, going forward. The authorities have made significant progress in containing the budget deficit, but it is crucial to continue efforts to enhance spending efficiency and to carefully rebalance public resource allocation. The fiscal position can be further supported by efforts to diversify revenue sources. Continued diversification efforts to broaden the economic growth base will be critically important to bolster resilience and long-term sustainability.

The Brunei economy has been in a downturn over the past four years, but has been showing signs of improvement recently. The low oil price and still slow oil and gas production, due to the ongoing maintenance and rejuvenation works of ageing offshore facilities, had dragged GDP growth into negative territory for the past four years. In the first three quarters of 2017, however, there have been signs of improvement as GDP growth has been trending up and returned to positive territory. The gradual recovery in oil and gas production and the implementation of major infrastructure and FDI construction projects is expected to restore positive GDP growth in 2017, which should accelerate further in 2018.

Consumer prices declined for three years in a row on account of lower imported prices and sluggish domestic demand. Inflation rate remained negative in 2016, but has bottomed out since early 2017, although it is still negative. For the whole of 2017, the inflation rate is expected to remain negative, albeit less so compared to 2016, and is expected to turn positive in 2018.

On the external side, the current account surplus is expected to narrow further as major infrastructure and FDI construction projects are progressing. The current account surplus narrowed sharply in 2016 as exports contracted with the collapse in oil prices. While exports are projected to increase with the modest recovery in oil prices, imports are expected to increase even more with the implementation of large infrastructure and FDI construction projects. As a result, the current account position will continue to weaken towards 2018 but will start to improve from 2019 onwards as downstream oil & gas industries begin commercial production and export.

The fiscal position is expected to improve markedly in 2017 with significantly restrained spending and a modest recovery in oil prices. Despite significant cuts in spending, the budget deficit widened considerably during the last three years, reflecting an even sharper decline in oil and gas revenue. Starting with 2.7 percent of GDP in the FY2014, the fiscal deficit widened to 15.4 percent and 19.3 percent of GDP in FY2015 and FY2016 respectively. With a modest recovery in oil prices and further cuts in current spending, the fiscal deficit is estimated to narrow to 12.1 percent of GDP in FY2017. Despite the large deficits, the authorities have been able to finance the deficits by drawing down their ample fiscal reserves that were built up during the oil boom years.

The banking system remained well-buffered overall in a challenging environment. Asset quality had deteriorated since H2 2015 on the back of a weakening domestic economy, with the gross non-performing loans/financing (NPLF) ratio trending upwards until recently. However, the aggregate gross capital adequacy ratio stood at 19.7 percent as of Q3 2017, which is well above the 10 percent minimum requirement under the Banking Order 2006 and Islamic Banking Order 2008. In addition, the banking industry remained highly liquid as reflected in the relatively high liquid assets-to-total assets ratio.

Risk and Vulnerabilities

Oil and gas-related factors remain the main risks to Brunei's economic outlook in the near- to medium-term. The first of the two main risks related to the oil and gas sector is that the existing fields are matured and as the rejuvenation work may take several years, the oil and gas sector is therefore more susceptible to production disruptions. Second, the prospect of a prolonged-period of low oil prices could weaken the commercial viability of Brunei's plan to increase oil and gas production. This will result in an investment slowdown, which in turn, will affect Brunei's growth prospects going forward.

Given the relatively large government contribution to the economy, the spillover from a further cut in fiscal spending also poses additional risks to the growth outlook. The government sector plays a substantial role in the economy as reflected in GDP both on the expenditure and production side. Given the government's substantial contribution to the economy, a further cut in government spending, especially in capital spending, will have a negative spillover on the rest of the economy.

Policy Recommendations

The government should continue to enhance its efforts to diversify and broaden the economic growth base to bolster resilience and long-term sustainability. Even though diversification efforts have shown some positive results such as the remarkable improvement in the World Bank's ease of doing business ranking, much remains to be done. The government should continue to broaden the growth base in order to enhance resilience and long-term sustainable growth. In addition, given that its economy is relatively small, efforts to enhance global market access should continue, in particular through further improvement in logistics to facilitate international trade as logistics in Brunei are relatively poor as compared to neighboring countries. In the labor market, the government should continue its initiatives to address diverse structural issues such as the skills mismatch, and the disparity in wages and benefits between the public and private sectors.

Efforts to strengthen the fiscal position should be continued. The authorities have made significant progress in containing and reducing the budget deficit in the past few years. Any further reduction in the fiscal deficit can be better achieved by enhancing revenue while containing expenditure growth. Efforts to diversify revenue sources are crucial to bolster long-term sustainability going forward. Drawing from other countries' experience, consideration could be given to the introduction of a broad-based tax such as the GST at a low rate. Continued efforts to enhance spending efficiency are advisable, while keeping fiscal policy supportive of economic activities. A carefully calibrated reprioritization toward more growth-enhancing spending will be critically important to mitigate the adverse growth impact as the substantial fiscal adjustments continue.

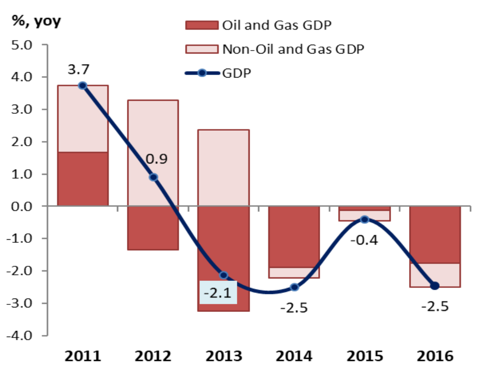
A. Recent Developments and Outlook

A.1 Real Sector

1. **On the back of faltering oil and gas production, Brunei's economy continued its negative GDP growth trend in 2016, recording a bigger contraction after a slight improvement in 2015.** The low oil price and still slow oil and gas production, due to the ongoing maintenance and rejuvenation works of ageing offshore facilities, had pushed GDP growth into negative territory for the past four years. After a short period of improvement in 2015, oil and gas productions contracted again by 3.0 percent in 2016, leading to a negative economic growth of -2.5 percent, down from -0.4 percent in 2015 (Figure 1). The non-oil and gas sector has been also in contraction as it has close linkages with the oil and gas sector and relies on government contracts.

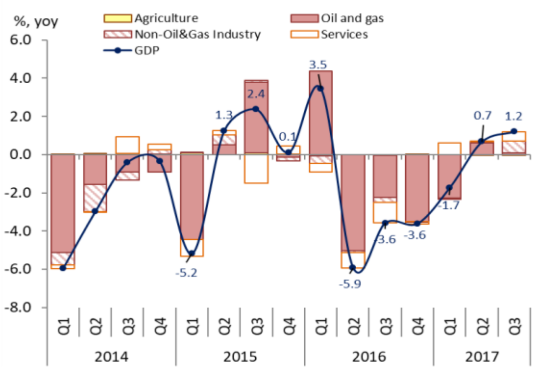
2. **In 2017, the economy showed signs of improvement on the back of a gradual recovery in the oil and gas production.** Since its lowest dip in Q2 2016, GDP growth has been trending up and turned positive at 0.7 percent in Q2 2017 and strengthened further in the following quarters on the back of a gradual recovery in oil and gas production. (Figure 2) On a yoy basis, oil production in Q1 and Q2 2017 recorded 7.2 and 4.1 percent growth respectively, compared to the same period last year. Even though its growth rate is still in negative territory, gas production seemed to have bottomed out and approaching positive territory in Q2 2017 (Figure 3). Services and the non-oil and gas industry, in particular construction, also recorded improvement in 2017.

Figure 1. Annual GDP Growth



Source: DEPD, AMRO staff calculations

Figure 2. GDP Growth Component: Production

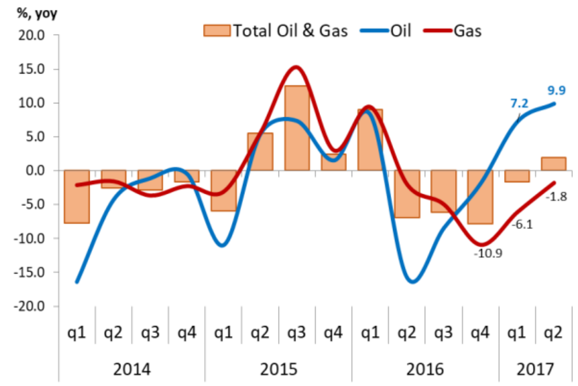


Source: DEPD, AMRO staff calculations

3. **On the expenditure side, the economy received a boost from government consumption and investment in 2017.** In Q1 and Q2, government consumption grew by 7.8 and 23.5 percent respectively, Over the same period, investment, comprising mainly private investment, continued to accelerate with growth reaching 14.1 percent in

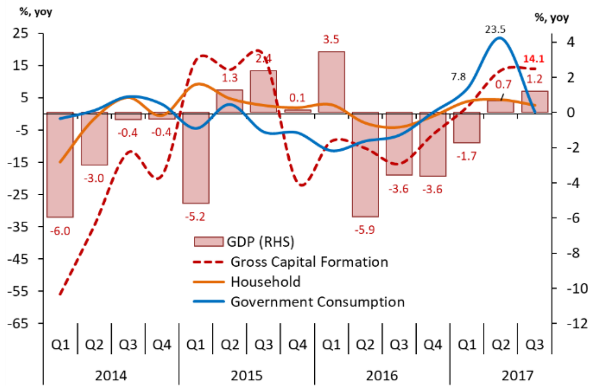
Q3 (Figure 4), owing to progress in the infrastructure and FDI construction projects, notably the construction of Temburong Bridge and Hengyi refinery facilities (see detail in Box A).

Figure 3. Oil and Gas Production



Source: DEPD, AMRO staff calculations

Figure 4. GDP Growth Contribution: Expenditure



Note: 2017P and 2018P are based on AMRO staff projections
Source: DEPD, AMRO staff calculations

4. **The government's efforts to diversify the economy away from its high reliance on oil and gas and to attract more FDI companies has begun to yield some positive results.** In late 2015, the government established FAST (FDI Action and Support Centre) and DARE (Darussalam Enterprise) to facilitate FDI and to support the development of domestic SMEs respectively. FAST provides well-coordinated and streamlined FDI facilitation regarding regulatory and business environment issues. Meanwhile, DARE facilitates a conducive ecosystem by providing a range of services to build MSME capacity and encourage their contribution to the Brunei economy. The diversification efforts have started to show positive results. Brunei is among the countries with the biggest improvement in the World Bank's ease of doing business rankings, jumping from 101 in 2015 to 56 in 2018. Such improvement in the business environment has also helped Brunei attract more FDIs.

Box A. Two Ongoing Mega-Projects to Support Economic Diversification Efforts

A number of large-scale construction projects are currently underway in Brunei, that are expected to benefit the economy significantly by attracting and facilitating FDI, enhancing connectivity and generating considerable value added for the economy.

The first mega project is a BND1.6 billion Temburong Bridge project. It is a government infrastructure project consisting of a dual two-lane highway crossing over the Brunei Bay, approximately 30 kilometers in length. It will connect the relatively isolated district of Temburong to three other districts. The connection will shorten significantly the travel time between the Brunei Muara District and the Temburong District—which is currently separated by Malaysian territory.

Construction work for the Temburong Bridge project started in early 2016 and is expected to be completed by end of 2019. The project is divided into six separate contract packages: CC1 (Mentiri tunnels, 3.6 km); CC2 (marine viaducts, 13.4 km); CC3 (navigation bridges of 1.1 km); CC4 (Temburong viaduct, 11.8 km); CC5A (traffic control and surveillance system, supervisory control and data acquisition systems, and road lighting); and CC5B (a power supply system). Currently, the project is executing three contract packages costing around BND1.3 billion which are the main construction works of the bridge; CC2, CC3 and CC4.[1] Upon completion, the Temburong Bridge will directly connect the main area of Brunei to Temburong district which will shorten considerably the travel time from around 1.5 hours to only 20 minutes by land.[2]

The second mega project—the most significant downstream project under development—is the Hengyi oil refinery and petrochemical plant at Pulau Muara Besar (PMB). The plant is being developed in two phases with the first phase worth around USD3.4 billion currently underway, while the second phase is expected to commence in 2019 with additional investment of around USD12 billion. The refinery and petrochemical plant are owned by the Hengyi Industries Sdn. Bhd., which is 70:30 joint venture between a Chinese firm Zhejiang Hengyi Petrochemical and the government of Brunei Darussalam. The first phase of the project will include an oil refinery producing gasoline, diesel and jet fuel with a capacity of 175,000 barrel per day (bpd). It will also produce by-products such as naphtha, para-xylene, and benzene. With regards to the output, Brunei will offtake 10 percent of the petroleum products from the refinery to meet domestic demand.

Despite some delays, phase I of the refinery and petrochemical plant is expected to be fully operational in Q1 2019. The plant's first phase was initially scheduled for completion in 2015, but faced some delays due to slower development of supporting infrastructure such as the bridge connecting Pulau Muara Besar with the mainland, water utilities and power plant. During AMRO's site visit to PMB in early November 2017, the Hengyi Industries representatives were very optimistic about completing the construction of the refinery of phase I by November 2018 to start production in Q1 2019.

The refinery and petrochemical project is expected to have substantial impact in the near-term and shape Brunei's economic future. With such a large-scale investment, the project will boost significantly aggregate demand and create a large number of jobs. There will be greater impact on growth when Hengyi Industries starts exporting in 2019. This mega project will go a long way towards meeting the government's ambitious targets for the downstream segment to produce BND21 billions of output (almost 1.5 times of the 2016 GDP) and BND5 billions of value added (32 percent of the 2016 GDP) annually by 2035, as set out in the "Energy White Paper". In addition, the refinery project will further substantiate the government's efforts to diversify the economy.

5. **The authorities has recently undertaken various measures to tackle the structural challenges in the labor market.** In line with the diversification strategy, the government has made organizational changes to tackle labor market issues. In early 2016, the Manpower Planning Council (MPC) was set up along with the supporting secretariat, the Manpower Policy and Planning Unit (MPPU). The main task of MPPU is to formulate policies which ensure sufficient skilled labor is supplied to match demand. Data collection on the labor market is also now being centralized at the MPPU through the JobCentre Brunei portal where all companies and jobseekers are required to register into the system.

[1] The contract of CC2 and CC3 are awarded to a Brunei – Korea joint venture company, Daelim Swee Sdn Bhd, costing BND600 million and BND276 million, respectively. Meanwhile, CC4 is undertaken by the China State Construction Engineering Corporation Ltd (CSCEC), worth around BND447 million.

[2] At present, traveling from Brunei Muara to Temburong Districts has to pass Limbang (Malaysia territory) and four immigration checkpoints which are frequently congested.

Based on the JobCentre database, unemployment rate as of September 2017 was around 5.2 percent, significantly lower than the 6.9 percent in 2014[3]. The decline in the unemployment rate has mainly been due to new job creation and training and apprenticeship programs undertaken by the government since early this year, in particular the “I-Ready” and the “Center for Capacity Building (CCB)” programs launched in 2017 (see Box B).

Box B. Some Initiatives to Tackle Structural Challenges in the Labor Market

According to the Brunei Darussalam Statistical Yearbook 2015, the unemployment rate stood at 6.9 percent and the youth unemployment rate 25.3 percent. In response to this, the Manpower Policy and Planning Unit (MPPU) was established under the Energy and Industry Department of the Prime Minister’s Office, with the objective of taking initiatives to reduce unemployment as well as to increase the employability and marketability of the local workforce.

The JobCentre Brunei portal acts as a one-stop shop to match available jobseekers with companies that are hiring. Jobseekers are encouraged to submit their particulars and relevant details into the JobCentre Brunei portal. According to the data collected, the unemployment rate as of September 2017, is estimated to be around 5.2 percent. On the other hand, since August 2016, it has been compulsory for all companies in the private sector to register and advertise any vacant positions through this portal.

The significant decline in the unemployment rate in Brunei Darussalam can be attributed to several policies and initiatives taken by the MPPU. From October 2016, the process of foreign worker work permit applications and renewals was changed to encourage the hiring of locals. While previously, companies could apply for or renew their existing quotas to hire foreign workers at the Ministry of Home Affairs, the compulsory advertisement of vacancies via the JobCentre Brunei portal, provides the companies with local talents first before they resort to hiring foreign workers.

Other initiatives related to training and increasing the capacity of the workforce are also ongoing. The Centre for Capacity Building started operations in September 2017, providing 3-to-6-month programs to allow jobseekers to be reskilled in certain fields such as scaffolding, rigging, steel craft and woodcraft. Successful applicants will also receive a conditional offer of employment in the private sector after completing the training. In the first batch, the Centre saw 633 people enrol. The second intake, which will start in January 2018, consists of 852 trainees. The Centre for Capacity Building is expected to increase the number of programs available from December 2017 onwards and is expected to increase its capacity to accommodate more trainees in 2018.

Partnership with local institutions such as the Institute of Brunei Technical Education is also to improve the skillset of the local workforce. The Energy Industry Competency Framework, focusing only on the capacity-building of those working in the energy industry, has been expanded to the Industry Competency Framework program, which now includes other sectors such as construction, hospitality, tourism, transportation and logistics. The programs, which are 18-month long, are longer than those offered at the Centre for Capacity Building; and those who are enrolled and have successfully completed these programs are eligible for conditional employment offers to work in the participating companies. To enhance the effectiveness of the programs and avoid unnecessary oversupply of skills, the MPPU works with industry players to ensure that there is demand for specific skillsets before the program is offered to the trainees.

The i-Ready program is a 3-year apprenticeship program to gain experience in a real working environment. The program, initiated by the PMO in April 2017, is fully funded by the government, where apprentices are paid BND800 a month when they secure a position in a

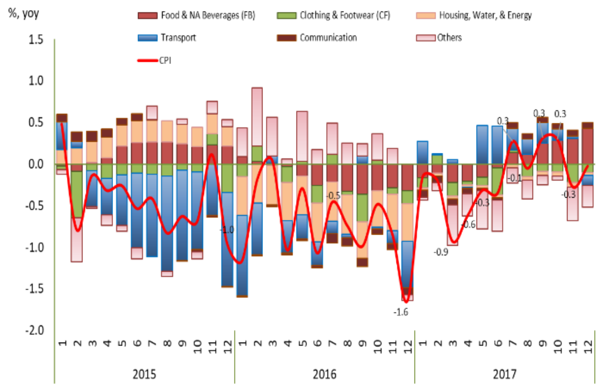
[3] The estimate was based on labor force forecast which include both local and foreigners, whilst the numerator includes only the local unemployment. The latest available data on unemployment rate is based on the labor survey data in 2014 which recorded the unemployment rate at 6.9 percent.

company under the i-Ready program. In a way, this program is an incentive for local companies to register with the JobCentre Brunei portal as they can hire graduates through this program. However, there is a quota of about 1,562 spots every year that can be filled by companies with the budget that was provided by the government. As of October 2017, there were 1,111 jobseekers who have already been deployed into the workforce, 47 of whom have already secured full-time positions at the respective agencies. The MPPU conducts 6-month reviews to assess the performance of these apprentices and to check whether the company can hire them full-time. This will allow other companies to apply for a spot in the i-Ready program and another jobseeker to be deployed into the workforce.

A.2 Inflation

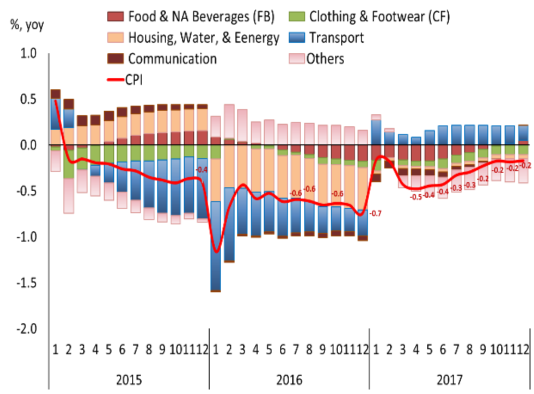
6. **Inflation remains negative, but has gradually bottomed out with the improvement in domestic economic activities.** Inflation remained negative at -0.7 percent in 2016, lower than -0.4 percent in 2015. In 2017, CPI inflation started to bottom out, recording a positive inflation rate (yoy) in H2 2017 (Figure 5). The recent improvement in CPI inflation has been driven mainly by rising transportation costs, in particular air transportation and the purchase of vehicles. For the whole year of 2017, inflation rate was at -0.2 percent, compared to -0.7 in the previous year (Figure 6). The inflation rate is likely to turn to positive in 2018 with growing domestic demand.

Figure 5: Monthly Inflation Rate (yoy)



Source: CEIC, AMRO staff calculation

Figure 6: Average Inflation Rate (ytd)



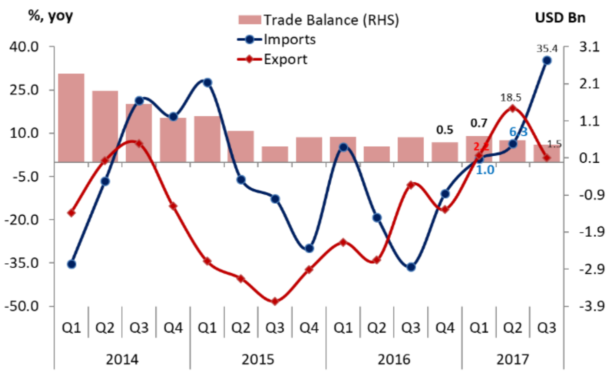
Source: CEIC, AMRO staff calculation

A.3 External Sector

7. **The trade balance has remained in surplus but continued to narrow as exports contracted faster than imports.** Oil and gas exports, which account for more than 90 percent of total merchandise exports, remained in contraction due to low oil and gas prices in 2016. With a modest recovery in oil prices and production in 2017, export growth has trended up and turned to positive in 2017 (Figure 7). Import growth also returned to positive territory and surged in 2017 owing to implementation of the infrastructure and FDI construction projects. Going forward, while exports are projected to increase with a

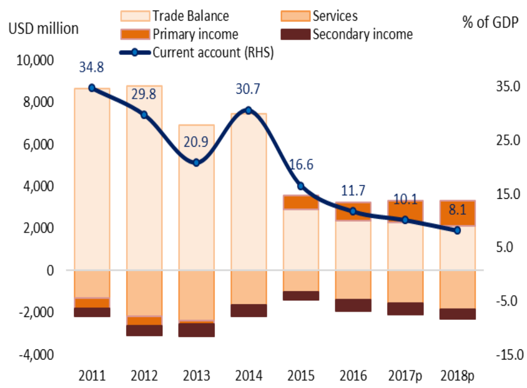
modest recovery in oil prices, imports are expected to increase even more as the implementation of infrastructure and FDI construction projects progresses.

Figure 7: The Trade Balance



Source: DEPD, AMRO staff calculations

Figure 8: Current Account Balance



Source: DEPD, AMRO staff calculations

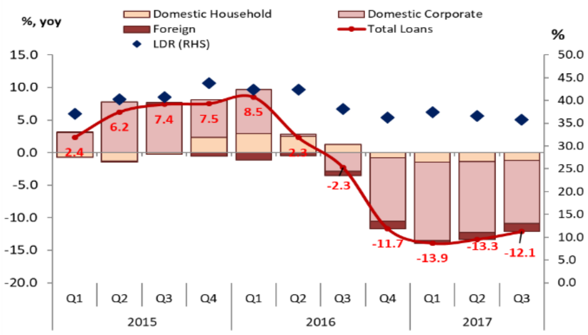
8. **The current account surplus continued to narrow.** As the trade surplus continued to shrink while the services and secondary income account remained in deficit, the current account surplus narrowed sharply to 11.7 percent of GDP in 2016 compared to 16.6 percent of GDP in 2015 (Figure 8). The current surplus is expected to weaken further in 2017 and 2018, to 10.1 percent and 8.1 percent of GDP, respectively, reflecting the implementation of the Temburong bridge and the Hengyi oil and gas refinery construction projects. From 2019 onwards, however, the current account is projected to improve sharply as major construction projects are completed and the downstream industries begin commercial production and export. The overall external position, however, remains relatively strong. The current level of international reserves can cover more than six months of imports of goods and services, and is expected to increase markedly after the downstream industries begin production and exports from 2019 onwards.

A.4 Financial Sector

9. **Credit to the private sector has contracted, reflecting the economic slowdown.** Bank loans to the private sector have been contracting since Q3 2016, driven mainly by corporate loans on account of subdued domestic economic activities. As of Q3 2017, bank loans/ financing recorded a sharp decline of 12.1 percent yoy. In addition to subdued domestic economic activities, the repayment of outstanding loans/ financing by large corporations also contributed to the decline. Loans to domestic corporate sector alone contributed -9.7 percentage points to the decline in total bank loan growth in Q3 2017, while the rest was shared equally between loans to household and foreign borrowers (-1.2 percentage points each) (Figure 7). Within corporate lending, manufacturing was the

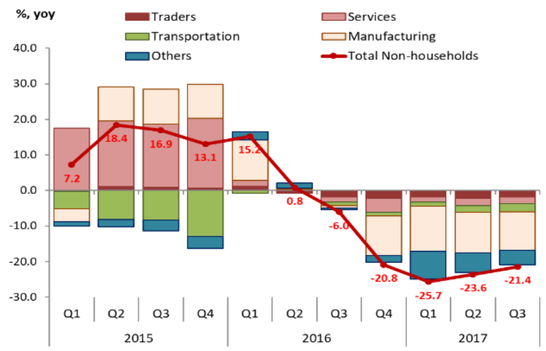
biggest contributor to the decline in loan growth, followed by transportation and traders sector (Figure 8). In the household sector, the relaxation of several regulations on personal loans in late 2015 led to an initial expansion in bank lending to households until H1 2016[4], but reverted to a contraction from late 2016. Further easing of TDSR (Total Debt Service Ratio) was taken by AMBD in H2 2017 to stimulate bank lending, especially for the property sector.[5] In addition, AMBD continued to review the regulatory framework to provide more supportive financial sector services through the amendment of the March 2013 Notice on the regulation of interest/ profit rates to deregulate most of the lending/ financing and fixed deposit rates in May 2017 .

Figure 7. Bank Loan Growth



Source: AMBD, AMRO staff calculations

Figure 8. Corporate Loan Growth



Source: AMBD, AMRO staff calculations

10. **The overall banking system remains sounds amid challenging environment.** The aggregate gross capital adequacy ratio, measured with the Regulatory Capital to Risk Weighted Assets Ratio (CRWA ratio), stood at 19.7 percent as of Q3 2017, which is well above the 10.0 percent minimum requirement under the Banking Order 2006 and Islamic Banking Order 2008. In addition, the banking industry remained highly liquid as reflected in the relatively high liquid asset to total assets ratio, which stood at 51.8 percent in Q3 2017 (Figure 9). Although it has improved slightly recently, the asset quality had deteriorated from H2 2015 to early 2017 on the back of weakening domestic economy, with the gross NPLF ratio on an upward trend (Figure 10). Banks, however, have maintained relatively high level of provisioning to buffer against losses.[6]

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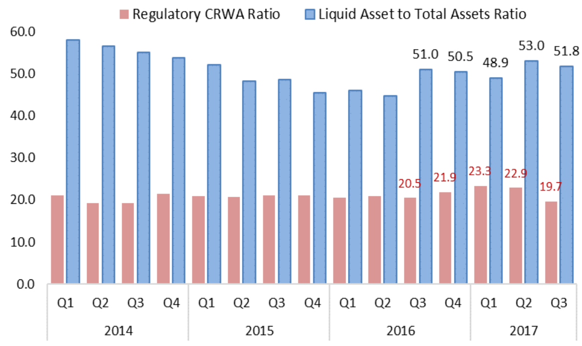
[4] Since October 2015, credit card issuance no longer requires clients to assign their salary or place a deposit under lien to the credit card issuing bank. The amendment on personal loans was on the expansion of what would fall as part of the borrower's 'gross monthly income', which includes rental and business income for sole proprietors. The authorities also allow an individual to restructure or top up his/ her loan after 50.0 percent of the original tenor has lapsed subject to certain conditions on the borrower's payment history. Another significant amendment in terms of personal loans was the withdrawal of the directives on minimum down payment for car loans at 12.5 percent of the price of a car.

[5] In August 2017, AMBD issued an amendment to the Notice on TDSR to increase the TDSR limit from 60.0 percent to a maximum of 70.0 percent for new credit/ financing facilities to finance the purchase or construction of properties. In November 2017, a further amendment was made to allow flexibility for relevant financing institutions to exceed the regulated TDSR limit under certain circumstances for mortgage equity credit/ financing facilities.

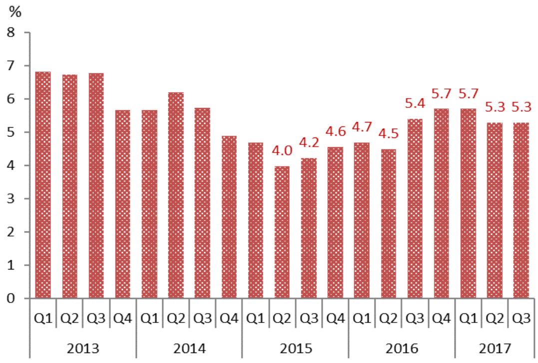
[6] As of Q3 2017, provision coverage, which are specific provision to total NPLFs, stood at 54.3 percent.

Figure 9. Capital Adequacy and Liquidity Ratio



Source: AMBD, AMRO staff calculations

Figure 10. Non-Performing Loans Ratio



Source: AMBD, AMRO staff calculations

11. **The impact of the HSBC exit on the Brunei banking sector appears to be limited**. The exit of HSBC, one of the major players in the financial market in Brunei, seems to have been well-managed and proceeded in an orderly manner. No significant disruption of banking services has happened so far. The transfer of its deposits to other banks has been carried out smoothly with AMBD's facilitation. In addition, the entry of Bank of China, Hong Kong Limited (BOCHK), a large Chinese bank, is expected to help maintain diversity in the system.

12. **In parallel with Wawasan Brunei 2035, AMBD launched the Financial Sector Blueprint in early 2017 to guide the development of financial sector in the next 10 years.** It sets out the strategic framework within which AMBD will be working with other ministries and stakeholders to achieve the objectives of Wawasan Brunei 2035. It lays out the medium-term roadmap on how Brunei's financial sector will be developed in the next 10 years based on five key pillars: (i) monetary and financial stability, (ii) competitive and innovative financial institutions and services, (iii) robust and modern infrastructure, (iv) enhanced international integration, and (v) human capital development.

A.5 Fiscal Sector

13. **Budget pressures continue, despite a modest recovery in oil prices and substantial government spending cuts.** Over the past three years, the budget deficit has been very large and increasing along with the decline in oil and gas revenue. Starting with 1.0 percent of GDP in FY2014, the fiscal deficit widened sharply to 15.4 percent and 16.6 percent of GDP in FY2015 and FY2016 respectively, on account of a sharp decline in oil and gas-related revenue. With a modest recovery in oil prices and continued restraint in current spending, the FY2017 budget projects a narrower but still large deficit of around 10.6 percent of GDP. Owing to the high reliance on oil and gas revenue, the fiscal position

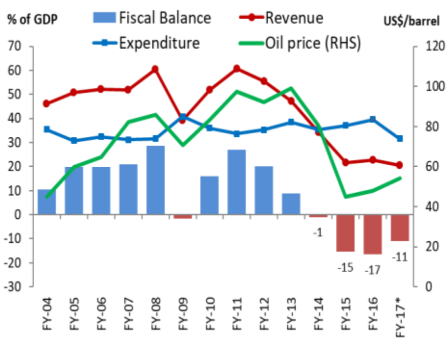
is closely correlated with global oil price movements, leading to a structural vulnerability to external oil price shocks. However, the ample fiscal reserves accumulated from fiscal surpluses in past decades have enabled Brunei to finance the deficits without difficulties.[7]

Table 1. Fiscal Development

Items	Nominal Value (BND millions)			Nominal Growth (%)		
	2015/16	2016/17	2017/18[B]	2015/16	2016/17	2017/18[B]
Total Government Revenue	**3,709**	**3,616**	**3,913**	**-47.6**	**-2.5**	**8.2**
Oil and Gas Revenue	2,757	2,584	2,799	-55.1	-6.3	8.3
Non-oil and gas Rrevenue	952	1,032	1,115	1.6	8.4	8.0
Taxes	427	346	479	-15.5	-19.0	38.4
Fees, Charges, Rent and others	525	686	636	21.6	30.6	-7.3
Total Expenditure	**6,338**	**6,252**	**5,689**	**-13.0**	**-1.4**	**-9.0**
Current Expenditure	*4,980*	*4,965*	*4,686*	-9.0	-0.3	-5.6
Charged Expenditure	1,145	1,100	1,086	-19.8	-4.0	-1.3
Personal Emoluments	1,985	1,978	1,926	0.0	-0.3	-2.6
Other Charges Annually Recurrent	1,850	1,887	1,674	-10.1	2.0	-11.3
Capital Expenditure	*1,358*	*1,287*	*1,004*	*-25.4*	*-5.3*	*-22.0*
Other Charges Special Expenditure	567	602	0	-23.4	6.1	
Development Expenditure	791	685	1,004	-26.7	-13.4	46.5
Budget Deficit/Surplus	**-2,630**	**-2,636**	**-1,776**			
Budget Deficit/Surplus (% to GDP)	**-15.4**	**-16.6**	**-10.6**			

Notes: *) figures are based on the AMRO staff projection
Source: Ministry of Finance, AMRO staff calculations

Figure 11. Oil Price and Fiscal Position



Notes: *) figures are based on the AMRO staff projection
Source: Ministry of Finance, AMRO staff calculations

14. **Total government revenue continued to decline but at a moderating speed in FY2016, while a slight improvement is expected in FY2017.** Oil and gas-related revenue fell sharply by 55.1 percent in the FY2015 as oil prices plummeted by around 44.0 percent from USD81 per barrel in FY2014 to USD45.0 per barrel. Even though the oil price edged up slightly to about USD48 per barrel in FY2016, lower production in the oil and gas sector contributed to a further decline in revenue. However, the FY2017 budget projects the oil and gas revenue to increase by around 8.3 percent compared to the realized level in FY2016, and the total government revenue to increase by 8.2 percent, from BND3.6 billion in FY2016 to BND3.9 billion.

15. **On the expenditure side, the government continued its efforts to restrain expenditure while improving spending efficiency.** In response to the sharp revenue decline, the government cut spending, leading to a sizable reduction in capital expenditure. In FY2015 and FY 2016, total spending amount was cut by around 13.0 percent and 1.4 percent, respectively, of which capital expenditure was reduced by 25.4 percent and 5.3 percent respectively. In the FY2017 budget, the government is expected to see another substantial spending cut to BND5.7 billion, 9 percent lower than the previous year's actual spending. In addition, in order to improve efficiency and to ease fiscal pressures going forward, the government has adopted performance program budgeting and restructured government organizations.

[7] Fiscal reserves, approximated by the cumulated budget surpluses from FY2004/2005 to FY2014/2015, amount to around BND30 billion (169.0% of GDP), as of March 2015.

B. Risks and Vulnerabilities

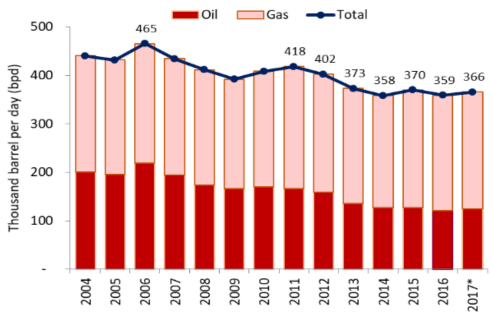
B. 1. Oil and Gas-related Risks

16. **Oil and gas related-factors remain the main risks to Brunei's economic outlook in the near- to medium-term.** In the past three years, the oil and gas sector was affected by two major impacts: disruptions in oil and gas production due to unscheduled deferment and an extended period of low global oil prices. These two impacts have translated into sluggish GDP growth, weaker fiscal performance and the deteriorating external balance.

17. **The economy is heavily dependent on the energy sector.** Around two-thirds of total value added in the country comes from the oil and gas sector. Its dominance is more apparent when it comes to exports and government revenue. Oil and gas exports account for more than 90 percent of total export of merchandise goods, and it accounts for almost 90 percent of total government revenue. Despite a slight decline recently due to falling oil prices and production disruption, Brunei's dependence on the oil and gas sector remains sizable.

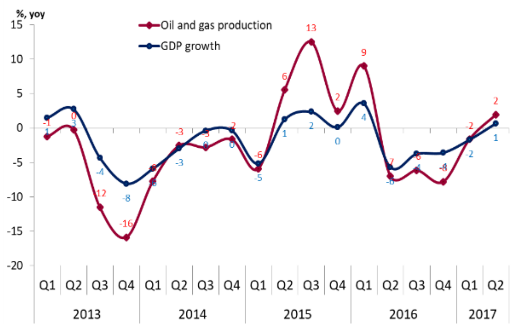
18. **Matured oil and gas fields and ageing facilities have made the oil and gas sector more susceptible to production disruption.** After reaching a peak in 2006, oil and gas production has been on a steady downward trend due mainly to matured fields (Figure 12). The biggest drop (in percentage terms) was recorded in 2013, which led to a significant contraction in GDP. With a more proactive approach through annual maintenance and rejuvenation works, oil and gas production inched up in 2015, but fell again in 2016 with disruptions in production, dragging GDP growth down. With GDP growth closely related to oil and gas production (Figure 13), the main risk to growth outlook in the near- to medium-term emanates mainly from oil and gas production.

Figure 12. Oil and Gas Production



Source: National authorities, AMRO staff calculations
Note: *) up to Q3 2017

Figure 13. GDP Growth vs. Oil and Gas Production Growth



Source: National authorities, AMRO calculations

19. **Another risk factor is the movement in global energy prices.** In addition to the dwindling oil and gas production, the economy has been adversely affected by low oil

prices in recent times. Continued low oil prices could also affect the commercial viability of Brunei's plan to increase oil and gas production, especially in deep-water fields where the development as well as tertiary recovery costs are much higher. This would result in an investment slowdown which, in turn, can affect Brunei's growth prospects going forward.

B. 2. Spillover Effects from a Weakening Fiscal Position

20. **Given the relatively large government contribution to the economy, the spillover from a further cut in spending also poses additional risks to the growth outlook.** The government sector is a substantial part of the economy. From the expenditure side, government consumption accounts for more than 30 percent of total GDP, while on the production side, it accounts for about 18 percent. In addition, government employees also account around 30 percent of total employment.[8] Given the fact that the spending cuts had mainly taken the form of a reduction in capital spending rather than compensation-related spending, a further cut in government spending—especially in terms of capital spending—will have a negative spillover to the rest of the economy, given the government's substantial role in the economy.

B. 3. Progress in Ongoing Infrastructure and FDI Projects

21. **Given the relatively small size of the economy, the implementation of ongoing large-scale infrastructure and FDI projects will affect the growth outlook of Brunei.** There are at least two ongoing mega projects; the Temburong Bridge project and the construction of the Hengyi oil refinery plant. The Temburong Bridge Project is a government infrastructure project comprising a 30-km long bridge connecting Brunei Muara with Temburong District with total investment of around BND1.6 billion. Meanwhile, construction of phase I of the Hengyi oil refinery facilities in Pulau Muara Besar is expected to cost around USD3.4 billion. These two projects were initially expected to be completed by 2018, but completion has now been rescheduled to 2019. Further delays in the implementation of these large projects will affect the near- to medium-term growth outlook. However, while the construction of those mega projects may boost the domestic economy, it will also lead to higher imports and weaken further the current account balance (Box C).

Box C. Impact of the Two Mega Construction Projects

[8] Based on the Labor Survey Data 2014, employment in the public administration itself makes up 27.3 percent of total employment. If we add the employment in the education and health services which are mainly government employees, those will account for more than 30.0 percent of total employment.

The two mega projects could contribute considerably to the infrastructure and economic development of Brunei. The Temburong Bridge will shorten the travel time from Brunei Muara to Temburong district as it directly connects these two areas without passing through Malaysia's territory. A smoother connection enables the government to ramp up infrastructure development in Temburong district, which has been lagging relative to the mainland. Furthermore, it provides a great opportunity for the government to enhance the development of the tourism sector to support economic diversification efforts. Meanwhile, the Hengyi oil refinery project will support the government's ambitious targets for the downstream industries set out in the "Energy White Paper" and further support the government's efforts to diversify the economy.

Given the size of Brunei's economy, the direct impact of these two projects on domestic economic activities are also significant. Owing to the large scale of the investments, the projects create a large number of jobs both during the construction stage and when fully operational. In addition, the projects provide direct support to domestic demand as reflected in the recent surge in private investment. Table B3.1 below illustrates rough estimates of the direct or first round impact of the two mega projects on aggregate demand. The recent implementation of the two mega projects is estimated to have boosted aggregate demand by around BND0.24 billion (1.5 percent of GDP) in 2017, taking into account the fact that part of total boost in demand from the investment goes into imports. The boost to aggregate demand is estimated to accelerate further to BND0.69 billion (4.4 percent of GDP) in 2018 as the construction work nears completion in 2019. The impact is expected to decelerate in 2019.

Table B3.1. Direct Impact of the Two Mega Projects (BND billion)

	2016	2017	2018	2019
Gross fixed capital formation	0.55	0.62	1.78	0.95
Materials	0.26	0.29	0.86	0.46
Equipment and other capital	0.16	0.18	0.50	0.27
Other Intermediate inputs	0.14	0.15	0.42	0.22
Consumption	0.01	0.01	0.02	0.01
Final goods materials	0.01	0.01	0.02	0.01
Imports	0.35	0.39	1.11	0.59
Total Impact to GDP	0.21	0.24	0.69	0.37

Notes: The estimation is based on information of the progress of the investment disbursement collected from the construction sites. As is typical to construction work, the investment disbursement follows the so called "S-Curve pattern". In classifying the cost structure of the projects, we follow a general pattern of cost structure of typical infrastructure projects based on study by Deloitte Access Economics (2014). Imports are calculated based on the import intensity coefficient for construction sector calculated from the 2010 Brunei Input-Output Table.

Source: Daelim Swee Sdn Bhd, Hengyi Industries Sdn Bhd, AMRO staff estimates.

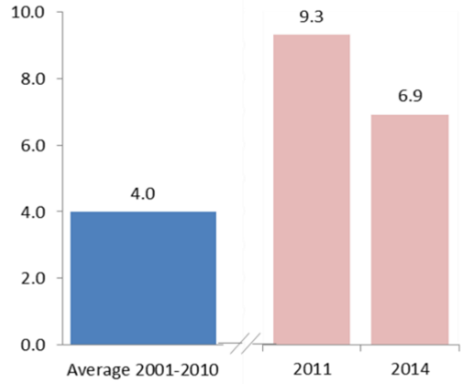
B. 4. Structural Challenges in the Labor Market

22. **Another domestic challenge to growth emanates from the persistent structural problems in the economy, particularly in the labor market**. The unemployment rate in Brunei is relatively high (6.9 percent in 2014)[9], dominated mainly by the young (aged 15 – 24 years) (Figure 14). According to the latest available survey in 2014, the unemployment rate among the youth was 25.3 percent, accounting for about 70 percent of the total unemployed. This is not due to cyclical or transitory factors, but a consequence of structural problems such as skills mismatch and the disparity in compensation between public sector and private sector jobs. Young people prefer to work in the public sector as it provides better security, and higher wages and benefits. Employment in public administration alone was around 30 percent of the total employment. Total public sector

[9] As of August 2017, unemployment rate in Malaysia, Singapore and Thailand was 3.4, 2.9 and 1.2 percent,

employment (combining public administration with education and health sector) could reach around 40 percent of total employment (Figure 15). In the case of the private sector, especially in the non-oil gas sector, the cost of hiring skilled workers in Brunei is relatively expensive and it is hard to attract employees from their public sector positions. This is one of the main challenges in diversifying the country's economy by developing the non-oil and gas sector.

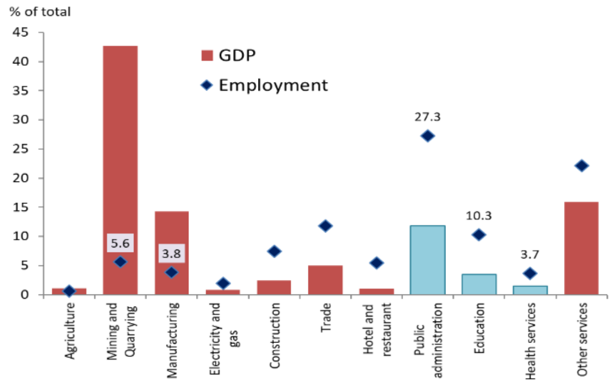
Figure 14. Unemployment Rate



Notes: The latest available unemployment data is based on the 2014 Labor Force Survey.

Source: DEPD, AMRO staff calculations

Figure 15. Employment by Sector



Source: DEPD, AMRO staff calculations

C. Policy Recommendations

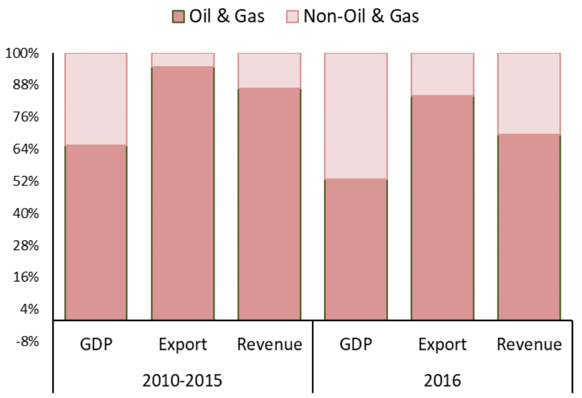
C.1. Continuation of Diversification Efforts

23. **The government should continue enhancing efforts to diversify and broaden the economic growth base to bolster resilience and long-term sustainability.** Although diversification efforts have shown some positive results, as reflected in the remarkable improvement in Brunei's standing in the World Bank's ease of doing business ranking, they have not yet resulted in a significant diversification of economic activities and much remains to be done. The economic growth base remains relatively narrow, and relies heavily on oil and gas production and the government sector (Figures 16, 17). Exports and government revenue are also dominated by the oil and gas sector.[10] In the services sector, after oil and gas, the government plays the biggest role, contributing around 30 percent of the total value added of the sector. The non-oil and gas private sector's role in Brunei's economy is relatively small. Thus, the government should continue fostering the private sector's role in the economy to broaden the growth base in order to enhance resilience and long-term sustainable growth. In this regard, incentive measures for the

[10] The decline of the energy sector's role in 2016 was mainly owing to the oil and gas sector as both oil price and production declined significantly.

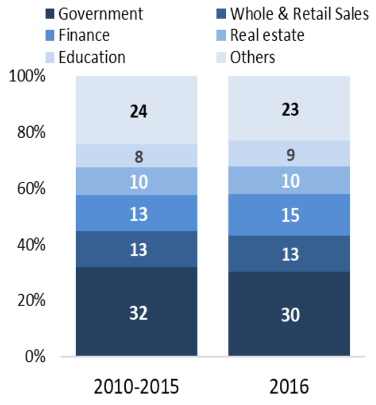
private sector should be continued in order to develop externally competitive SMEs, attract FDIs, and support prioritized sector activities.

Figure 16. Role of the Energy Sector in the Economy



Source: National authorities, CEIC, AMRO staff calculations

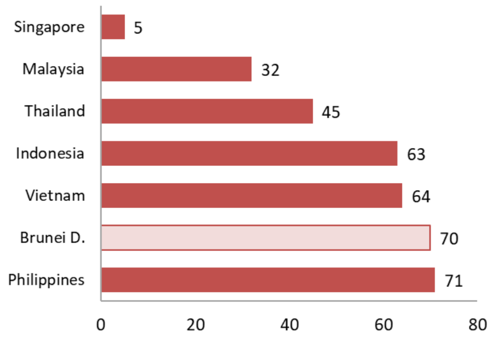
Figure 17. Government's Share in the Service Sector



Source: CEIC, AMRO staff calculations

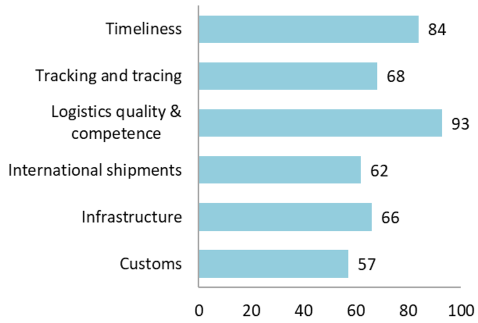
24. **Given its relatively small economy, efforts to enhance global market access should continue.** Better access to the global market will help existing companies optimize their production capacity as well as attract more export-oriented FDI to Brunei. The government should step up its efforts to improve logistics to smoothen international trade flow in tandem with the recent intensified efforts to diversify the economy. Logistic condition in Brunei is relatively lagging compared to the neighboring countries (Figure 18). In terms of the logistics situation, Brunei was ranked 70th out of 160 countries in 2016, far behind Singapore (5th), Malaysia (32nd), and Thailand (45th), and even below Indonesia (63rd) and Vietnam (64th). Logistics quality, the competence of logistics operators (for example, transport operators) and timeliness (delivery time of shipments) are among the components which the government should focus on more in order to facilitate trading across borders (Figure 19). In addition, continued efforts to accelerate reforms to align the domestic economy with the higher standards required under international trade agreements are essential to improve the business environment, boost competitiveness and attract more FDIs, which will promote further diversification.

Figure 18. Overall Ranking in Logistics



Source: Word Bank

Figure 19. Brunei's Ranking across Logistic Components



Source: Word Bank

C.2. Labor Market Policy

25. **Policy efforts to resolve structural challenges in the labor market should be continued.** The government needs to further enhance its policy initiatives to address diverse structural issues such as lack of skills or skills mismatch and disparity in wages and benefits between public and private sectors. Without addressing these structural issues, the progress in economic diversification will be constrained by insufficient supply of skilled labor. In this regard, the recent curb in public sector hiring is also expected to encourage private sector employment. AMRO welcomes the government's recent expansion of its vocational training programs to equip the labor force with sufficient skills combined with hands-on training programs. Continued efforts to improve the educational system to become more aligned with long-term labor market planning are also important to support economic diversification efforts going forward.

C.3. Fiscal Reform towards Economic Diversification and Growth

26. **Efforts to strengthen the fiscal position should be continued.** The authorities have made remarkable progress in containing and reducing the budget deficit in the past few years. Any further reduction in the fiscal deficit can be better achieved by enhancing revenue while containing current spending. While Brunei is blessed with abundant oil and gas reserves, it has also led to a revenue structure that is highly vulnerable to external shocks. Efforts to diversify revenue sources away from the heavy reliance on the oil and gas sector are crucial to bolster long-term sustainability going forward. Drawing from other countries' experience[11], consideration could be given to the introduction of a broad base tax such as GST at a very low rate. This should provide policy menu to Brunei for further

[11] Faced with similar challenges, a number of oil exporting countries in the middle-east have undertaken several measures to diversify revenue sources by introducing several types of taxes, in particular VAT at 5.0 percent at the beginning of 2018. (Annex 1)

actions to diversify revenue sources. Introducing GST with a low rate of 3 or 5 percent could improve Brunei's fiscal position faster over the medium term (Annex 1).

27. **Continued efforts to enhance spending efficiency are advisable, while keeping fiscal policy supportive of economic activities.** In order to strengthen the fiscal position while providing support for sustainable economic growth and the diversification process, continued efforts to enhance spending efficiency will be crucial. A carefully calibrated reprioritization toward more growth-enhancing spending would be critically important to mitigate the adverse growth impact as the substantial fiscal adjustments continue. Recent initiatives such as the public sector hiring freeze would help to ease budget pressures temporarily, while the implementation of performance program budgeting should further enhance efficiency and support the diversification process. In addition, the current highly subdued inflationary environment should provide an opportune moment to recalibrate retail prices and reduce untargeted subsidies, in particular energy subsidies.

C.4. Maintaining Financial Sector Stability

28. **The authorities should continue efforts to strengthen the stability and development of the financial sector.** Although the financial sector is highly capitalized and stable, the authorities' measures to strengthen the stability and soundness of the financial sector is important to create a conducive business and investment environment to support the diversification process. The implementation of the first pillar of Basel II on capital adequacy requirements as of Q1 2017 was aimed to strengthen banking sector's soundness and prudence. Amid sluggish domestic economic activities, recent efforts to further develop a supportive financial sector landscape are crucial, in particular the initiative to deregulate most of the lending/ financing and fixed deposit rates. Furthermore, efforts to introduce government sukuk with longer tenure as well as the launch of the secondary sukuk market to provide investors with broader investment avenues in Brunei are welcome. The Financial Sector Blueprint 2016-2025 released in early 2017 is also expected to provide a solid framework for financial sector development, to strengthen financial sector stability, and to support economic growth going forward [12].

[12] The Financial Blueprint 2016 – 2025 is aimed to further strengthen its financial services platform, robustness of the regulatory framework and linkages to an interconnected global economy. It also targets to enhance the financial sector's contribution to GDP from 5.1 percent to 8 percent by 2035.

Annexes: Selected Issues

A1. Revenue Diversification and Medium-term Fiscal Consolidation

Background

The recently slumping oil and gas sector has affected the economy considerably. Given Brunei's high reliance on the energy sector, the prolonged-period of low oil prices combined with some disruption in oil and gas production had dragged the economy into contraction for four years in row since 2013. Furthermore, starting with a deficit in FY2014, the fiscal position continued to weaken, recording a sizable deficit of 16.6 percent of GDP in FY2016.

The government has been adapting to the challenging environment well with some policy adjustments. It has implemented major structural reforms aimed at attracting foreign direct investment (FDI), supporting and developing local small medium enterprises (SMEs), and diversifying the economy to enhance long-term sustainability since 2015. Progress has been substantive, in particular, in the improvement in the business climate. On the fiscal front, while Brunei has ample buffer to absorb the adverse shocks, the government has taken the opportunity to implement fiscal consolidation focusing on reducing wastages and prioritizing spending to contain the deficit. Nevertheless, as fiscal deficit remains at a high level despite substantial spending cuts, the government should step up its efforts to diversify revenue sources. A more diversified revenue base could also improve long-term fiscal sustainability, enhance fiscal policy capacity through more effective automatic stabilizer and provide extra resources for policy purposes.

Medium-Term Fiscal Outlook and Policy Adjustment

The fiscal outlook will likely remain challenging over the medium-term. Following the staggeringly high fiscal deficit at 16.6 percent of GDP in FY2016, the fiscal position is expected to improve in FY2017 owing to a modest recovery in oil prices and production. Over the medium-term, however, big upward movement of oil prices seems less likely, as high oil prices are likely to stimulate U.S. shale oil and gas production which would put downward pressure on oil prices. With limited room for further expenditure cuts at this stage, the fiscal balance is expected to remain in deficit in the next few years up to 2021, assuming no substantial policy changes are made and a modest recovery in oil production and price. (Table A1.1).

Table A1.1. Medium-Term Fiscal Outlook

	Actual		Projection					
	FY2015	FY2016	FY2017	FY2018	FY2019	FY2020	FY2021	FY2022
			In millions of BN$					
Revenue	3,709	3,616	3,913	4,215	4,614	4,979	5,382	5,853
Expenditure	6,338	6,252	5,689	5,587	5,514	5,579	5,646	5,715
Fiscal blance	-2,630	-2,636	-1,776	-1,372	-901	-601	-264	138
			In percent of GDP					
Revenue	21.7	22.8	23.4	24.7	26.0	27.0	28.1	29.4
Expenditure	37.1	39.4	34.0	32.8	31.1	30.3	29.5	28.7
Fiscal blance	-15.4	-16.6	-10.6	-8.1	-5.1	-3.3	-1.4	0.7

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

Nevertheless, the government has the capacity to finance the deficit through its sizable fiscal buffer. As of March 2017, Brunei's fiscal reserves, approximated by the cumulated budget surpluses from FY2004 to FY2016, amounted to around USD19 billion, or around 4 times the projected cumulative deficit from FY2017–FY2022 under current policies. The government, however, has committed to take a prudent and conservative fiscal policy approach through continued streamlining of less-productive spending.

The fiscal position over the medium-term is critically dependent on global oil price movements and domestic oil production. The fiscal deficit will remain sizable in the next few years unless oil prices rise durably towards USD69/barrel[13] under current policies and there is a gradual improvement in oil and gas production. A fiscal stress test is employed to illustrate the outlook of fiscal position in the medium-term under different scenarios including a possibility of fiscal policy adjustment by the government.

Baseline scenario. The baseline scenario assumes: (i) crude oil and LNG prices of USD53/barrel and USD8.2/MBTU (Million British Thermal Unit), respectively, in FY2017 and stabilize at USD58/barrel and USD8.5/MBTU on average throughout 2018–2022, (ii) oil and gas production gradually and consistently improves following the current trend, and (iii) no policy changes throughout FY2018–FY2022, and no further spending cuts. The results show that the fiscal balance is expected to recover slowly but to turn surplus in FY2022 (Table A1.2).

Upside scenario. The upside scenario assumes: (i) the oil and gas prices gradually recover faster than the baseline by 20 percent to average USD64/barrel and USD9.7/MBTU on average throughout FY2018 – FY2022, (ii) oil and gas production gradually increases following the current trend as in the baseline, and (iii) no policy changes. Under the upside scenario,

[13] The oil price in this report reflects the average of the West Texas Intermediate (WTI) and Brent spot prices. As of January 10th, 2018, on average, oil price was at USD58/barrel.

the fiscal balance will recover relatively faster than in the baseline scenario and is expected to turn into surplus by 2021.

Table A1.2. Medium-Term Fiscal Balances Under Different Scenarios

	Projection					
	FY2017	FY2018	FY2019	FY2020	FY2021	FY2022
	in % of GDP					
Fiscal balance Under:						
Baseline[1)]	-10.6	-8.1	-5.1	-3.3	-1.4	0.7
Upside[2)]	-10.6	-6.1	-2.5	-0.9	0.8	2.5
Downside[3)]	-10.6	-9.6	-8.2	-7.3	-6.4	-5.6
Policy adjustment						
Introduction of GST 5%[4)]	-10.6	-6.9	-3.9	-2.2	-0.3	1.8
Introduction of GST 5% while oil price increases	-10.6	-4.9	-1.4	0.2	1.9	3.6
Memorandum items:						
Baseline oil price (US$/barrel)	53	56	59	60	61	62
Baseline oil production (bpd)	128	131	134	138	142	146
Baseline gas production (boepd)	238	244	252	262	274	286

Notes :

1) Crude oil price and LNG prices stabilize at USD58/barrel and USD8.5/MBTU respectively through 2018–2022 from their initial level of USD53/barrel and USD8.2/MBTU in 2017. In addition, the oil production follows current trends with a gradual but modest recovery.

2) Oil and LNG prices Increase by 20.0 percent and stay at USD64/barrel and USD9.7/MBTU respectively throughout 2018–2022, whilst oil production follows its recent trend and witnesses a gradual but modest recovery.

3) Oil and LNG prices decline slightly from its initial level in 2017 and stay at USD50/barrel and USD7.8/MBTU respectively, whilst oil production stabilizes throughout 2018–2022.

4) GST collection efficiency is assumed to be 60.0 percent of its potential.

Source : National authorities, AMRO staff estimation

Downside scenario. Assumptions under the downside scenario are as follows: (i) oil and gas prices slightly fall again in FY2018 and stabilize at USD50/barrel towards FY2022, (ii) after a modest recovery in FY2017, oil and gas production remains flat during FY2018–FY2022, and (iii) no policy changes are made at this stage. In the downside scenario, the results show a very slow improvement of the medium-term fiscal position by 2022, possibly depleting the Fiscal Stabilization Reserve Fund accumulated from past decades fiscal surpluses.

Policy adjustment scenario. The government is assumed to have no more room to cut spending and start to diversify the revenue sources by introducing GST at very low rate of 5.0 percent. The results show that the introduction of GST of 5.0 percent could help the recovery of the fiscal position. The simulation shows that this policy change can expedite the pace of consolidation compared to the baseline. The government budget would approach towards balance in FY2021 and turn to surplus quite strongly in FY2022.

Another scenario is a combination of the introduction of GST of 5.0 percent and an oil and gas price increase. If the oil and gas prices recover faster (upside scenario price USD64/barrel) than in the baseline scenario while at the same time the government introduces a GST of 5.0 percent, the results show that the fiscal position could improve faster and be brought to surplus by FY2020.

Room for Revenue Diversification

Measures to broaden the non-oil and gas revenue base is worth considering. Recent consolidation measures have focused more on the spending side. As shown earlier, spending cuts contributed considerably to contain the fiscal deficit. However, at this stage, further spending cuts might not be helpful on the growth side, and therefore the authorities should focus more on reprioritization toward more growth-enhancing spending under the given spending envelop. Given substantial fiscal deficits and the prospects of low oil and gas prices, the government might need to start taking steps to diversify revenue sources.

The experiences of the other resource rich countries and neighboring countries show some potential measures to diversify revenue sources. In response to the considerable fiscal challenges in recent times, the GCC countries announced some major tax reforms—notably the introduction of an excise on tobacco products and sugary soft drinks, and a broad-base consumption tax—VAT—at a relatively low rate of 5.0 percent (Table A1.3). In the region, Malaysia also successfully introduced a GST of 6.0 percent in 2015, while India just started to apply GST of 15.0 percent this year (Table A1.4). As shown in the simulation, the introduction of a 5.0 percent GST (with exemptions for health and education spending) in Brunei will be able to significantly support ongoing fiscal consolidation efforts.

Table A1.3. Major Non-Oil and Gas Tax Reforms in GCCs

Countries	Excise		VAT/GST	
	Measures	Implemen-tation Date	Measures	Implemen-tation Date
Qatar	Excise on tobacco, energy and soft drinks	2017	VAT at 5 percent	2018
Saudi Arabia	Excise on tobacco, energy and soft drinks	2017	VAT at 5 percent	2018
Bahrain	-	-	VAT at 5 percent	2018
Kuwait	-	-	VAT at 5 percent	2018
Oman	-	-	VAT at 5 percent	2018
UAE	-	-	VAT at 5 percent	2018

Source: KPMG (2017)

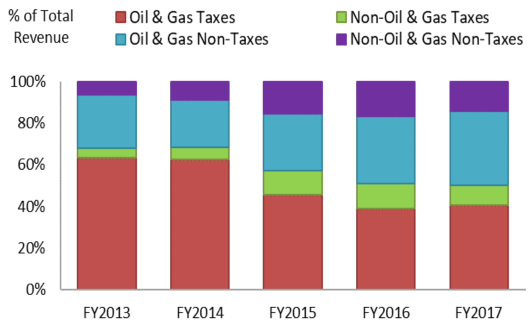
Table A1.4. GST/ VAT Rates Comparison

Countries	Standard GST/VAT Rate	Implemen-tation
Oil Producing Countries		
Nigeria	5	1993
Norway	25	1970
Indonesia	10	1984
Malaysia	6	2015
Canada	5	1991
Other Comparator Countries		
Singapore	7	1994
Philipines	12	1998
Thailand	7	1992
Japan	5	1989
India	15	2017

Source: EY Worldwide Indirect Tax Guide

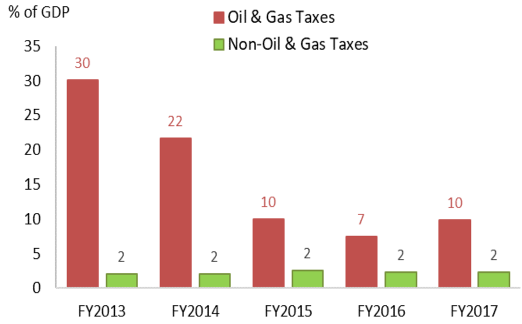
A relatively narrow revenue base and low inflationary pressures give room for Brunei to step up efforts to broaden the non-oil and gas revenue base. Brunei does not have the full range of taxes found in most economies in the region, including some emerging market oil exporters. There is no personal income tax nor a broad-based consumption tax. Oil and gas-related revenue accounts for around 80 percent of total revenue (Figure A.1.1, A.1.2), and this makes the fiscal position more vulnerable to external shocks. Given the relatively narrow tax base, there is room for Brunei to broaden its non-oil and gas revenue sources and be less vulnerable to external shocks. The possible adverse impacts on domestic prices are expected to be minimal given the current subdued inflation in Brunei.

Figure A.1.1. Government Revenue Structure



Source: National authorities, AMRO staff calculations

Figure A1.2. Tax Revenue

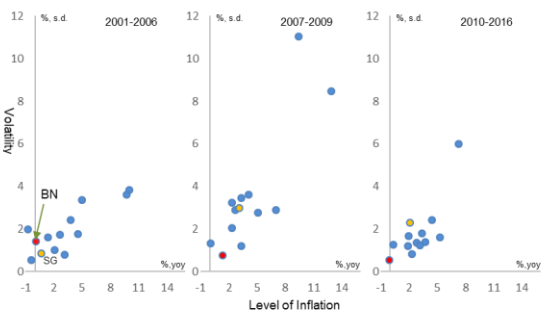


Source: National authorities, AMRO staff calculations

A2. Factors Behind the Low-Inflation Environment in Brunei

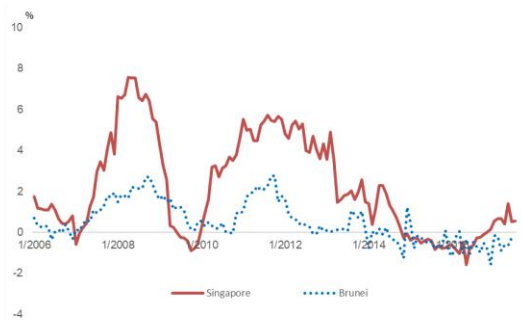
Inflation in Brunei is among the lowest when compared to other countries in the ASEAN+3 region. It is also the least volatile in the region. Especially since the GFC, while inflation has been trending down across the region, Brunei's inflation has been the lowest—it was negative on average during 2010-2016 (Figure A2.1). Inflation is also significantly lower in Brunei than it is in Singapore, to whose currency the Brunei Dollar is pegged under an interchangeability agreement (Figure A2.2).

Figure A2.1. The Degree and Volatility of Inflation in ASEAN+3 Economies



Source: World Bank, AMRO staff calculations

Figure A2.2. Headline Inflation in Brunei and Singapore



Source: Department of Economic Planning and Development (PMOP, Brunei), Department of Statistics Singapore

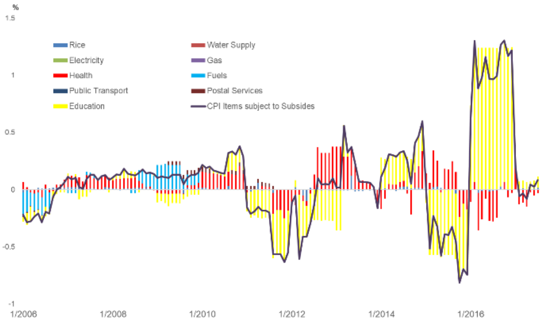
Price administration through subsidies and price controls is among the key factors contributing to the low inflation environment in Brunei. First, subsidies and price controls reduce the CPI weight of the items as households could spend less on items under subsidies or price controls. For instance, compared to Singapore's housing and utilities, which account for one quarter of the CPI weight, housing and utilities only account for 11.0 percent of the basket weight in Brunei due to sizable subsidies for these items.[14]. Second, besides the weight variations in the CPI basket, subsidies and price controls also affect price movements

[14] Housing subsidy in Brunei

themselves and consequently have an impact on headline inflation. On average, inflation related to subsidies and price controls is lower than in Singapore—it was 0.4 percent in 2006-2016, 2.2 percentage points lower than in Singapore. The volatility of inflation is also 0.5 ppts lower in Brunei as compared to Singapore.

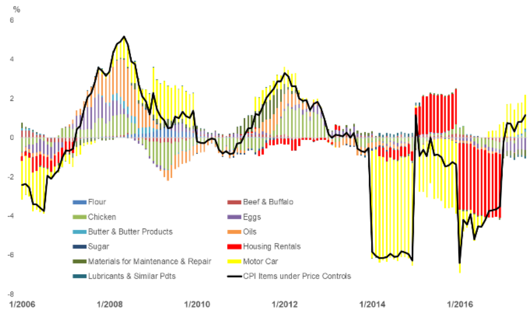
While subsidies and price controls dampen the level of inflation as a whole, changes in prices of items under subsidies and price controls can have substantial impact on headline inflation. Direct subsidy mechanisms and price controlling processes have muted the price pressure from food and energy-related items.[15] On the other hand, some other items such as education, health, housing rentals and motor cars have contributed to greater volatility over time (Figures A2.3 & A2.4).

Figure A2.3. Inflation Dynamics of Items with Subsidies



Source: Price Control Act Order (2012), Kok (2015), AMRO staff caculations

Figure A2.4. Inflation Dynamics of Items under Price Controls

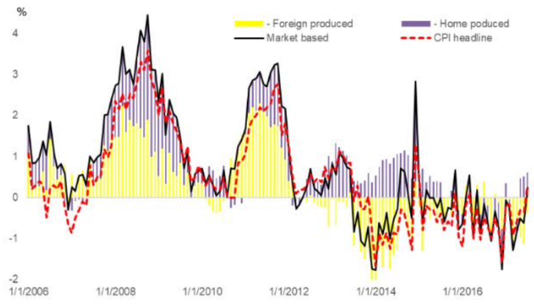


Source: AMRO staff caculations

Despite the dampening effects of subsidies and price controls, other items whose prices are based on market demand and supply drive the movements of headline inflation. Such other items, the prices of which are determined by market dynamics of demand and supply (hereafter referred to as market-based items), account for 70 percent of the basket and are the main drivers of headline inflation, as the close co-movement between the market-based inflation component and overall headline inflation shows (Figure A2.5).

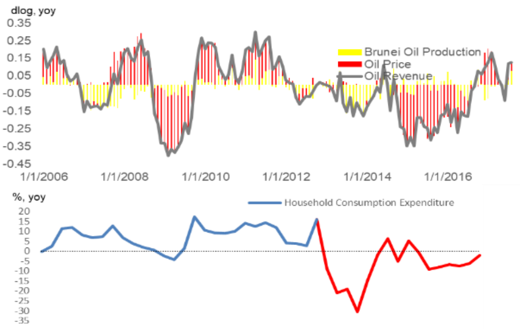
[15] The Price Control Act (CAP 142) came into effect on 13 March 1974. The latest amended version—the Price Control Act (Amendment) Order 2012—has been in effect since 13 November 2012. One of the biggest subsidy costs is the petrol subsidy, which cost the government USD380 million and USD328 million out of its budget during FY2013 and FY2014, respectively. The budgeted subsidy was USD160 million in FY2015. (Source: http://borneobulletin.com.bn/subsidies-stay-prudence-advised/)

Figure A2.5. Market-based Inflation by Sector



Source: AMRO staff calculations

Figure A2.6. Household Expenditure and Oil Revenue



Source: Department of Economic Planning and Development, U.S. department of energy，Bloomberg, AMRO staff estimations

The deflation episode during 2012-2016 was mainly caused by domestic demand shocks, especially on imported goods. As headline inflation is mainly driven by inflation dynamics of market-based domestic-goods and foreign-produced goods, it is therefore sensitive to changes in demand. In the case of Brunei, due to declining oil production since H2 2012 and later the drop in global energy prices, there were concurrent domestic demand shocks in light of the importance of oil revenues in Brunei's economy, as suggested by substantial declines in household expenditure during 2012 to 2016. Declining domestic prices were mainly due to falling prices of imported goods. The demand elasticity for imported goods is higher than for domestically produced goods in the CPI basket and accounts for around 27 percent of weight in CPI basket (Box D). On the other hand, we do not find significant exchange rate pass-through effects on domestic inflation during the period.

Box D. An Empirical Examination of Inflation Dynamics

The following Philips-Curve type empirical equation with exchange rate pass-through for inflation and based on quarterly data is examined as follows.

$$\pi_t = \beta_1 \pi_{t-1} + \beta_2(\pi^*_{t-1} - e_{t-1}) + \alpha \widehat{x_t} + \epsilon_t \qquad \text{(E1),}$$

where π is domestic inflation; π^* and e represent inflation in foreign prices and the change in exchange rate[16]; and $\widehat{x_t}$ is the change in domestic expenditure (demand)[17].

[16] Foreign prices refers to weighted core consumer prices of top eight imports trading partners of Brunei, including China, Japan, Korea, Malaysia, Singapore, the U.K., the U.S. and the E.U.. Exchange rates refer the weighed bilateral exchange rate of the respective countries.

[17] It is represented by the domestic household expenditure which is survey-based and available in the national income account.

Table D1.1. Regression Results with Law of One Price

Model Specification	β_1	β_2	α
Headline Inflation	0.884*	0.002	0.011*
Market-based Inflation	0.861*	0.004	0.015*
Domestic-produced	0.900*	0.023	0.008
Foreign-produced	0.775*	-0.056	0.039*

Notes: *) significant at 5.0 percent

The results suggest that domestic household expenditure has a big impact on market-based inflation, particularly on inflation caused by foreign-produced items.

A more flexible form which allows different coefficients for π^*_{t-1} and e_{t-1} is also examined in the following equation

$$\pi_t = \beta_1\pi_{t-1} + \beta_2\pi^*_{t-1} + \beta_3 e_{t-1} + \alpha\widehat{x_t} + \epsilon_t \quad \text{(E2).}$$

Table D2.: Regression Results

Model Specification	β_1	β_2	β_3	α
Headline Inflation	0.849*	0.048	0.000	0.012*
Market-based Inflation	0.764*	0.127	-0.002	0.019*
Domestic-produced	0.753*	0.208*	-0.042	0.007
Foreign-produced	0.750*	0.025	0.064	0.040*

Notes: *) significant at 5.0 percent

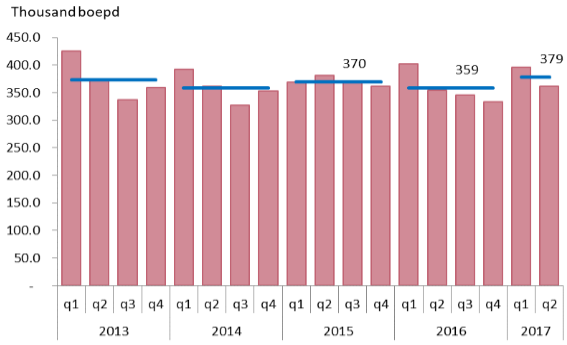
The results in Table D2 are consistent with those in Table D1 with respect to the impact of domestic demand on inflation. Meanwhile, the exchange-rate pass-through is found to be not significant on their respective coefficients.

Appendices

Appendix 1. Major Economic Indicators for Brunei Darussalam

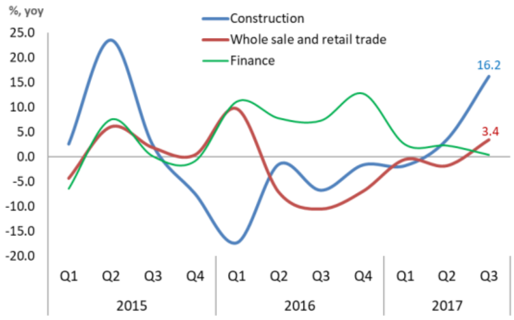
Figure 1. Real Sector, GDP Growth and Prices

Oil and gas production is expected to increase in 2017 compared to a year before.



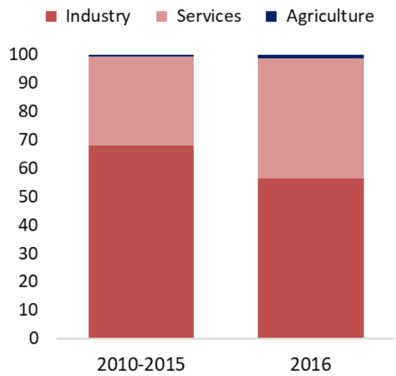
Source: National authorities, AMRO staff calculations

The non-oil and gas sector, particular construction and wholesale and retail sales, appears to show a gradual recovery in 2017, reflecting progress on the ongoing large scale construction projects and the strengthening domestic demand.



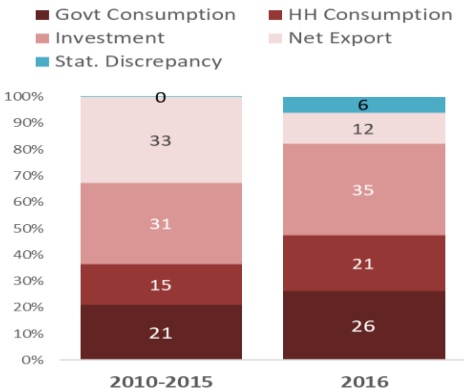
Source: National authorities, AMRO staff calculations

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



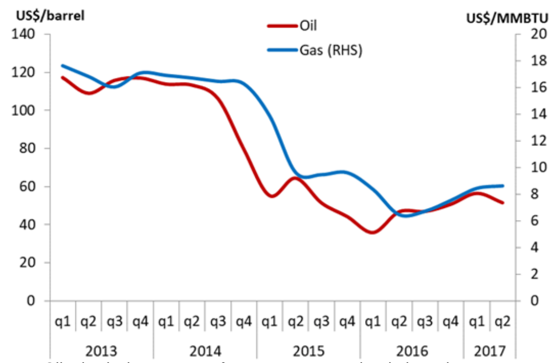
Source: CEIC, AMRO staff calculations

On the expenditure side, the largest contribution is from investment, followed by government consumption.



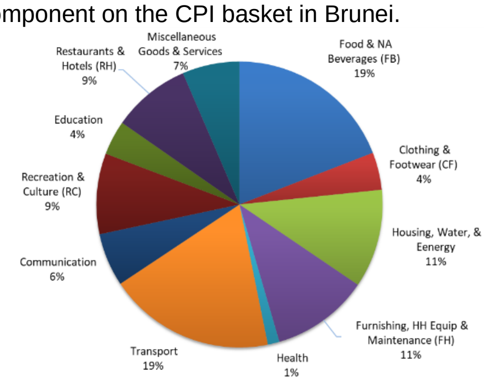
Source: CEIC, AMRO staff calculations

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



Note: Oil price is the average of UK Brent, WTI and Dubai Fateh
Source: CEIC, AMRO staff calculations

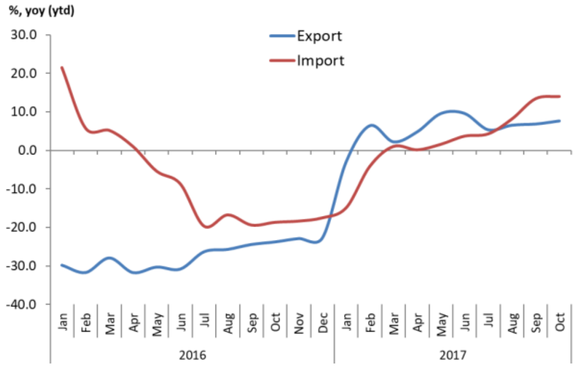
Transport and food and beverages are the two biggest component on the CPI basket in Brunei.



Source: CEIC, AMRO staff calculations

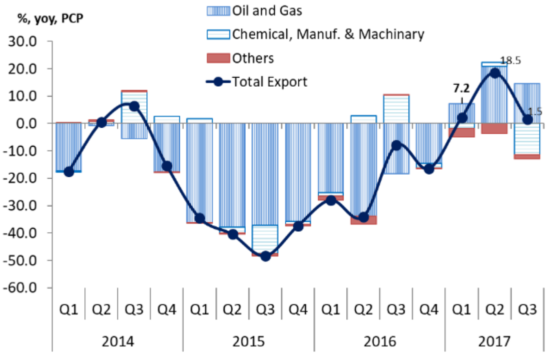
Figure 2. External Sector

Export and import growth have been back to positive territory, and imports have outpaced exports as the infrastructure and FDI construction projects have progressed.



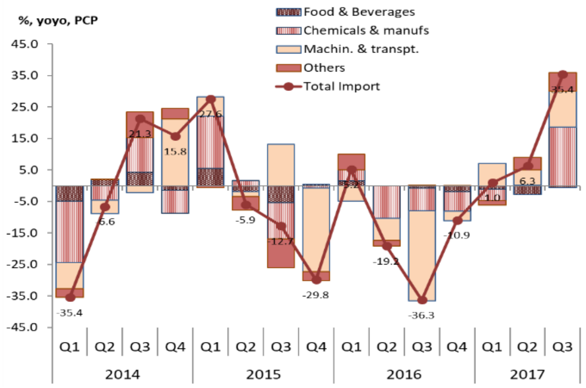
Source: CEIC, AMRO staff calculations

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



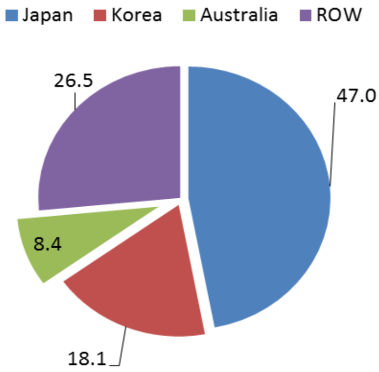
Source: CEIC, AMRO staff calculations

Imports increased in 3Q 2017, driven by machinery and transportation, as investment increased.



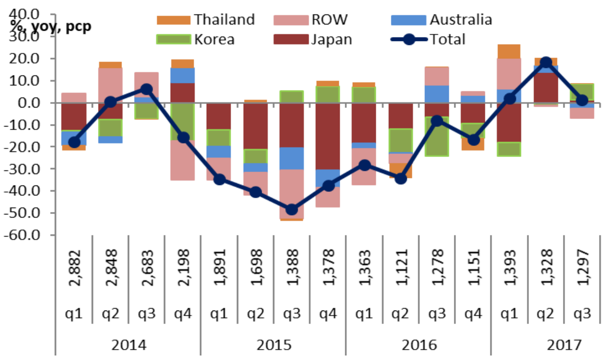
Source: CEIC, AMRO staff calculations

The two main export destinations in 2016 were Japan and Korea.



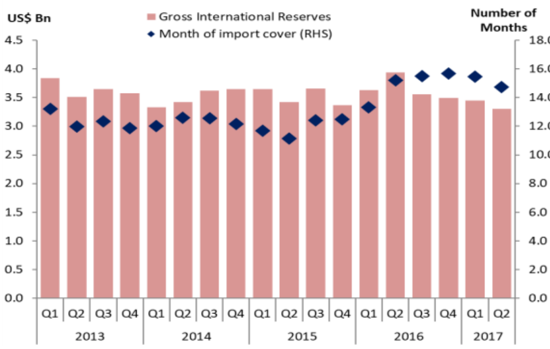
Note: ROW refers to rest of the world
Source: CEIC, AMRO staff calculations

The improvement in exports was due mainly to the increase in exports to Japan, Thailand and Korea.



Note: ROW refers to Rest of the world.
Source: CEIC, AMRO staff calculations

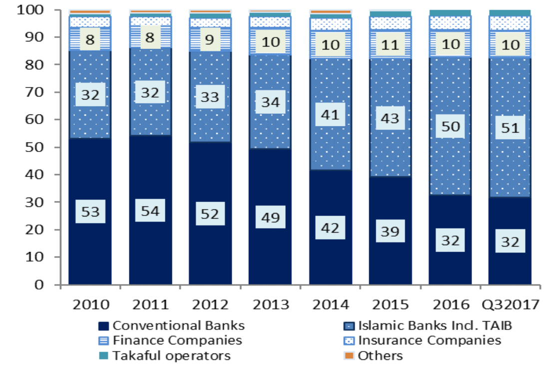
The overall external position remained well-buffered as Brunei's international reserves cover around 14 months of merchandise imports.



Notes: Imports cover only merchandise imports as the latest service account is only available up to 2015.
Source: CEIC, AMRO staff calculations

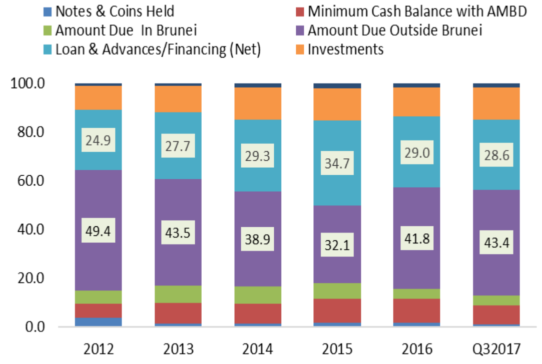
Figure 3. Financial Sector

Islamic banks (including TAIB) increasingly dominate the financial sector structure in Brunei.



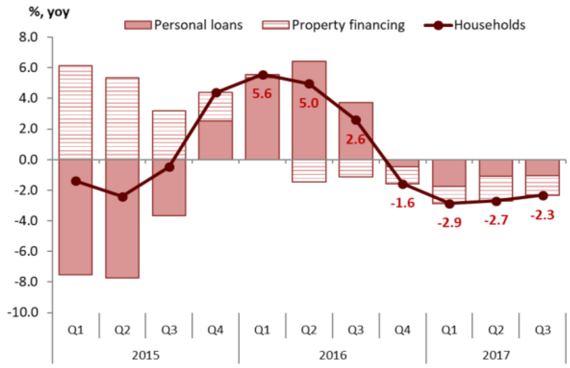
Source: AMBD, AMRO staff calculations

In term of asset placement, as of Q3 2018, around 40.0 percent of assets are held outside Brunei, while loans and advances/ financing account for less than 30.0 percent of total assets.



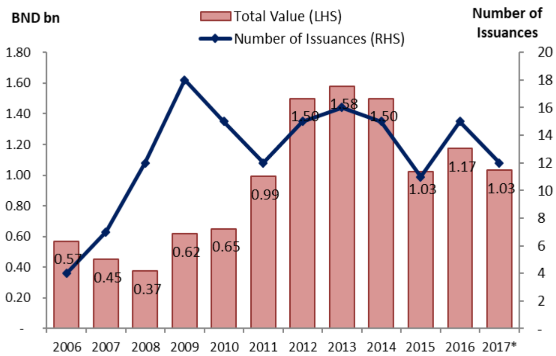
Source: AMBD, AMRO staff calculations

The push from relaxing some regulations on personal loans and credit card issuances in H2 2015 dissipated quickly and credit growth to household decelerated with weaker economic activities in 2016, but with slower pace in 2017.



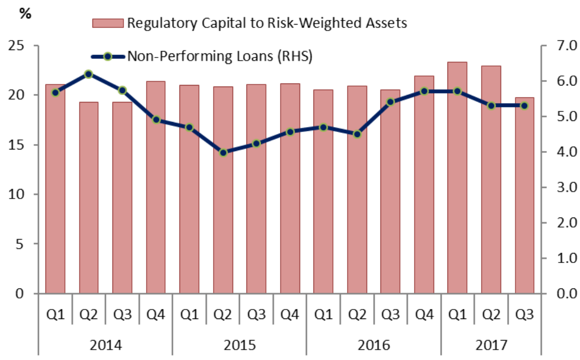
Source: CEIC, National authorities, AMRO staff calculations

Up to October 2017, total value of sukuk issued was BND11.3 billion, with outstanding as of October was BND232.4 million.



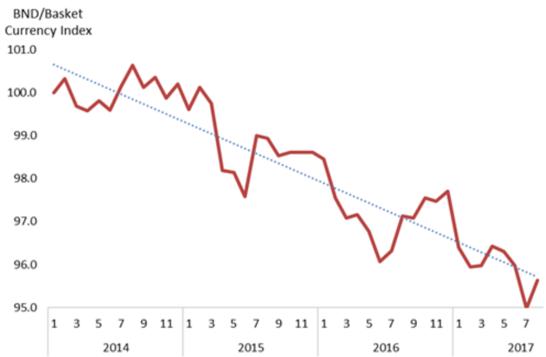
Note: The issuance of sukuk in Brunei is mainly to build the Government Securities yield curve as a benchmark for corporate sukuk.
Source: AMBD, AMRO staff calculations

Banks remain well-buffered with a relatively high capital adequacy ratio, while the recent trend or rising NPLs eased slightly in Q2 and Q3 2017.



Source: National authorities, AMRO staff calculations

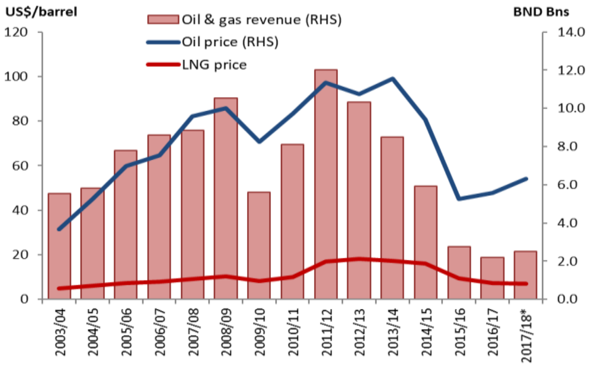
The BND appreciated against a basket of its main trading partners' currencies.



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

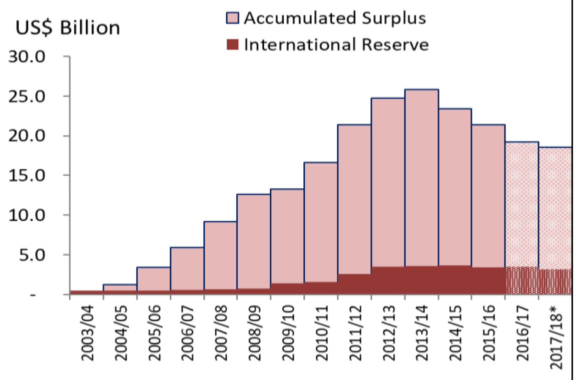
Figure 4. Fiscal Sector and Others

Oil-related revenue dropped sharply as oil and gas prices plummeted; but oil prices have slightly improved recently.



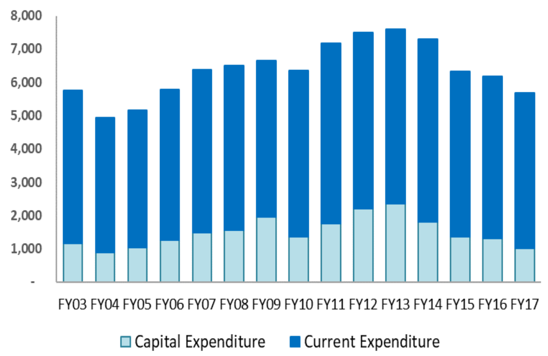
Notes: *) Based on the government budget. Fiscal year: April to March
Source: Ministry of Finance Brunei Darussalam, AMRO staff calculations

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



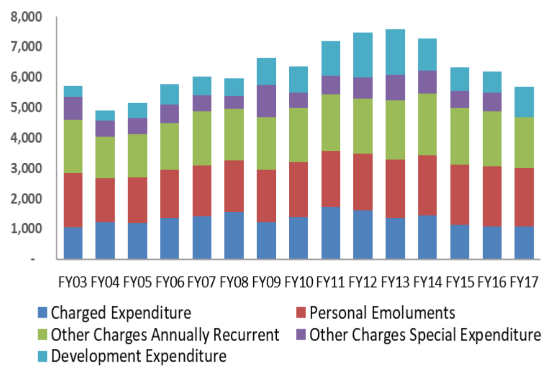
Notes: *) Based on the government budget. The gross international reserves position is as of June 2017.
Source: Ministry of Finance Brunei Darussalam, AMRO staff calculations

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



Note: Fiscal year: April/March
Source: Ministry of Finance, Brunei Darussalam, AMRO Staff calculation

Personal emoluments and other charges annually recurrent take up the biggest chunk of the government spending.



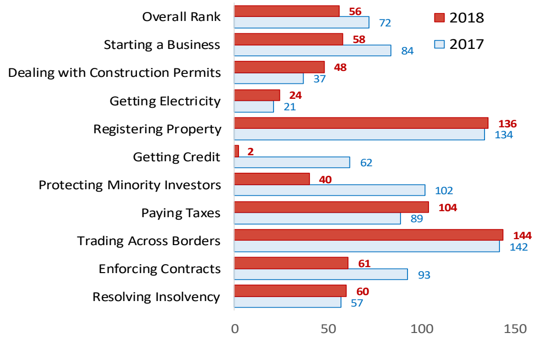
Note: Fiscal year: April/March
Source: Ministry of Finance, Brunei Darussalam, AMRO Staff calculation

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

	2017	2018	Change in Rank
Singapore	2	2	0
Malaysia	23	24	-1
Thailand	46	26	20
Brunei Darussalam	**72**	**56**	**16**
Vietnam	82	68	14
Indonesia	91	72	19
Philippines	99	113	-14
Cambodia	131	135	-4
Laos	139	141	-2
Myanmar	170	171	-1

Source: World Bank's ease of doing business ranking

There is, however, still much to be done to improve the business environment further.



Source: World Bank

Appendix 2: Brunei's Selected Economic Indicators and Projection: 2012-2018

	2012	2013	2014	2015	2016	Projection 2017	2018
National Income and Prices	(Annual percentage change, unless otherwise specified)						
Real GDP	0.9	-2.1	-2.5	-0.4	-2.5	0.6	1.6
Consumer price inflation (average)	0.1	0.4	-0.2	-0.4	-0.7	-0.2	0.2
Balance of Payments	(In millions of US dollars unless otherwise specified)						
Trade balance	8,763	6,915	7,433	2,893	2,380	2,303	2,125
Current account balance	5,674	3,773	5,244	2,141	1,338	1,226	1,004
In percent of GDP	29.8	20.9	30.7	16.6	11.7	10.1	8.1
Gross international reserves	3,449	3,575	3,648	3,367	3,489	3,339	3,337
In months of imports of goods & services	6.1	5.5	7.5	8.3	9.8	7.4	6.1
	(in annual percentage change based on USD value, unless otherwise specified)						
Export value	4.1	-11.9	-7.3	-40.2	-17.6	12.4	9.9
Oil and gas	4.5	-11.2	-11.1	-39.9	-26.5	13.9	9.9
Crude Oil	-1.0	-18.3	-13.3	-46.6	-19.6	21.2	9.8
LNG	10.7	-3.9	-9.2	-34.4	-31.2	8.1	10.0
Others	-2.7	-28.1	98.4	-44.3	102.2	4.2	9.4
Export volume	-6.4	-8.9	-3.8	-3.0	13.2	-1.6	6.3
Import value	-1.0	1.3	-0.5	-10.0	-17.4	26.3	22.0
Import volume	-1.4	1.9	0.1	-4.7	-16.0	24.4	21.2
Terms of trade	10.7	-2.8	-3.0	-34.7	-25.9	11.6	2.1
Government1)	(in percent of GDP)						
Revenue and grants	50.0	41.8	34.4	21.7	22.8	23.4	24.7
Oil and gas revenue	43.9	38.1	29.9	16.2	16.3	16.7	18.1
Non-Oil and Gas Revenue	6.1	3.7	4.5	5.6	6.5	6.7	6.7
Expenditure	31.8	34.1	35.4	37.1	39.4	34.0	32.8
Current Spending	22.5	24.2	26.6	29.2	31.3	28.0	26.8
Capital Spending	9.3	9.8	8.8	8.0	8.1	6.0	6.0
Budget Balance	18.1	7.8	-1.0	-15.4	-16.6	-10.6	-8.1
Monetary Sector	(Annual percentage change, unless otherwise specified)						
Domestic credit	71.4	45.4	32.9	28.5	-21.3	-2.7	1.2
of which: private sector	3.0	7.6	1.1	4.9	-8.4	-3.3	0.6
Broad money	0.9	1.5	3.2	-1.8	1.5	-1.8	2.2
Memorandum items:							
Exchange rate (BND/US$) period avg	1.25	1.25	1.27	1.37	1.38	1.38	1.38
Exchange rate end of period (BN$/US$)	1.22	1.27	1.33	1.42	1.45	1.34	1.34
GDP in millions of US$	19,048	18,094	17,098	12,930	11,400	12,115	12,321
GDP in millions of BN$	23,802	22,639	21,664	17,778	15,748	16,729	17,031

Note: 1) figures are for fiscal years that run from April to March. Figures for 2017 and 2018 are based on AMRO staff projections
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 the expenditure and production sides. Quarterly GDP data is also available both expenditure and production side, however, have not been made available.	Quarterly GDP data comes with a 4-to-6-month lag with an unclear schedule. For example, the Q1 and Q2 GDP 2017 were released in October 2017, while Q3 GDP was released in late December 2017.	In some occasion, statistical discrepancy remains relatively high. For example, in 2016, statistical discrepancy accounted more than 6.0 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	Quarterly balance of payments data is released with a time lag of more than one year.	Net errors and omissions are frequently quite large and 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 4 months	-		
Financial Sector Soundness Indicators	Financial soundness indicators are available in quarterly bases	The data is released with a time lag of 2 to 6 months			
SOE Statistics	SOE statistics have yet to be made available				

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.