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Close-Up Report

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The Coming of the ASEAN Economic Community: Southeast Asia as a New Economic Powerhouse

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Introduction

Global economic growth has slowed since the 2008/09 crisis. Over the 2001 to 2008 period, real world GDP expanded on average by about 4% per year. In comparison, the average annual growth rate of world real GDP between 2009 and 2012 has been around 2.9%, just under three-quarters of the earlier period.[1] In the coming years, a much slower growth of the global economy is expected, with virtually all the major growth engines of the world operating at reduced speed. China, for instance, which accounted for close to a quarter of world GDP growth in the previous decade[2], is likely to slow to 75% of its earlier speed at best, and could be lower if some of the planned domestic reform policies fail to perform as expected. The euro zone, which accounted for a tenth of global economic expansion in the earlier period, is expected to have only very anemic and inconsistent economic growth, while a prolonged period of contraction cannot be ruled out should the crisis take a turn for the worse. The US, in the short term at least will see its economy struggle, due to its dysfunctional politics and high public sector debts, in spite of its underlying structural strength, an increasingly competitive corporate sector and a powerful shale oil and gas energy revolution. Taking all these into account, the average annual growth of world GDP of 2.9% from 2009 to 2012 is actually not a bad record. In the medium term -- the coming five years -- it is realistic to expect world economic growth to hover around 2.5% per year, or less than two-thirds of that of the 2001 to 2008 period.

Emerging Markets and the Imperative of Inclusive Growth

Much of the slowdown will come from reduced consumer spending in the developed countries that were some of the most important destinations for emerging markets' exports. Given the level of export-dependency in many emerging markets, weaker external demand will hurt many of their export-oriented sectors, with rippling effects across the rest of the economy. Under such conditions, domestic demand in emerging markets will have to do more of the heavy lifting if robust economic growth is to be sustained. For domestic demand to become more effective as an engine of growth, its two key components of domestic investment and domestic consumption will have to be more productive and mutually reinforcing. In other words, investment in emerging markets will have to benefit the rank and file working people to raise household incomes such that private consumption can rise in tandem with investment. Increases in household spending in turn will then open up new opportunities to encourage further business investment. When all goes well, a virtuous circle can be set in motion with both domestic investment and domestic consumption benefiting from each other. For this to happen, 'inclusive' growth is required.

Inclusive growth can be simply defined as growth that is broadly based, which comes with improving income distribution and equality of opportunities for the vast majority of the society. In practice, it means economic growth that produces an expanding, dynamic, and increasingly prosperous middle class. Inclusive growth therefore requires that the fruits of an expanding economy be more equitably shared, benefiting not just a few large and powerful business conglomerates but small businesses and entrepreneurs, as well as the workforce

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1 IMF WEO data.

2 Calculated on the basis of purchasing power parity.

at large. It is only with inclusive growth that household income can rise in step with an expanding economy, thereby making domestic consumption a viable substitute, over time, for weaker demand for exports. In a slower growing global economy in the coming years as described above, inclusive growth will be the primary success criterion for emerging markets. It is a much more exact and demanding success criterion compared with those of the previous decade, and it will come as a rude shock to many emerging markets.

The reason for this is because emerging markets had been spoiled during the previous decade. A tsunami of easy money from 2000 onwards had pushed up growth everywhere. In 2000, it is estimated that capital flow going into emerging markets was running at an annual rate of US$200 billion. By 2008 this had risen to over US$1 trillion.[3] It was a rising tide lifting all boats phenomenon. In fact, one would have to have tried very hard to not grow at all. In the decades prior to the 2000s, in any given year about two-thirds of all countries in the world managed some economic growth. The remaining one-third suffered either stagnation or even contraction. In contrast, because of the tsunami of easy money in the 2000s, by 2007 only three countries in the world failed to grow; Fiji, Zimbabwe and the Congo. The same tsunami of easy money also fueled consumer spending in the developed countries, thus driving up demand for exports from emerging markets. Under these conditions, emerging markets could get away with little or no inclusive growth, at least for a time. But not anymore.

Southeast Asia's Growth Dynamics

Developing Asia (including China) has managed reasonably well since 2009 in spite of much weaker global demand for exports. While real GDP growth averaged a feeble 0.5% a year between 2009 and 2012 in the G-7 advanced countries, developing Asia expanded by a robust 7.9% per year. Southeast Asia is the core region of developing Asia outside of China. Indeed, the four major emerging markets in Southeast Asia - Indonesia, Malaysia, Philippines and Thailand - have managed to sustain strong growth in real GDP over the difficult 2009-2012 period. It is domestic demand that has enabled these countries to continue to power ahead, effectively compensating for weaker demand for exports. Table 1 shows the increase in domestic demand over this period, which exceeds their respective cumulative real GDP growth.

Table 1 Power of Domestic Demand in Southeast Asia

2009 - 2012	Increase in Domestic Demand	Cumulative GDP Growth
Indonesia	21%	19%
Malaysia	32%	18%
Philippines	20%	17%
Thailand	22%	15%

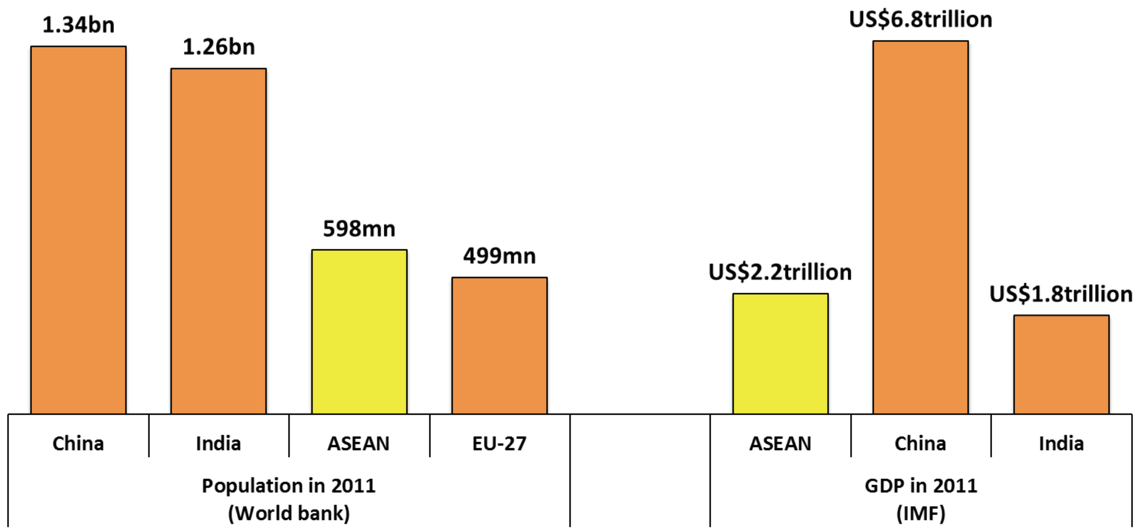
(ADB)

3 Estimated with data from the IMF and BIS.

This outstanding performance is not accidental. Southeast Asia has come a long way since the 1997 financial crisis. The lessons learned during that crisis have not been forgotten. Southeast Asia's macroeconomic management has improved significantly compared with the pre-1997 years. Both domestic investment and foreign direct investment (FDI) have contributed greatly to expanding the region's industrial base and infrastructure, while private consumption has expanded simultaneously, creating increasingly vibrant consumer markets. The Association of Southeast Asian Nations (ASEAN) was originally a political grouping created in 1967 to counter the communist threat by its six founding members: Singapore, Indonesia, Malaysia, Thailand, Philippines and Brunei (known as the ASEAN-6). It has since expanded to include Cambodia, Laos, Myanmar and Vietnam in the late 1990s as the Cold War receded. In the last decade, economic connectivity between ASEAN members has intensified and increasingly ASEAN has been seen as an economic bloc of tremendous potential.

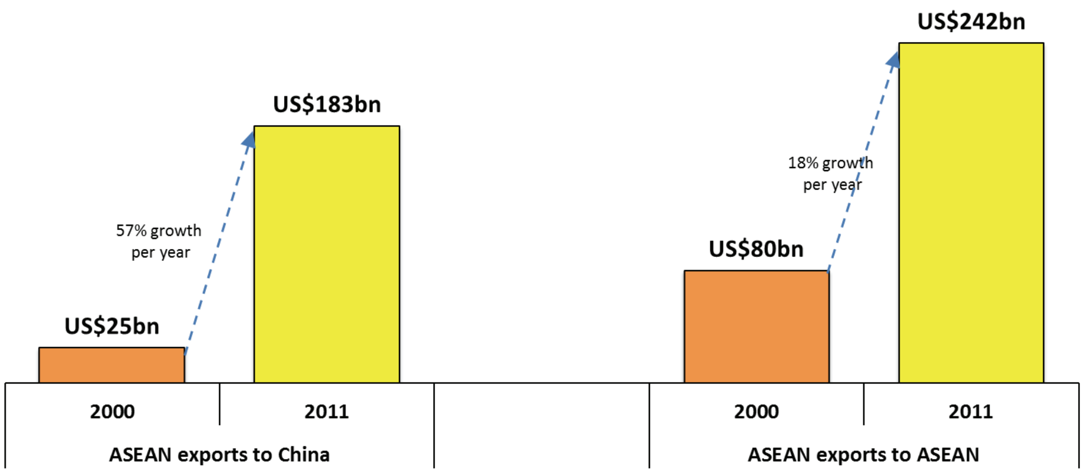
As a potential single market, ASEAN has what it takes to hold its own in the global economy. As illustrated in Chart 1, ASEAN's population in 2011 was estimated to be around 598 million -- close to half of that of China and of India -- and slightly bigger than EU-27. In GDP terms, ASEAN is one-third of China but about 20% more than India, as shown on the right hand side of the chart.

Chart 1 ASEAN as a Single Market



ASEAN has also been very successful at both tapping into Asia's biggest growth engine, China, and at increasing intra-ASEAN trade. As Chart 2 shows, ASEAN exports to China rose from US$25 billion in 2000 to US$183 billion in 2011, representing an astonishing average annual growth rate of 57% over this decade-long period. In the meantime, intra-ASEAN exports rose from US$80 billion to US$242 billion, the result of an average annual growth of 18%.

Chart 2 ASEAN as a Single Market



(UN Trade Statistics)

What we have witnessed is a process of economic integration at the grassroots level, with businesses seizing new opportunities to build supply chains connecting the various ASEAN economies to take advantage of their respective comparative advantages to feed both China's rapidly expanding assembling manufacturing sector as well as each other's expanding consumer markets in the 1990s and 2000s. By 2011, intra-ASEAN trade had risen to account for up to a quarter of total trade of the ASEAN-6 and much higher for the newer ASEAN members like Laos and Myanmar. Table 2 shows the share of intra-ASEAN trade as a percentage of total trade for each ASEAN country.

It is worth noting that ASEAN's exports to China are very well diversified. In 2011 for instance, some US$82 billion worth of industrial raw materials and food items were exported to China. Similarly it exported US$78 billion in high tech products, US$13 billion in industrial machinery and US$11 billion in chemicals. Such a well-balanced mix helps to keep ASEAN exports more stable and resilient in times of economic volatility. It is a similar picture for intra-ASEAN exports. In 2011, industrial raw materials accounted for 41% of intra-ASEAN exports, high tech products 18%, industrial machinery 14%, consumer products 10%, vehicle parts 6% and chemicals 6%.[4]

As impressive as this growth record is, the future looks decidedly more exciting because of the planned ASEAN Economic Community (AEC) project.

Table 2 Intra-ASEAN Trade, 2011

	Intra-ASEAN Trade as% of Total	Growth Rate
Thailand	25%	15%
Malaysia	23%	8%
Singapore	22%	6%
Indonesia	20%	12%
Philippines	16%	3%
Vietnam	18%	17%
Cambodia	10%	15%
Laos	36%	15%
Myanmar	52%	24%

(ASEAN Statistics)

4 ASEAN Statistics.

The ASEAN Economic Community: a Game Changer

The AEC is unmistakably a game changer. It plans to turn ASEAN into an economically integrated area with free movement of goods, services, skilled labour and capital, and is scheduled to launch on January 1, 2016. The AEC is to be accompanied by massive investment in transport and logistics infrastructure aimed to greatly increase the connectivity between the markets in ASEAN as well as with the southern provinces of China. There are two flagship projects: the ASEAN Highway Network Project and the Singapore-Kunming High Speed Railway. The first extends the current highway network in Singapore and Malaysia to span across

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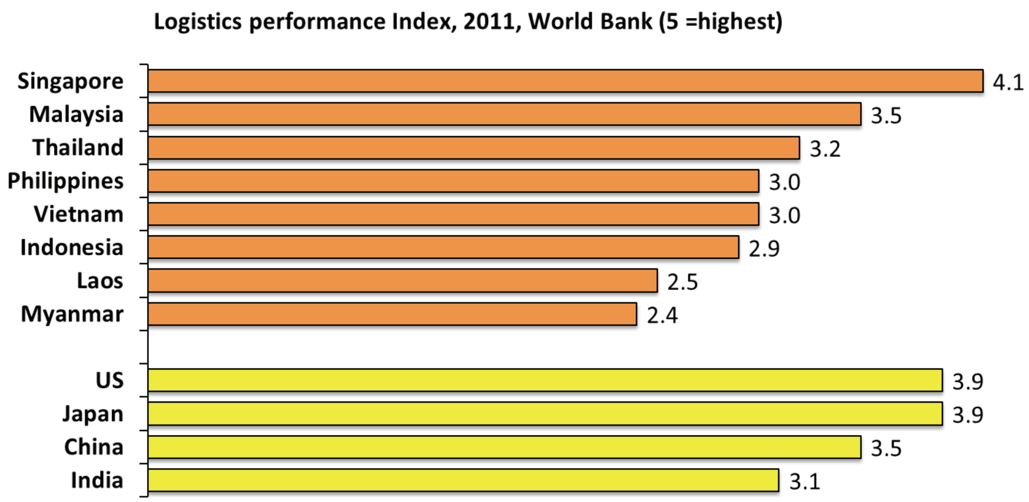
Thailand, Myanmar, Cambodia, Laos and Vietnam. The latter will connect Singapore, Malaysia, Thailand, Cambodia, Vietnam and southern China by an integrated rail network by 2015. In addition, additional projects are underway to build or upgrade 47 port facilities in nine ASEAN countries.

Together, these projects will massively improve the logistics efficiency in ASEAN, providing further impetus for intra-ASEAN trade and investment. Chart 3 compares the "Logistics Performance Index" between the different ASEAN countries and with the US, Japan, China and India. With the exception of Singapore, a small island city state with a highly developed economy, the logistics performance index for

Chart 3 ASEAN's Economic Potential with Integration

* Massive potential in improving economic efficiency through investing in logistics & infrastructure



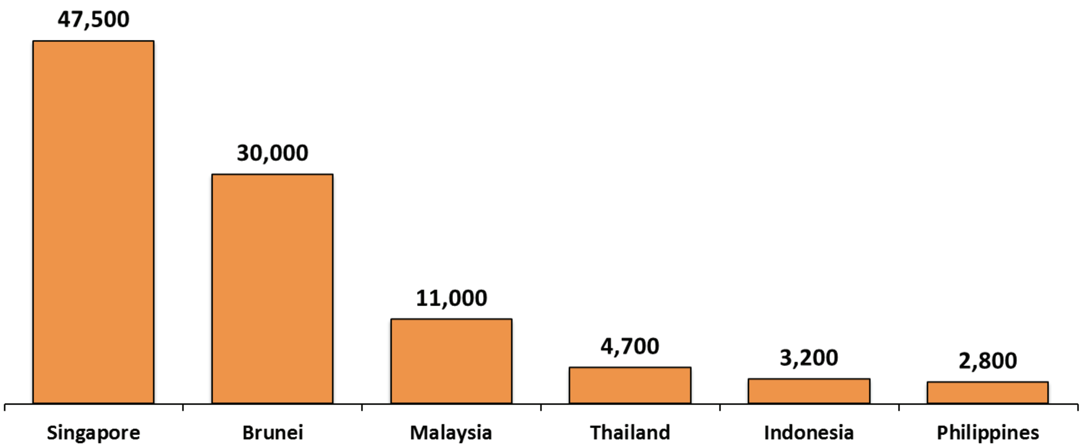
ASEAN countries tends to be lower than China and India. Malaysia is the highest in the index among developing Southeast Asia, and is at par with China. Thus, the potential for boosting logistics efficiency in ASEAN is huge, to say the least.

The AEC is also stimulating domestic investment by the key ASEAN countries as well. Take Thailand for example, as part of its preparation to get ready for the launch of AEC, some US$57 billion of investment in infrastructure has been planned between now and 2020, amounting to around 20% of Thailand's GDP in 2012.[5] Even if just half of such planned investment comes to fruition, Thailand's operational efficiency will be powerfully upgraded as a result.

The AEC will enable the comparative advantages of ASEAN countries to come into play more effectively through vastly expanded scale of production as well as facilitating intra-ASEAN transfer of technology and business knowhow. Levels of income and development vary greatly between ASEAN countries. Any progress in reducing barriers of trade and movement of factors of production in this context will immediately encourage more business activity and to take advantage of these new opportunities. As Chart 4 shows, the per capita GDP in ASEAN in 2011 ranges from US$47,500 in Singapore to US$2,800 in Philippines -- and

Chart 4 ASEAN's Economic Potential with Integration

* GDP per capita in 2011 in US$



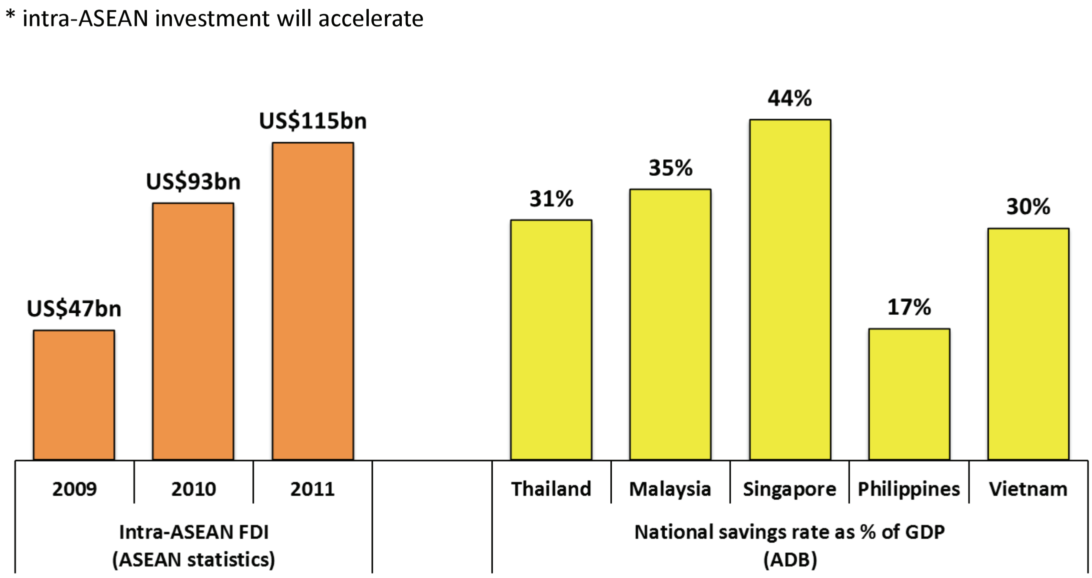
(IMF)

5 Estimates by Thai Development Institute. 20 Federal Reserve.

much lower in Vietnam, Cambodia, Laos and Myanmar. These are precisely the conditions that will allow economic integration to produce massive new opportunities for investment and growth.

As a result, the AEC will become a hotbed of new business investment. Intra-ASEAN investment has already been climbing steadily in recent years, as seen in the left hand side of Chart 5, rising from US$47 billion in 2009 to US$115 billion in 2011, reflecting a very impressive average annual growth of 48%. With the coming of AEC, intra-ASEAN investment is set to accelerate. ASEAN will be able to finance much of this new investment domestically since many of its member countries have high savings rates, as the right hand side of Chart 5 shows. The savings rates run as high as 44% in Singapore to 35% in Malaysia, 31% in Thailand and 30% in Vietnam.

Chart 5 ASEAN's Economic Potential with Integration

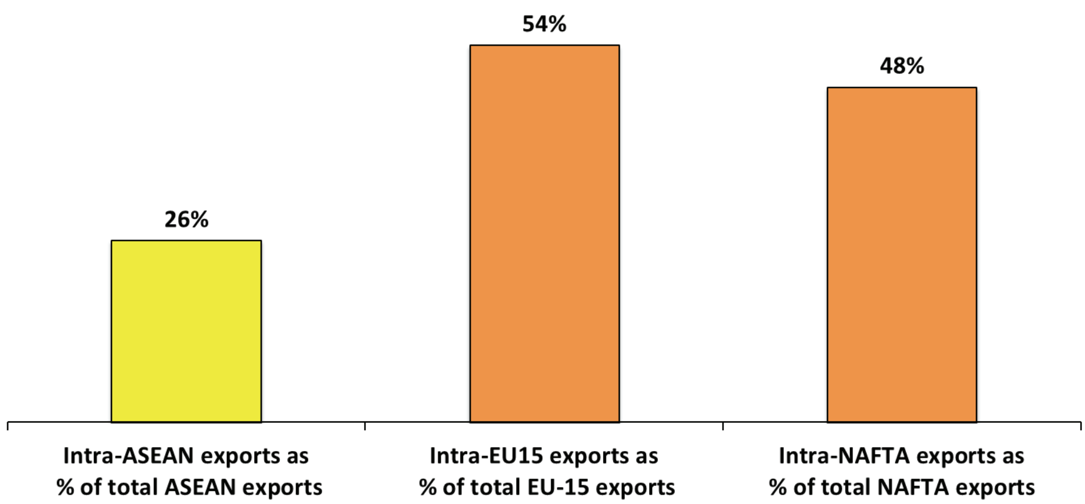


The Philippines is the only market in ASEAN that has a savings rate below 20%.

A more economically integrated ASEAN will also attract more FDI. For example, Japanese investment in ASEAN-6 plus Vietnam has jumped in recent years, in part in anticipation of the AEC, and in part to diversify away from its investment in China. Some US$6.5 billion of Japanese FDI went into these seven markets in 2009. Merely two years later, in 2011, Japanese FDI had increased over three-fold to US$21.0 billion.[6] This may well be a harbinger of things to come.

One way to assess the growth potential of the AEC is to compare the level of intra-regional exports between AEC, NAFTA (North America Free Trade Agreement area), and EU-15 (the 15 euro zone members); which is presented in Chart 6. In 2010, intra-ASEAN exports amounted to only 26% of total ASEAN exports, whereas it is 54% in EU-15, and 48% in NAFTA. In other words, using EU-15 and NAFTA as benchmarks, intra-ASEAN exports could double with the implementation of the AEC, ushering in massive new market development opportunities.

Chart 6 ASEAN's Economic Potential with Integration



(World Bank)

6 ASEAN Statistics.

Southeast Asia: Coming of Age of an Economic Powerhouse

The AEC is set to bring together the recent growing trends of intra-ASEAN trade and connectivity that could, in a single step, turn the region into a new economic powerhouse. Economic integration will both deepen the current economic specialisations of the various key ASEAN countries as well as widen their market reach, creating new synergies between their specialisations. In broad strokes, the key ASEAN countries' economic specialisations in the future AEC will look like this:

- Singapore will consolidate its position as a regional hub for high end services, including finance, health care, education and scientific R&D. Its attractiveness as a destination city of tourism will grow even stronger.
- Thailand will continue to enjoy a diversified economy which is based on a highly productive agricultural sector and associated food processing industries, while evolving into an increasingly efficient producer of consumer durables. In the automotive sector, Thailand is the indisputable leader within ASEAN -- in 2000 it is estimated that some 450,000 vehicles were produced in Thailand; by 2011 it had risen to 2,400,000, reflecting an astonishing 39% growth rate per year in a decade-long expansion. Bangkok is also strategically located to be a hub for global companies seeking opportunities and managing their operations in an economically integrated Mekong Delta region.
- The Indonesian economy will be driven by both the production and export of commodities and a rapidly expanding domestic consumer market. Production of thermal coal, palm oil, oil and gas and minerals will remain the major pillar of the economy, generating income and employment that will become more dispersed across the country. Accordingly, the growth of consumer spending will become stronger in the provinces outside of Java.
- The Philippines will gain traction as a producer of intermediate technology products and components like semi-conductors and industrial machinery, supported by a steadily improving infrastructure. Robust growth of domestic consumer spending will continue to be supported by overseas remittances. With improving infrastructure, the Philippines may also be able to finally start exploiting its tremendous potential in agricultural production and exports. Unique among ASEAN markets, the Philippines has a large and growing business process outsourcing sector, currently employing three quarters of a million skilled workers, with an annual output approaching US$10 billion.
- Malaysia's production of industrial raw materials and intermediate technology products and components will receive a much needed boost from the AEC which will allow Malaysia to leverage its advantages in logistics and infrastructure to expand its footprint in ASEAN rapidly. It also has the potential of shifting faster to higher value-added production because of its relatively well educated labour force and R&D capability.
- Vietnam is set to be a major beneficiary of the AEC as a

result of both new investment from, and expanding exports to, other ASEAN countries. Its growth of exports to key ASEAN markets like Thailand and Singapore in the last decade has been impressive and will certainly accelerate with the coming of AEC.

In addition to being producers and exporters to the global economy, and to each other, ASEAN's domestic consumption is maturing as a growth engine for the region due to the power of inclusive growth. The expanding middle class is a hallmark of economic success in ASEAN over the years since the 1997 Asia Financial Crisis. In 2011, for example, it is estimated that about 18% of the population in the developing markets in ASEAN could be considered middle class, up from 12% in 2000.[7] Applying this growth trend rate from the previous decade and projecting forward, we will see that by 2015[8] about 28% of ASEAN's population will belong to the middle class segment. This means that the ASEAN middle class population will expand from 107 million in 2011 to 170 million in 2015. Therefore, the potential of the AEC is not just that of a booster of investment and production, rather, under the right conditions, AEC could also become a facilitator for more inclusive growth in ASEAN, leading to a faster expansion of the middle class. It is the synergy of mutually reinforcing domestic investment and domestic consumption that will transform Southeast Asia into a new economic powerhouse in the coming decade.

It is the synergy of mutually reinforcing domestic investment and domestic consumption that will transform Southeast Asia into a new economic powerhouse

7 For developing Asia, the income threshold for defining a middle class household is US$7,500 per year.
8 ASEAN Statistics.

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GEMS is an exclusive service for clients of The Insight Bureau provided in partnership with Dr Yuwa Hedrick-Wong. It is designed to provide senior international executives and boards with timely, actionable business intelligence about the world's most dynamic growth markets. Consistent with The Insight Bureau's mission to help senior executives make better business decisions, GEMS has been launched to explain the crucial linkages between the world's developed economies and the developing world, to identify the main drivers of growth, to highlight significant changes, to assess the threats and opportunities facing international businesses, to provide a reality-check about popularly-held assumptions and to alert executives about the likely implications of recent events or developments.

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Yuwa Hedrick-Wong is a global economist and business strategist, based on Salt Spring Island off the west coast of Canada. He is the HSBC Distinguished Visiting Professor of International Business at the University of British Columbia in Canada, as well as being the global economic advisor to MasterCard, ICICI and Southern Capital Group. Along with other leading economists, journalists and business commentators, Dr Hedrick-Wong belongs to The Insight Bureau's resource network, providing speeches and presentations at business conferences and also delivering confidential, in-house briefings to senior executives and boards.
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