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ECONOMIC INSIGHT

SOUTH EAST ASIA

Quarterly briefing Q4 2013

STRONGER GLOBAL GROWTH TO PROVIDE RESPITE TO AN ASEAN BELEAGUERED BY WEAK EXPORTS

Welcome to ICAEW's *Economic Insight: South East Asia,* a quarterly forecast for the region prepared specifically 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 largest economies of the Association of South East Asian Nations (ASEAN) – namely Indonesia, Malaysia, the Philippines, Singapore and Thailand.

After slowing since 2010, world economic growth is set to accelerate over the coming years, bringing with it fresh hope of revitalised demand for international trade. Despite this, economic and political events across the globe run the risk of unsettling this upward trajectory. In the US, an improving economic outlook may potentially be dampened as a result of the government shutdown triggered by both political parties as they reached another impasse on policy. This was then compounded by stark political brinkmanship over increasing the debt ceiling – a political strategy that brought into focus the risk of default. While markets showed no real sign of panic, the willingness of the US political elite to walk so dangerously close to the edge could reduce confidence in their ability to manage a healthy recovery and may dampen economic growth slightly.

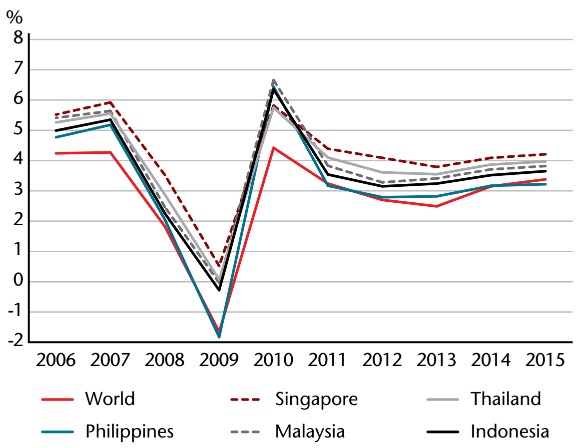
Chinese GDP growth increased in the third quarter of this year, sending signals that the economy remained in a fairly healthy position for growth. Beyond this headline figure, however, other indicators suggest that the world's second largest economy is still very much on track for a soft landing. Slowing manufacturing growth is strongly indicative of a cooling Chinese economy. Meanwhile, a return to growth in the eurozone is welcome news for ASEAN, providing the possibility of greater demand for exports from one of its key trading partners. However, significant disparities in economic performance remain embedded within the single currency area. For example, although the latest survey data suggest increasing manufacturing output overall in the region, they also indicate that the manufacturing sector in France is still shrinking.

The tragic destruction caused by Typhoon Haiyan will directly impact the economic performance of the Philippines as the damage to infrastructure, cities and livelihoods limits economic expansion towards the end of this year. The other ASEAN economies are closely integrated with the Philippines' and are hence also expected to suffer, albeit to a lesser extent. While the full impact is difficult to estimate at this stage, it is likely that this natural disaster will hold back trade between ASEAN members as well as international trade more generally. In these uncertain times, ASEAN countries will need to be prepared to take full advantage of any opportunities to boost their exports and their economy. The next section of this report analyses how well ASEAN is positioned to benefit from growth in the global economy over the next couple of years.

ASEAN STANDS READY TO EXPLOIT PICK UP IN WORLD GROWTH

Traditionally seen as exporting machines, ASEAN's member nations are highly integrated with the world economy and as a result their own health relies heavily on the strength of their trade partners. Over the last two years economic growth in ASEAN's key trading partners has measurably slowed down, leading to a deceleration in the pace of exports. Figure 1 shows how global economic growth weighted by share of ASEAN's goods exports has evolved over time.

Figure 1: Global economic growth weighted by share of ASEAN's goods exports, against actual world economic growth



Source: IMF, Cebr analysis and forecasts

After weakening for two consecutive years, many of ASEAN's export markets are set to experience faster economic growth rates over 2014 and 2015, which will feed through into stronger demand for exports from South East Asian economies. This will lessen the pressure that ASEAN's exporters have been experiencing since the financial crisis and will therefore help to support overall economic growth. In particular, an acceleration of economic activity in the US, which accounts for 11% of ASEAN's exports of goods, will boost demand for ASEAN's goods and services.

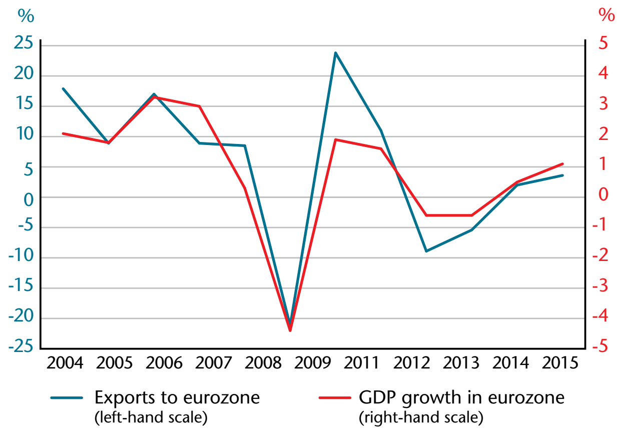
However, in the medium term, a gradual but firm trend of cooling Chinese economic growth will continue to act as an export growth cap, limiting the extent to which ASEAN can return to its traditional economic model of using exports to drive growth. Despite some more positive data on GDP growth in the third quarter of this year, there are clear indications that economic growth in the world's second largest economy will continue to slide in coming years. Slowing expansion in manufacturing and heavy increases in leverage both point to a high chance of a soft landing for China. As China currently demands 16% of the goods exported by the region, this will take much of the steam out of recovering growth rates for ASEAN exports over 2013 and 2014 – hence the fairly shallow gradients in Figure 1 above.

Japan meanwhile, which currently accounts for 13% of ASEAN's goods exports, will also reduce its demand for ASEAN goods and services in the short term. The policies of 'Abenomics' have crushed the value of the Japanese yen, making ASEAN's exports far less affordable. This impact has been somewhat mitigated by the depreciation of ASEAN currencies earlier in the year – most notably Indonesia's – nonetheless, a continuation along this trajectory will see Japan's share of ASEAN's exports decrease in future years.

In spite of these negative pressures, ASEAN's exporters are well positioned to capitalise from the steady improvement in global economic activity in 2014 and 2015, as illustrated in Figure 1. For all members, except the Philippines, the bulk of ASEAN's key export markets are forecast to grow by more than the global average in these years. Broadly speaking, ASEAN's exporters are oriented towards those markets that we expect to experience relatively high economic growth. This will support their economic health and insulate them to an extent from a global economy that is, in general, weaker than it was before the financial crisis.

LONG-AWAITED RETURN TO GROWTH IN THE EUROZONE WILL INCREASE DEMAND FOR ASEAN'S GOODS

Figure 2: Annual change in ASEAN's goods exports to eurozone; and annual change in eurozone GDP



Source: IMF, Cebr analysis and forecasts

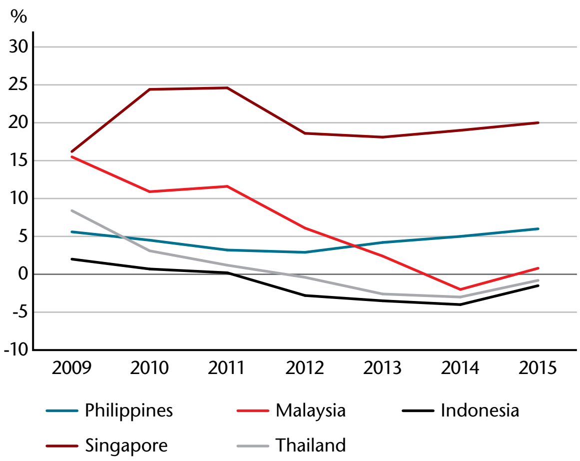
The eurozone will make an important contribution to improving growth rates for ASEAN's exports in coming years. Prolonged weakness and recession in the single currency union has led to its share of ASEAN's exports falling from 13% before the financial crisis to 10% in 2013. While the nascent recovery in the region will not dramatically increase this share in the near term, it will ease the drag on export growth that ASEAN has been feeling in recent years. This prospect gains credence from the improving sentiment among purchasing managers in the manufacturing sectors of eurozone economies. This indicates that there will be future increases in the eurozone's demand for ASEAN commodities and other exports in the near term.

Figure 2 shows the strong correlation between overall GDP growth in the eurozone and the region's demand for ASEAN's goods exports.

During the six consecutive quarters of recession in the eurozone between Q4 2011 and Q1 2013, its demand for goods exported by ASEAN fell by 20% – a sharp reduction, which hurt ASEAN's overall economic performance. Now, the emerging shoots of economic recovery in the currency union will drive GDP growth of 0.7% and 1.1% in 2014 and 2015 respectively. While weak, this will cause the eurozone's demand for goods from ASEAN to bounce back by approximately 2% to 4% in each of the two years. This will provide a helpful boost to ASEAN's economies at a time of slowing demand from China and Japan. Return to growth in the eurozone and stronger expansion in the US in coming years will offer ASEAN some breathing space which could be used to enact social and economic reforms to help further strengthen international trade and investment links. The significant variation in economic performance between the economies within the eurozone, however, is a threat to this possible respite. Burgeoning public debt, austerity measures and highly elevated unemployment are all risks to the budding recovery without which ASEAN goods exports to the region will suffer.

STRONGER EXPORTS TO SHRINK CURRENT ACCOUNT DEFICITS

Figure 3: Current account balance for individual ASEAN economies as a percentage of GDP



Source: Bank Indonesia, Bank of Thailand, Department of Statistics Malaysia, Singapore Department of Statistics, Bangko Sentral ng Pilipinas, Macrobond, Cebr analysis and forecasts

An economy's current account balance represents its net financial position once all payments for imports and exports of goods and services have been made. A current account deficit occurs when an economy imports more than it exports, while a surplus occurs in the opposite scenario. In recent years several ASEAN economies have seen their current account balances deteriorate as cooling global growth, particularly in China and Japan, has led to imports outpacing exports. However, stronger export performance down the road will help to reverse this slide into the red, and will help to bolster ASEAN's balance of payments. Figure 3 shows the current account balance for individual ASEAN economies as a percentage of GDP and presents forecasts for the future.

For most of ASEAN, the implications of easing ASEAN export demand growth from China will prove the dominant factor in 2014, outweighing the increases in export demand from the US and the eurozone. This is particularly the case for Indonesia, where China and Japan together hold a 27% share of goods exports versus 8% for the US. Moreover, the economic damage caused by Typhoon Haiyan will negatively impact exports from the entire ASEAN region, as reduced exports from the Philippines will also have knock-on effects on the exporting capability of the other ASEAN economies. Consequently, current account deficits for Indonesia, Thailand and Malaysia are forecast to widen slightly in 2014. However, robust increases in demand from the US and eurozone in 2015 will push these current account balances back towards, and in Malaysia's case into, positive territory.

The Philippines has experienced a lower volatility in its current account balance relative to its ASEAN neighbours, partially because the economy is less export-centric. Another important factor is the relatively high share of goods exported by the Philippines to the US. This share is currently at 14% – almost double the corresponding shares for Indonesia and Malaysia, which stand at approximately 8%. However, the damage inflicted by the recent typhoon will hamper the relatively strong improvement in its current account so far this year, as rebuilding efforts hurt export performance and support demand for imports.

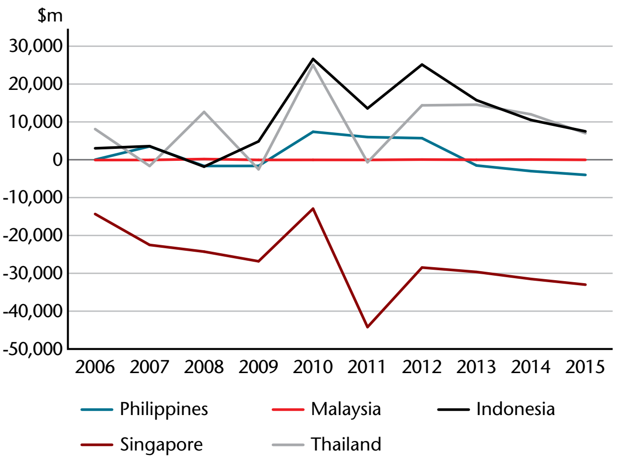
Meanwhile, since 2009, Singapore has maintained a succession of current account surpluses consistently greater than its neighbours, in percentage of GDP terms. As a highly developed city state economy, Singapore will continue to benefit significantly from increased demand for its services, as well as its goods, as the global economy improves over coming years. As a result, Singapore will see its trade surplus as a percentage of GDP increase in 2014 and 2015. Furthermore, the establishment of the ASEAN Economic Community, which is currently planned for 2015, will encourage free trade and improve competition between ASEAN's various economies. This will lead to exporters becoming more efficient and more productive, and will offer another boost to export growth over coming years.

While current account deficits will narrow by 2015, they must still be accounted for. One way of financing these deficits is through the capital account, which is the subject of the next section.

CAPITAL ACCOUNTS TO FEEL THE SQUEEZE OF TIGHTER MONETARY STANCE IN THE US

The capital and financial account is a second important component of an economy's balance of payments. It shows the net financial position of all capital that flows in and out of an economy. If capital outflows dominate, the capital account is in deficit, whereas if capital inflows dominate, the capital account is in surplus. Loose monetary policy across the world since the financial crisis, particularly in the US, has made money available more cheaply. This in turn has increased investors' appetite for risk and has driven tides of capital to ASEAN and other emerging markets. As the Federal Reserve tightens the strings on its monthly asset purchases early next year, yields in developed economies will grow, attracting capital back from the emerging world. Figure 4 illustrates the evolution of the capital account balances in ASEAN economies as well as our forecasts for 2014 and 2015.

Figure 4: Capital and financial account balance ($ millions)



Source: Bank Indonesia, Bank of Thailand, Department of Statistics Malaysia, Singapore Department of Statistics, Bangko Sentral ng Pilipinas, Macrobond, Cebr analysis and forecasts

The nomination of Janet Yellen as next in line to take the helm of the Federal Reserve when Ben Bernanke's second term finishes at the end of January 2014, has eased markets previous nervousness about an early tapering of the central bank's asset purchasing programme. Yellen is widely reputed to have more dovish monetary policy views than her predecessor and as such markets are calculating reduced odds of an early taper.

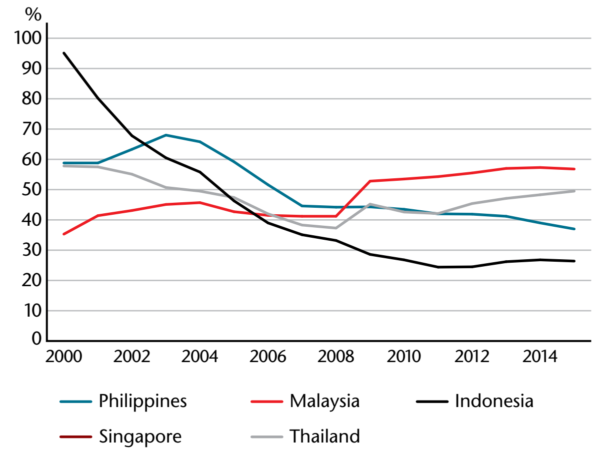
Nonetheless, capital inflows to Indonesia and Thailand will slow over the next two years as yields in the developed world begin to rise. Meanwhile, the Philippines will experience net capital outflows and Singapore's capital account balance, once again, stands out from the crowd. High current account surpluses and relatively low yields on investment in Singapore compared to its neighbours will help spur net capital outflows.

Nonetheless, investor sentiment is liable to quick and unexpected change. While global monetary policy is a key factor influencing capital flows into ASEAN, it is by no means the only one. Another closely watched indicator is public debt levels, which are examined in the next section.

RISING DEBT LEVELS WILL KEEP INVESTORS WARY

When deemed to be unsustainable by investors, high debt levels are toxic to any economy, regardless of the true, underlying state of its health. If investors' fear of losing their returns is strong enough to cause large increases in borrowing costs, then their expectations become self-fulfilling. Public debt to GDP ratios are forecast to increase for most of the large ASEAN economies, as shown in Figure 5.

Figure 5: Public debt to GDP ratio



Source: IMF

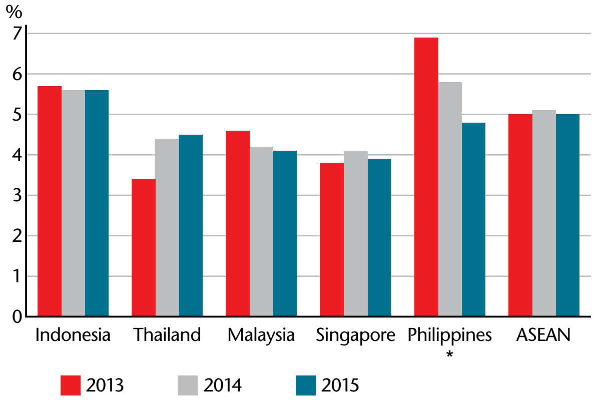
Public debt in Thailand and Malaysia will come closer to 60% of GDP over coming years – a point at which investors become more concerned about the sustainability of such a financial position. The cost of servicing and repaying this level of debt will have significant implications for future government spending, investment and household consumption, and will decrease the attractiveness to foreign investors of investing in these countries. This will exacerbate reduced capital inflows into Thailand and Malaysia at a time when tighter monetary policy will already be increasing the appeal of assets in Western economies, putting pressure on investment from abroad.

Indonesia will also see its debt to GDP ratio increase over the next two years, but successive falls over the previous decade will limit investors' concerns over this development. A political willingness to tackle a number of fiscal battles indicates that the economy's public debt burden will remain significantly lighter than its ASEAN brethren. Singapore's debt to GDP ratio has been excluded because it only shows the government's liabilities and as a result is somewhat misleading. Singapore's Government invests borrowed funds into assets, while returns from these investments are then used to cover the debt servicing costs and as such, Singapore's public finances remain very healthy.

CAUTIOUS CAPITAL FLOWS INTO ASEAN TO LIMIT GROWTH

We forecast ASEAN to grow by 5.0% this year as the recession in Thailand weighs down on overall economic growth in the region. While Thailand is expected to exit recession in the second half of this year, next year will see China continue on its trajectory of a soft landing, bringing down growth in its demand for ASEAN's goods and services. Stronger global growth and the establishment of the ASEAN Economic Community will offer some respite, but tighter monetary policy in the US as the Federal Reserve begins to taper, will mean growth remains relatively subdued at 5.1% in 2014 and 5.0% in 2015. Figure 6 illustrates our forecasts for GDP growth for the five largest economies in ASEAN, and for the region as a whole. The recent tragic natural disaster in the Philippines has damaged countless lives and is expected to negatively impact economic growth this year. Intra-regional trade will be adversely affected and will therefore also hamper growth in other ASEAN countries while rebuilding activity and strengthening trade in 2014 creates the potential for stronger economic growth. However, it is too soon to accurately quantify the full extent of the economic implications of the recent typhoon. Our current forecasts, shown below, have not accounted for this at this stage, but the economic implications of the devastation caused by the typhoon present significant downside risks to growth in ASEAN. These estimates will be revised for the next edition of this report as more information becomes available.

Figure 6: Cebr forecasts for annual growth in real GDP for five largest economies in ASEAN



*Forecasts for Philippines are subject to change given the recent natural disaster
Source: Cebr forecasts

A slight pick up in Chinese economic growth in the second half of this year will soften the blow of the giant's cooling economy on **Indonesia's** exports, allowing ASEAN's largest economy to grow by 5.7% over 2013. Tighter US monetary policy in 2014, combined with concerns about the value of the rupiah, will spur central bankers to increase interest rates, hitting investment and consumption. We forecast that growth will tick down to 5.6% in both 2014 and 2015. The Indonesian presidential election of 2014 brings the possibility of new reforms aimed at improving international trade links which could boost economic growth. A commitment to improvements in infrastructure and tackling graft would help to reduce inefficiencies in the Indonesian economy and would be welcomed by investors. However, a departure from fiscal discipline could result in making financial markets nervous so any reforms would have to be designed and implemented carefully.

Thailand's economy will escape technical recession in the second half of this year thanks to stronger exports, and will grow by 3.4% this year. Healthier consumption and export performance will cause GDP growth to increase to 4.4% in 2014. While a softening Chinese economy, investor wariness of Thailand's public debt levels and tapering asset purchases in the US will stop growth rates from accelerating to pre-crisis levels, stronger exports to Western economies will help GDP growth tick up slightly to 4.5% in 2015.

While a slightly stronger Chinese economy will help **Malaysia** post economic growth of 4.6% this year, weaker Chinese growth in 2014 will pull down growth to 4.2%. Concurrently, high household and public debt levels will fuel concerns of unsustainable credit growth which will in turn hurt investment and household consumption. Moreover, the implementation of a revamped general sales tax in 2015 will further hamper consumption growth. However, a stronger global economy should mitigate this somewhat – we forecast that GDP will rise by 4.1% in 2015.

Economic growth in **Singapore** will remain relatively robust compared to the rest of ASEAN. Healthy increases in consumption and strong performance in exports of both goods and services will boost GDP by 3.8% this year. Strong momentum and greater demand for its services will help increase growth to 4.1% in 2014, although this will decelerate slightly to 3.9% in 2015.

Strong government spending in the **Philippines** and an expected increase in exports to China in the latter half of this year were forecast to boost GDP growth to 6.9% in 2013. However, the tragic devastation caused by Typhoon Haiyan and the resulting economic and social damage will prevent this level of growth. While it is too early to reliably quantify the economic implications of this natural disaster, we expect economic growth to be noticeably weaker in the final quarter of this year. Slowing growth in government spending and tighter monetary policy in the US is expected to limit growth to 5.8% in 2014, although rebuilding activity in the wake of the recent typhoon could help to support growth. Obstinately high unemployment rates and high poverty levels, combined with the need to raise interest rates to attract capital, will cause GDP growth to fall to 4.8% in 2015. These forecasts will change as more information about the economic impact of the typhoon and the subsequent rebuilding effort becomes available.

A HARD LANDING FOR CHINA OR RENEWED CRISIS IN EUROZONE WOULD HAVE SERIOUS IMPLICATIONS FOR ASEAN

Any development that significantly and adversely impacts the demand of a key trading partner for ASEAN's exports would have dire repercussions for economic growth in South East Asia. A sudden, unexpected slowdown in China would amplify the difficulties that ASEAN is already experiencing and would cripple export growth, which is still a crucial contributor to overall economic performance. Similarly, renewed crisis in the eurozone would further reduce demand from a region of the world that currently commands 10% of ASEAN's goods exports.

Meanwhile, should the incoming Chair of the Federal Reserve, Janet Yellen, be less eager to maintain loose monetary policy than investors expect, markets will be caught by surprise. Markets met with unexpected surprises are liable to overreact and in ASEAN's case sell assets including domestic ASEAN currencies. Further, sudden depreciations in domestic currency will weaken investor confidence in ASEAN, hitting external financing and investment even as exports are slowing. This would significantly and quickly transform the credit environment in South East Asia and would forcibly wean the region's economies off any dependence on loose monetary conditions to drive growth. The consequences of this would be hard-felt in Indonesia and Thailand, whose economies have experienced high growth rates in net capital inflows since the financial crisis. Fortunately, ASEAN's central banks have steadily increased their reserves over the previous decade, giving them some firepower to guard against possible currency depreciations. This leaves ASEAN better placed to deal with unexpectedly high capital outflows than they were before the South East Asian financial crisis in the late 1990s and early 2000s.

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For enquiries or additional information, please contact:

Leisl Pillay

T (+65) 6407 1527
E leisl.pillay@icaew.com

ICAEW
9 Temasek Boulevard
#09–01 Suntec Tower Two
Singapore
038989
icaew.com/southeastasia

ICAEW
Chartered Accountants' Hall
Moorgate Place
London
EC2R 6EA UK
icaew.com