# Economic Insight South East Asia

## Quarterly briefing Q3 2015

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, Thailand and Vietnam.

## Global powers vie for influence as ASEAN's presence grows on world stage

China's rise on to the economic and geopolitical world stage has already transformed ASEAN and is set to further do so. From the establishment of the Asian Infrastructure and Investment Bank, which gained its 50th country in June, to the Maritime Silk Road passing from east to west via South East Asia, to the growing web of complex interlocking trade deals across Asia, ASEAN is central to China's global economic ambitions. China is already South East Asia's largest trading partner and is now one of the largest investors in the region.

India is making similar moves, albeit with a later start. Late 2014 saw the signing of an Indian–ASEAN free trade agreement for services and investment, four years after free trade in goods was established. New President Narendra Modi's 'Look East' policy of active diplomacy has turned into 'Act East' with relations between India and ASEAN given high priority and several bilateral meetings between Modi and ASEAN heads of state.

These developments have prompted the US and Japan, established outside actors in the region, to solidify their own interests with South East Asian partners. They are already large investors in, and trading partners of ASEAN and see the region as a production base, an expanding export market and a source of raw materials.

This report focuses on the economic relationships between the big four economies – the world's four largest[1] – and ASEAN. It discusses how they will change the landscape for trade and investment in South East Asian markets. While the dynamic of competing interests could be seen as a clash, in fact South East Asian people and businesses stand to make significant gains from these shifts. ASEAN's original purpose was to allow the region to speak with a unified voice and avoid countries being drawn into disputes between global powers. This purpose will remain essential as South East Asian nations attempt to gain from trade flows, foreign direct investment

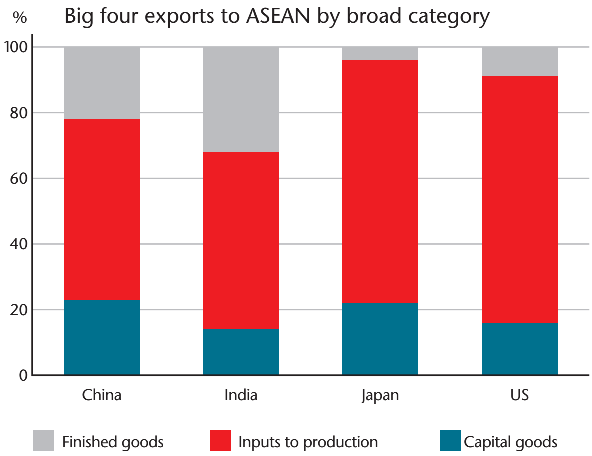
(FDI) and opportunities for developmental aid which will result from competition for influence between global economic giants. Ongoing regional integration, by which members intend to create the ASEAN Economic Community (AEC) by the end of 2015, improves the chances of profiting through this by enhancing South East Asia's economic bargaining clout.

## ASEAN's trade relationships with the big four

What makes this an area of strategic importance?

- It is a manufacturing hub, highly competitive due to its large pool of relatively cheap labour. All ASEAN economies have followed a model of export-led growth to some extent. They attract large inward flows of FDI as firms set up manufacturing bases from which they export worldwide. This spurs investment in the infrastructure that facilitates this role.
- ASEAN is home to some 600m consumers, including one of the world's fastest-growing middle classes. This encourages large economies to sign trade agreements with ASEAN in order to export their own products to it. It also reinforces the manufacturing hub role, as producing near consumers is cheaper.
- The area is rich in commodities, in high demand from those nations that have large manufacturing bases themselves.

**Figure 1: Different trading patterns reflect different priorities for the big four in ASEAN**




Source: UN COMTRADE via World Bank World Integrated Trade Solution (WITS)

Figure 1 shows the profile of exports between the four largest economies and the ASEAN trading bloc. While these countries may be economic rivals, the differences between their developmental stages and structural features of their economies mean their trade with ASEAN is very different. Global production is usually carried out across markets. Inputs (such as raw materials, processed materials and machine parts) are extracted in one country, processed in another, then turned into parts, assembled and finally sent to end-consumers.

The Japanese and Chinese inputs include much larger proportions of capital goods/parts, meaning any machinery or equipment used in production of any type. This requires precision engineering. The 'manufacturing hub' relationship means Japanese and Chinese corporations set up plants in South East Asia and these subsequently assemble goods from parts, which may also come from Japan or China. The assembled goods are consumed in ASEAN or exported worldwide. For example, in the more granular breakdown of trade, we find that the Japanese exports in the 'inputs to production' category include high proportions of car parts and parts of capital goods. These parts go to South East Asia for assembly, a relatively low-value part of the supply chain. In time, this work can evolve into manufacturing the parts themselves which is more valuable.

Japan has long pursued an industrial model whereby its corporations use neighbouring economies as production bases. This became a necessity to maintain competitiveness as Japan itself moved from a developing to an advanced economy. The role of China in this relationship is diminishing as Chinese incomes in turn rise; corporations then manufacture in ASEAN economies. Vietnam, the Philippines, Thailand and Indonesia are particularly important locations at present. For example, Vietnamese exports by domestic firms were similar to those by foreign firms in 2002; now foreign exporters based in Vietnam export over double the domestic sector's total. Wages in Malaysia and Singapore are generally too high for basic manufacturing/assembly, and the poorer ASEAN-3 (Myanmar, Cambodia and Laos) do not yet have the necessary skills.

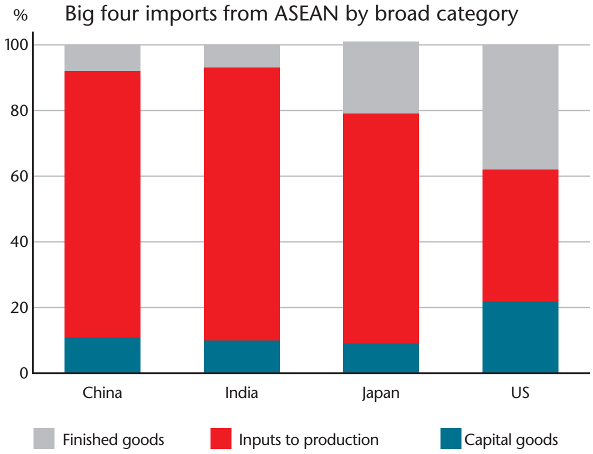
Japanese car manufacturers have a longstanding relationship of producing in Thailand. But a series of recent setbacks is leading to Indonesia and Vietnam taking greater prominence: severe floods disrupted supply chains in 2011, and this was followed by years of political unrest culminating in the coup of May 2014. Since this, foreign investment has become increasingly difficult to push through, meaning that Indonesia and Vietnam have a chance to attract Japanese investment in plant. Another factor encouraging production in ASEAN is a subtle form of trade protectionism, whereby manufactured goods must include a certain proportion of local inputs. This means that in order to tap local markets, 'You basically have to build cars in the country in which you want to sell them,' according to Matt Hobbs of General Motors.[2]

As China follows a similar model to Japan, it has reached the stage where wages become uncompetitive for low-value production. Offshoring production becomes cheaper, and therefore Chinese firms look to ASEAN for the low-wage, assembly stage of the production process. But there is a difference: despite China being richer than most of ASEAN, it exports large (and increasing) quantities of consumer goods whereas Japan and the US do not. This defies the script of China's planned development path, under which China is supposed to shift from exports to domestic consumption-driven economic growth. As Chinese households are not buying more of its vast output as they become richer, it continues to export large quantities of consumer goods to overseas markets, even ones that are poorer than itself such as much of ASEAN. This demonstrates ASEAN's second function for China: with excess industrial capacity, China needs overseas consumer markets until it can persuade its own consumers to soak up domestic production.

India's inputs sent to ASEAN largely consist of fuel, which it sends to Singapore. Refined petroleum dominates trade between the two countries, with a (slightly less) large volume travelling in the other direction. Surprisingly, this is in the absence of either country having substantial reserves. Both have huge refinement capacity, and this now represents one of India's main goods exports. Singapore, as a global hub for trade in oil and gas, is crucial to the Indian economy.

US exports to ASEAN are similar to those for Japan and China, but lighter on finished goods since the US is a service-driven economy. The US exports a significant amount of military equipment, which it supplies to South East Asian allies.

**Figure 2: Huge trade in inputs shows the integration of East Asian production system**




Source: UN COMTRADE via World Bank World Integrated Trade Solution (WITS)

The four major economies' imports from ASEAN show starker differences. The US and Japan, being advanced economies, are important export markets for finished goods.

South East Asia sends huge quantities of inputs to production in China and India. Japan imports little by way of machine parts/accessories from ASEAN – this would imply an assembly role, which there is little value in Japanese workers doing. But it relies heavily on ASEAN for its fuel (28% of total imports), while in China this forms a much smaller part of its import basket (6%). Not only does China have oil reserves of its own, it also has a wider network of sources which it can draw upon. But China relies heavily on raw and processed 'industrial supplies', meaning mainly commodities. Indonesian coal and palm oil, Thai rubber, and food from the Philippines are all crucial inputs for the factories of the world's largest manufacturer.

China also has much larger trade flows with the three poorest economies of ASEAN – Cambodia, Laos and Myanmar – than the other powers. China takes 10% of its imports from ASEAN from the ASEAN-3, compared to just 3% on average for the US, India and Japan; in exports these figures are 6% and 2% respectively.[3] Apart from geography, this reflects a strategic motive: China generally does more trade with small economies. It often seeks recognition as a market economy, as opposed to a centrally planned economy, as a pre-requisite for a deal – the World Trade Organisation (WTO) holds the opposite view on China, which tends to disadvantage it in negotiations.

## Big four cement trading relationships with ASEAN

In order to expand trade with their crucial partner, the large global powers have been signing trade deals with ASEAN. The largest such deal is the Trans-Pacific Partnership (TPP), the Pacific counterpart to the giant TTIP (Transatlantic Trade and Investment Partnership) between the EU and the US. The TPP has 12 members including the US, Japan, Canada, Australia and most of ASEAN. However, it excludes Indonesia – which has historically been wary of free trade deals – and China.

A second, overlapping, trade deal is the Regional Comprehensive Economic Partnership (RCEP). The RCEP includes all of ASEAN, Australia, China, India, Japan, New Zealand and South Korea. Most of these economies already have bilateral deals with ASEAN: for example, the ACFTA (ASEAN–China Free Trade Agreement) lowered Chinese import tariffs on goods from 9.8% to 0.1% while those on Chinese goods exported to ASEAN fell from 12.6% to 0.6%.[4] Such agreements have increased exports on both sides, but China now runs a large trade surplus in relation to the trading bloc.

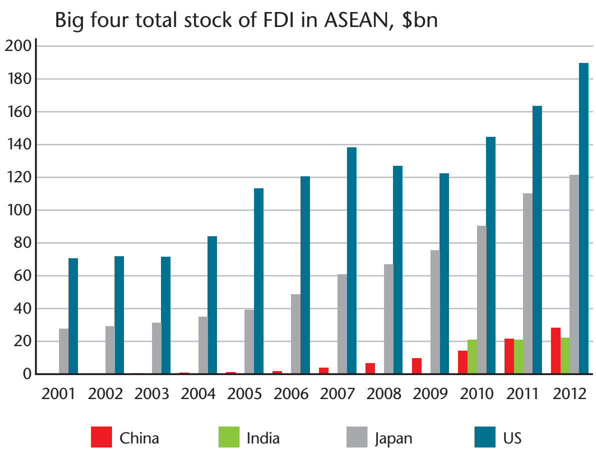
India's free trade deal with ASEAN came into effect in 2012. In this case, goods liberalisation has helped ASEAN more than India, the latter's trade deficit growing since introduction. India is striving to start the next stage of the trade deal ie, free trade of services and investment, through which it hopes to even the imbalance. Unlike China, trade deficits are an important concern for several ASEAN economies, such as Malaysia and the Philippines, and for India.

The overall result of these deals is a complex web of bilateral and multilateral arrangements across Asia, described by *The Economist* as a 'noodle bowl' of overlapping links. The problem with this 'regionalisation' of agreements that used to be made under the WTO is that this introduces distortions, where a less-competitive economy ends up artificially more competitive than another in a third market due to more favourable trade arrangements, an outcome termed 'trade diversion'.

Regionalisation also undermines the strength of the Geneva-based WTO, which China sees as protective of Western interests in the world trade system. The US–China Economic and Security Commission attributes various motives to Chinese trade policy, such as improving its resource security, pursuing regional security interests and improving its position in the international trading regime. This explains strong links with countries that are not US-aligned, such as Myanmar and Cambodia.

A recent shift for China is a tendency towards investing abroad rather than just trading. Investments tend to take place in larger, more advanced economies – such as the ASEAN-6. The next section addresses FDI in ASEAN.

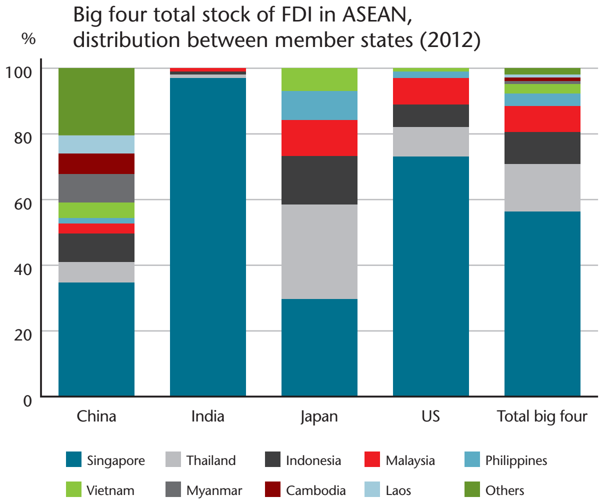
**Figure 3: China moving from trading nation to large overseas investor**




Source: UN Conference on Trade and Development (UNCTAD) FDI/TNC database
Pre-2010 data not available for India

Figure 3 shows how the big four economies have changed their stocks of investments in ASEAN. The bars represent the entire productive stock anywhere in South East Asia owned by each respective country: factories, offices, ports, mines, etc. Despite the very assertive Chinese moves into trading with ASEAN, Asia's largest economy remains far behind the US and Japan in investing there. Until 2010, mainland Chinese investment lagged behind even India.[5] But China will soon catch up with the US and Japan. Its investment is growing far more rapidly than the others': on average, since 2003 its stock in ASEAN has grown by 54% per year, compared to 14% for Japan, 9% for the US and just 3% for India.

**Figure 4: Singapore most popular destination by far, but others catching up**




Source: UN Conference on Trade and Development (UNCTAD) FDI/TNC database

Figure 4 shows where within ASEAN these investments are going. For all four, the largest single total stock is in Singapore. But this varies from 30% of Japan's to 97% of India's. Singapore's many attractions for locating multinational headquarters are well known: very good infrastructure; an educated workforce; low taxes; and integration in global capital markets. These apply to many other investments in the city-state, which the open investment regime encourages.

Japanese and Chinese investments are widely distributed across South East Asia, in keeping with the manufacturing hub relationship, while the US and India have concentrated their stocks in Singapore. Japanese firms have set up many factories to produce electronics in Vietnam, making it the largest single investor there. Even US companies, such as chipmaker Intel, have followed, as relations between the two nations gradually thaw. As well as high-tech exports, Vietnam produces footwear, clothing, textiles and wooden furniture for advanced-nation consumers; much of that is made in facilities owned by foreign investors.

China's investment pattern is radically different to the other three powers. No other economy has more than 0.1% of its ASEAN investment stock in Myanmar, Laos or Cambodia, and yet China has 11%, 7% and 8% respectively of its ASEAN investment in these countries. It also invests very little in the Philippines, which has received 2.1% of the Chinese South East Asian investment compared to an average of 4.3% for the big four. This reflects China's economic ties to countries not aligned with the US, and weaker ties to countries that are traditionally staunch American allies. Wider geopolitical concerns play a role in trade and investment policy.

Europe and the US have isolated Myanmar economically and politically for many years with relations only recently thawing, whereas China sees the country as pivotal to its own interests. Chinese strategic interests centre on access to the Indian Ocean and Myanmar's natural resources, but its main contribution so far has been investment in the energy sector, a key requirement for stimulating the very underdeveloped economy.

Another country investing relatively little in the Philippines is India: these two countries have similar trading patterns, as lower middle-income economies with strong services sectors that are fulfilling back-office roles for advanced nations. But the commonality is holding back trade between the two: India and ASEAN have just signed a free trade agreement in investment and services, but this excludes the Philippines, which feared the effects of competition from Indian firms in the IT and business process offshoring industries.

Otherwise, India expects to gain from its 2004 investment agreement with ASEAN. Despite being an offshoring hub itself in areas such as pharmaceuticals and IT, Indian firms are set on investing in South East Asia to expand capacity. They will join Indian high-tech giants such as Infosys and Wipro which already have operations in Manila.

ASEAN itself shows how structurally-similar economies, instead of being harmed by regional competition, can harness complementarities to create cross-border production networks. Maximum gains from trade are reaped when each country can specialise to its full extent – causing supply chains to extend across East Asia where raw material extraction, processing, parts manufacture, and assembly all take place in different locations. Essential to this is good infrastructure. A company that invests in plant generally has little reason to improve roads, power networks or telecoms, as little of the benefit accrues to it. The Philippines and Indonesia have seen their competitiveness hindered by a lack of resources to invest. This may change soon.

## Competition for influence to relieve capital shortages, unlocking investment in ASEAN

China is striving to increase investment in ASEAN. To this end, it has created a sovereign investment fund with a mandate to invest in the region. The China–ASEAN Investment Cooperation Fund (CAF) promises to focus on energy, infrastructure and natural resources in the region. The first phase of the fund aims to raise $1bn, with the ultimate target $10bn.

China's ambitions go further. It is seeking soft power through its new Asian Infrastructure Investment Bank (AIIB), formed as a counterweight to the US-dominated World Bank and the Japan-dominated Asian Development Bank (ADB). The AIIB is in addition to the newly founded New Development Bank, also known as the 'BRICS' bank.[6] Many large economies have signed up to join the AIIB, while the US and Japan are notable for their absence.

While the poorer parts of ASEAN have huge infrastructure needs and little by way of capital with which to fund them, China currently has an excess of infrastructure, much of it underused, and plentiful savings in search of investment opportunities. The Chinese export–import bank sponsors the CAF, suggesting that infrastructure improvements in ASEAN are likely to benefit Chinese firms.

ASEAN stands to gain through this source of capital, as it has through the other two development banks. For example, Malaysia is no longer eligible for World Bank income as its income has grown too high. The AIIB has different criteria, and may come to fund Malaysian infrastructure. Shortly after the AIIB announced its capitalisation of $100bn, Tokyo unveiled a plan to invest $110bn in Asian infrastructure projects, much of it through the ADB. On a recent trip to Japan, Indonesian President Joko 'Jokowi' Widodo welcomed a promise for $1.2bn for a new high-speed rail line. Jokowi has increased infrastructure spending by 53% in the latest budget, but this is in the context of an economy ranked 56th in the world in infrastructure quality,[7] significantly behind regional competitors like Vietnam and Thailand. The scale of investment needed to turn it into a competitive manufacturer is great.

In all three areas of trade, investment and development assistance, ASEAN can gain from the rivalry of the big four as they compete with each other for access to South East Asian workers, consumers, resources and favour from governments. Integration within ASEAN increases each nation's attractiveness – it could never have become a production hub attracting billions of dollars in Chinese and Japanese investment without the internal free movement of goods. Movement of people will become increasingly important as it seeks to move from the low-cost model that much of it currently espouses to one that will propel more ASEAN economies to high-income status.

## Recent economic news in ASEAN

New **Indonesian** President Jokowi is meeting difficulties in his programme of economic reform. Infrastructure promises have been very forthcoming but so far, construction has been less so: the Indonesian Investment Coordinating Board estimated in January that only 6% of promised investment had arrived.

The **Malaysian** ringgit has fallen to its joint-lowest level against the dollar since the Asian financial crisis in 1998.[8] Falls in the Chinese stock market, which are helping to depress commodity prices, and the expected rise in US interest rates, are propelling the ringgit's slide. It was exacerbated after allegations of corruption, which he denies, engulfed the Prime Minster Najib Razak.

The **Philippines**' cautious fiscal policy stance has won further plaudits as the Japanese Credit Rating Agency upgraded its government debt from BBB to BBB+. Following recent announcements of a strong 6.1% growth rate and 0.6% budget deficit for 2014, it is the latest in a series of upgrades awarded by various agencies.

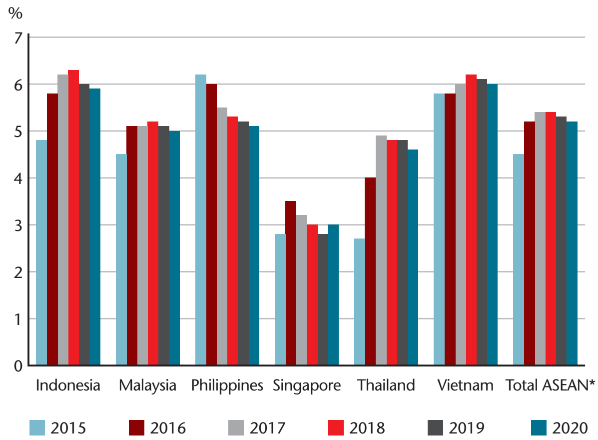
**Singapore's** stock market is experiencing fallout from the sharp declines in Chinese equities during late June and early July. The movements primarily signal a correction – downward adjustments for overvalued stocks – and so do not require a downgrade for Singapore's economic growth forecast for the year. But other sectors, including manufacturing and property, have had a tepid first half of 2015, meaning we now expect growth of 3.1% this year (down from a previous forecast of 3.5%).

The Bank of **Thailand** (BoT) has appointed former IMF economist Dr Veerathai Santiprabhob as new governor. In common with other central banks in South East Asia, the BoT is operating very loose monetary policy. The benchmark interest rate stands at 1.5% after two successive cuts, while consumer prices have shown an annual fall during every month so far this year. Together with fears of a slowdown in China and the Federal Reserve's anticipated rate hike, the baht, like the ringgit, has fallen steeply. However, policymakers are welcoming the boost to exports that depreciation could create. The growth rate is gradually rising, but from a low base of just 0.9% during 2014. Meanwhile, as the US and EU isolate Thailand diplomatically, it has edged closer to Russia.

Moreover, the recent bombing at the Erawan shrine in Bangkok is one of the worst terrorist attacks in Thailand's history. As well as representing a tragic and senseless loss of life, Thailand may suffer economically if a slowdown in the important tourist industry drags the growth rate further down.

In a sign of further warming of relations between the countries, the chief of **Vietnam's** ruling Communist Party, Nguyen Phu Trong met US President Barack Obama at the White House. The TPP promises to improve Vietnamese access to US clothing and footwear markets in exchange for reducing the state's role in the economy. The deal is also likely to allow US companies to export arms to Vietnam and lead to its recognition by the US as a market economy.

**Figure 5: GDP growth forecasts for ASEAN-6 and whole area, 2015–2020**




Source: Cebr analysis

* (ASEAN-6 plus Brunei, Cambodia, Laos and Myanmar)

ENDNOTES

1 China, the US, India and Japan have the largest GDP measured at purchasing power parity. Measured at market exchange rates, Germany replaces India.

2 Quoted in *The Economist*, 25 July 2015

3 Source: UN COMTRADE via World Bank World Integrated Trade Solution (WITS)

4 US–China Economic and Security Commission, 'Chinese Trade Ambitions: Strategy and Objectives behind China's Pursuit of Free Trade Agreements', May 2015

5 Note that large Chinese companies are often owned in Hong Kong, so Figure 4 will understate these flows

6 Brazil, Russia, India, China and South Africa

7 The World Bank Logistics Performance Index 2014

8 This is based on the exchange rate at the time of writing (25.08.2015), at RM$4.23=$1

## Cebr

The Centre for Economics and Business Research is an independent consultancy with a reputation for sound business advice based on thorough and insightful analysis. Since 1993 Cebr has been at the forefront of business and public interest research. They provide analysis, forecasts and strategic advice to major multinational companies, financial institutions, government departments and trade bodies.

Making Business Sense

ICAEW is a world leading professional membership organisation that promotes, develops and supports over 144,000 chartered accountants worldwide. We provide qualifications and professional development, share our knowledge, insight and technical expertise, and protect the quality and integrity of the accountancy and finance profession.

As leaders in accountancy, finance and business our members have the knowledge, skills and commitment to maintain the highest professional standards and integrity. Together we contribute to the success of individuals, organisations, communities and economies around the world.

**Because of us, people can do business with confidence.**

ICAEW is a founder member of Chartered Accountants Worldwide and the Global Accounting Alliance.
www.charteredaccountantsworldwide.com
www.globalaccountingalliance.com

## For enquiries or additional information, please contact:

**Amy Tee**

**T** (+65) 9108 1517
**E** amy.tee@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**