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ECONOMIC INSIGHT

SOUTH EAST ASIA

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Balance of power shifts East as Western economies suffer the after-effects of the biggest financial crisis since the Great Depression

Welcome to the first issue of the ICAEW *Economic Insight: South East Asia*, a new quarterly forecast for the region prepared directly for the finance profession. Produced by Cebr, ICAEW's partner and acknowledged experts in global economic forecasting, it provides a unique perspective on the prospects for South East Asia over the coming years. We focus on the six largest economies of the Association of South East Asian Nations – namely Indonesia, Malaysia, the Philippines, Singapore, Thailand and Vietnam.

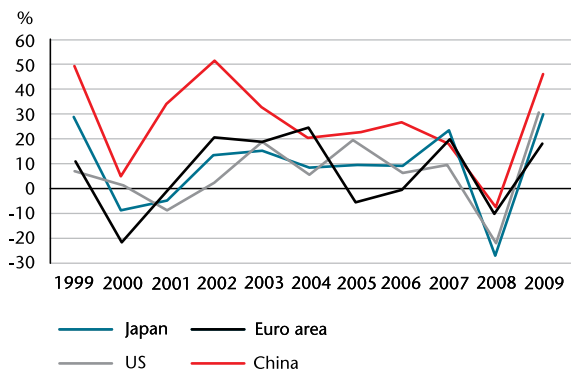
The Western¹ world's share of global GDP fell below 60% in 2008 and is on track to decline to under 50% within the decade, the end of about 500 years of economic dominance. This decline in material strength is being accompanied by ageing populations in many industrialised countries and worries about their fiscal sustainability that go beyond the current eurozone debt crisis and the summer US budget ceiling dispute. Both long-term factors will weigh on growth and hasten the relative decline of the West.

At the same time, the Asian economies continue to power ahead, with China unequivocally on track to rival US superpower status and India certain to join their ranks in the coming decades. This shift in the world's political centre of gravity has economic drivers that are profoundly impacting neighbouring South East Asia. Importantly, growing trade in the region plays a crucial part in raising ASEAN's output and finances imports as domestic consumption increases.

Trade with China is expanding quickly

Trade growth shown in Figure 1 illustrates that ASEAN export volumes to China have been rising faster than those to other major trading partners Japan, the US and the eurozone. A free trade agreement with China has been in effect since 2010. This is boosting growth and will continue to do so as Asian economic integration gathers pace. Looking further ahead, it is likely that India will take China's place as a fresh source of growth once population ageing in the People's Republic begins to slow its economy from around 2030.

Figure 1: Annual ASEAN export growth to major trading partners



Source: IMF

Monetary policy tightening and weak Western growth to curb trade

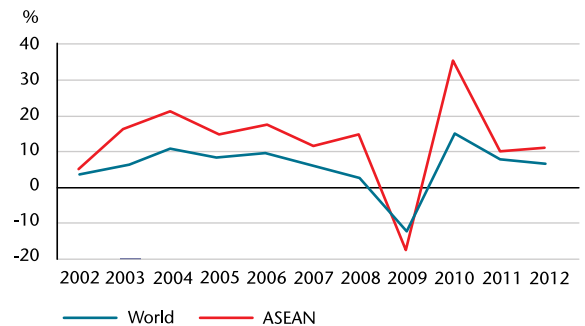
The global economy is slowing noticeably after its strong 2010 performance that saw global GDP rise an impressive 5%, a figure that was only exceeded shortly before the financial crisis. This sharp rebound was temporary and supported by global inventory restocking, rather than sustained consumption and investment. A gradual reduction in both the public and private sector debt burdens in industrialised nations will hold back consumption, resulting in several years of elevated unemployment and below-trend growth in the Western world. In terms of risk factors, market volatility due to uncertainty about the global economic trajectory and the eurozone debt crisis may severely undermine consumer and business confidence and threaten the recovery.

The situation is different in emerging markets. Their voracious demand has pushed up commodity prices, forcing a restrictive monetary policy on fast-growing countries struggling to contain inflation, which is further being fanned by strong domestic consumption. Tighter money started to rein in the overheating economy of India, with a July decline in inflation, and depressed Brazil's industrial production in June. The latest data suggest that China is finally beginning to slow from the unsustainable growth rate of over 9% per annum in the last six quarters. The question is whether the Chinese economy can be slowed without stalling completely. Although we believe that this is the likely outcome, a collapse of the property sector is a major risk that would drag Chinese growth down and have an adverse impact on the world economy.

A reduction in global output expansion will have a knock-on effect on the trade growth rate (see Figure 2).

Our projections show trade growth declining by about half, going from 15.2% in 2010 to 6% in 2011 and falling by another percentage point in 2012. With its export-dependent industrial structure, this slowdown in global trade is going to be felt strongly across the ASEAN region, with sales of goods and services set to increase at a slower rate than was the norm in the 2000s. After a massive 35.4% increase in 2010, ASEAN export growth will decline to about 10% in 2011 – partly due to the supply chain disruption caused by the Japanese earthquake – but pick up again in 2012.

Figure 2: Annual export growth, percentage change



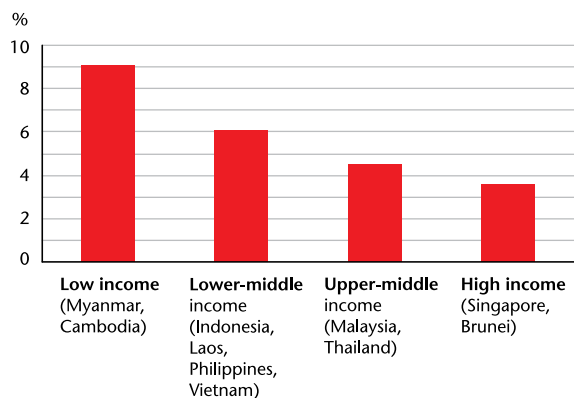
Source: IMF, CPB, Cebr analysis

ASEAN growth to be more domestically driven

Within ASEAN, regional integration is continuing apace. Internal trade (measured in nominal US\$) increased 3.6 times, while external trade grew a more modest 2.8 times between 1993 and 2009. We expect this diverging trend to continue in the long-term, leading to greater prosperity from increased specialisation and division of labour within ASEAN. The success of the Iskandar Malaysia economic zone in South Johor, which benefits from Singaporean know-how and a highly productive yet affordable Malaysian labour force, is one example of the many regional cooperation options.

On a cautionary note, the income levels of ASEAN nations span the entire range from low to high income countries. This contrasts with the EU, which is a club of rich countries. Convergence of living standards has been a major benefit of EU membership for new members and Figure 3 shows that a similar story is unfolding within ASEAN. The region's low income countries have grown at strong average rate of 9.1% annually over the past decade from 2001 to 2010, the lower-middle income countries grew 6.1%, the upper-middle group added an average 4.5% per year and the high income economies achieved growth of just 3.6%. Despite this degree of catch-up, the large gulf in living standards – 2010 per capita income below \$1000 in Laos, Cambodia and Myanmar compared to \$43,000 in Singapore – means that EU-style political integration is unlikely in the foreseeable future due to the absence of a shared economic background. Nevertheless, ASEAN is turning from a range of countries that compete for foreign direct investment into a group with mutually reinforcing progress through greater regional linkages and trade.

Figure 3: 10-year average GDP growth by World Bank country grouping



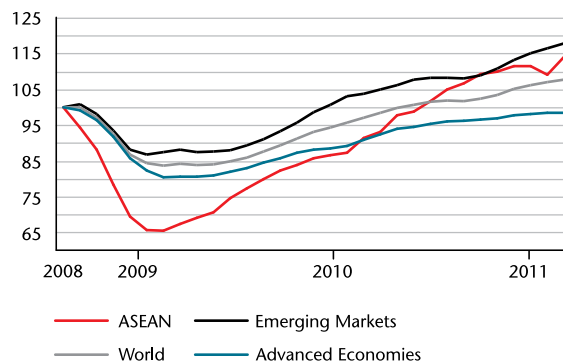
Source: IMF, World Bank

The variety of ASEAN member states is a source of opportunity for the region. Competitive labour costs in low income and lower-middle income countries will become increasingly attractive as wages rise in the world's manufacturing powerhouse China (Chinese hourly labour rates have risen from around \$0.60 in 2003 to about \$2.25 in 2010). Abundant confirmed fossil fuel deposits in Malaysia, Indonesia, Brunei as well as expected discoveries in the South China Sea will provide fuel for power-hungry emerging nations dependent on cheap fuel for their fast-rising electricity consumption. Extensive land resources for agricultural production will benefit rural populations as commodity terms of trade finally shift in their favour. We expect non-fuel commodity prices to remain elevated, with the IMF Non-Fuel Index to rise slightly above one third over the 2010 level this year, but decline 7% year-on-year in 2012, while a weighted average of the three main oil indices is expected to average \$107 a barrel this year before falling to \$95 in 2012.

ASEAN's future is tied to emerging markets

In terms of export performance, ASEAN was hit harder than other regions during the financial crisis. From the time of Lehman's collapse in September 2008 to the first quarter of 2009, exports dropped by roughly one third, compared to one fifth in advanced economies and less than a sixth in other emerging economies. Despite this, export growth from ASEAN managed to overtake the advanced economies by early 2010 and had even caught up with emerging markets late that year. Despite a relatively slower pace of growth since then compared to other emerging markets, ASEAN's exports have still risen by 14.1% compared to September 2008 whereas advanced economies appear stuck slightly below their level of September 2008. Taken together, this underscores that the region's fortunes are increasingly tied to emerging markets, a link that has swelled prosperity according to the GDP growth analysis shown in Figure 4.

Figure 4: Export volume index; September 2008=100

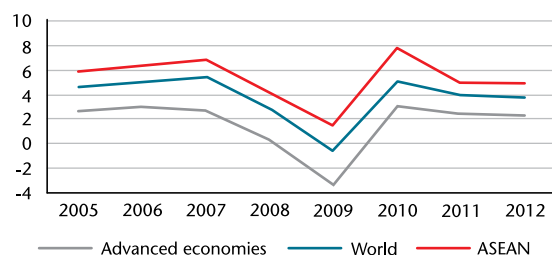


Source: CPB, IMF, Cebr analysis

An international growth comparison from 2005 until the forecast horizon of 2012 reveals that ASEAN has been the most economically successful emerging region in GDP growth terms since last year, with GDP-weighted growth of 7.7% in 2010 and a still-strong 4.9% expected in 2011. We project outperformance over the rest of the world economy to continue into next year. A slowing to 4.8% growth due to softening import demand of major Western markets, but a benign mix of factors should support ASEAN growth. These comprise high commodity prices, including agricultural, energy and most other mineral resources, strong exposure to the fast-growing Asia and, most importantly for the future beyond price cycles, growing private consumption.

While rising exports have historically been a major driver of successful Asian economies, rising domestic consumption means that net trade will take on a supporting rather than a leading role in coming years. The expanding middle class of Indonesia, Malaysia and Thailand is likely to boost private expenditure growth to above 5% annually as rising income levels increasingly support the purchase of sophisticated durable goods. These countries have a combined population of similar size to the US. With their rising middle classes, this makes them an attractive market for durable consumer goods, turning countries previously thought of as manufacturers into major customers for global firms. In this context, rising export volumes mainly serve to finance growing imports.

Figure 5: Comparison of annual economic growth rates by region, annual percentage change

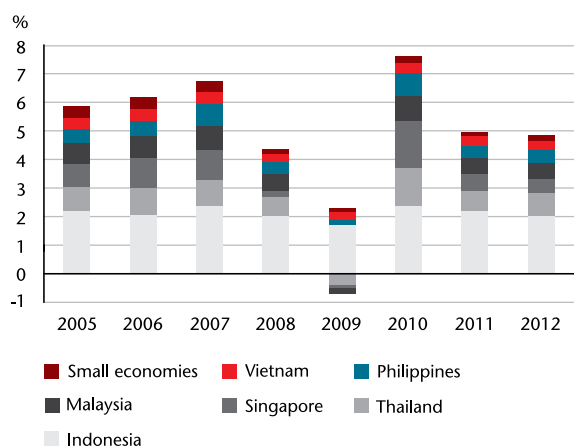


Source: IMF, Cebr analysis

Indonesia has been and will be the main driver of regional growth, providing 31% of ASEAN's output expansion in 2010. With 234 million people – containing four in ten of the region's citizens – the country dwarfs its neighbours and regional integration means that its performance will lift the fortunes of South East Asia as a whole. Posting a growth rate of 4.6% in 2009, Indonesia's strong growth in the aftermath of the financial crisis is especially remarkable and suggests a more stable economic base, in contrast to the country's severe contraction during the financial crisis. We forecast Indonesia to make an even bigger 42.8% contribution to ASEAN growth in 2012.

Although its population is 45 times smaller than Indonesia's, Singapore nevertheless contributed 21.5% of regional growth in an exceptionally strong year for the city state in 2010. Showing that these medium-sized middle income countries are similarly crucial to regional prosperity, Thailand added 17.6% and Malaysia 12.1% to output growth. Vietnam still contributed 5%, despite its low per capita income level. Brunei, Cambodia, Laos and Myanmar only added 2.9% to regional GDP in 2010, but as convergence of living standards takes place in the lower-income countries, their impact is bound to grow substantially.

Figure 6: Country contributions to ASEAN growth, percentage points

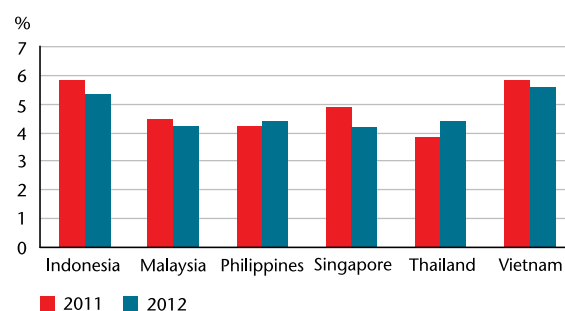


Source: IMF, Cebr analysis

Given the variety of economic structures among the ASEAN, different factors impact the respective economies. Generally speaking, high commodity prices are supportive of growth due to the importance of fossil fuels for Malaysia and Indonesia and an important agricultural sector in all countries but Singapore. Figure 7 provides an overview of 2011 and 2012 growth projections for the six countries.

Strong foreign direct investment and goods prices for its commodity exports as well as rising domestic consumption are set to support a continuation of fairly stable growth in **Indonesia**. We forecast output to rise by 5.8% in 2011 and 5.3% in 2012, contingent on

Figure 7: Country-level GDP growth forecasts



Source: Cebr analysis

Bank Indonesia being able to control rising inflationary pressures with a steady increase in interest rates. An announcement of public investment plans is a positive sign, but the longer-term sustainability of high GDP growth depends on infrastructure investment. This may be difficult to finance by the public sector due to the high cost of fuel subsidies putting pressure on public finances.

Solid growth of **Malaysia's** strong export sector will allow the country to increase its consumption of foreign goods without jeopardising its current account surplus, unless a further appreciation of the ringgit puts pressure on export competitiveness. With consumer spending rising above the rate of growth, Malaysia is a good example of the regional tendency for the domestic market to gain in importance. Forecast GDP growth rates of 4.5% in 2011 and 4.3% in 2012 are slightly below trend and subject to downside risk as consumer and business confidence may be adversely affected by political events.

Healthy private consumption growth amid a gradual decline in unemployment and a good performance of the sizeable agricultural sector is going some way to counteract a worsening of the trade balance in the **Philippines**. The country remains heavily reliant on remittances, however, and political tensions in the Middle East are putting some pressure on this part of national income. On balance, we expect annual growth of 4.2% in 2011 as the economy cools after last year's extraordinarily strong performance. Next year, we see growth at around 4.4% since sub-standard infrastructure holds the growth rate below potential.

Aside from an unexpected contraction in second quarter GDP, **Singapore** continues to post impressive growth rates thanks to strong exports and its status as both a trade hub and a regional financial centre with a burgeoning asset management industry. Seen in the context of a huge 14.5% output expansion in 2010 and recent unemployment of only 2.1%, a moderate slowdown is beneficial. In this light, popular but potentially disruptive policies such as the tightening of policies for foreign workers in the aftermath of an unexpected electoral result for the long-ruling PAP look unlikely to seriously disturb growth, which we expect to come in at 4.9% this year and at 4.2% in 2012.

With a decisive election win of the allies of exiled former Prime Minister Thaksin Shinawatra and the acceptance of the result by the country's establishment, **Thailand** looks set for a period of relative calm after the economically disruptive disturbances of previous years. The new government is likely to carry on redistributive policies, including fuel subsidies and support for rural areas. Combined with the introduction of a minimum wage, these measures should support domestic consumption and help the economy return closer to its growth potential of around 5% next year. In 2011, however, a disruption of the important automotive industry due to the Japanese earthquake and weaker export demand should lead growth to dip to about 3.8%. Given an unemployment rate near 1%, the threat of domestic wage pressures may force the Bank of Thailand to keep raising interest rates. Given its reliance on manufactured exports, further rises of the already strong baht resulting from higher interest rates would pose a risk to economic growth.

As wages rise in the coastal regions of China, **Vietnam** is becoming an increasingly attractive location for labour-intensive manufacturing. While this should result in rising exports as productive capacity is added, growing imports due to fast-growing private

consumption and the purchase of foreign capital goods are leading to a large trade deficit. This has prompted ratings agencies to downgrade Vietnam's sovereign debt over fears of a balance of payments crisis that could bring the currency down and make foreign debt unserviceable. Amid high growth of 5.8% in 2011 and 5.6% forecast for 2012, inflation is another worry that will require a restrictive monetary policy, raising the risk of choking growth. While its fundamentals are promising, the country therefore faces serious challenges in the coming year.

From a longer-term economic perspective, the challenge for most countries in the region is to make a similar transition towards industrialisation that other ASEAN nations have achieved before them. Vietnam, for instance, needs to invest heavily in infrastructure and education to replicate the success of Malaysia, whereas Malaysia needs to take the next steps in forging an economic and regulatory system that will allow it to replicate Singapore's success in building an internationally competitive and widely diversified industrial base. For Singapore itself, creating a workforce that rivals the creativeness of global innovation leaders poses a challenge that, while widely recognised already, will require substantive efforts if high growth rates are to be maintained.



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¹ Western world is defined here as North America and Western and Central Europe.

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