KPMG

Southeast Asia in transition

Geopolitical dynamics and implications for investment

Contents

KPMG and the Singapore Institute of International Affairs jointly produced this report "Southeast Asia in Transition"

Foreword

ASEAN has seen strong growth since 2000, eventually presenting a collective potential that is much larger than the sum of its parts. But there are still many challenges to confront, gaps to be bridged and disparities to address. As Southeast Asia pushes to strengthen its ties by completing the ASEAN Economic Community (AEC) integration plan, the region is starting a new chapter in its economic development. But it will take the right catalysts to ignite more dynamic and inclusive growth.

Understanding the politics and local business ecosystem could be the key that unlocks Southeast Asia's full potential. Because ASEAN is not a monolith. It's a purposeful gathering of ten nation-states, not just for economics but for security, political cooperation and resource sharing.

In recent years, ASEAN has come into focus for the business community more intensely, as the AEC integration plans hold the promise of a combined market of over 600 million consumers. As labour costs rise in China, Southeast Asia will be where manufacturing and services grow. With momentum in the shift of resources from agriculture to manufacturing in Southeast Asian societies, we see the industrialisation process yielding an expanding skilled and semi-skilled labour force, and booming urbanisation. This shift also supports the continuing growth of the "consumer class," making Southeast Asia a pivotal market for companies in a range of industries.

Keeping pace with this growth and creating cities with a high quality of life will demand infrastructure, housing, education and healthcare. And once these factors come into play, there will be a new urgency to sustain economic growth by increasing productivity – requiring continuing investment to further raise the quality of skills and infrastructure.

It will be important to remember, that even while continually evolving, these ten countries each hold their distinct character. To acknowledge this and treat them as different propositions is the wiser approach to tapping all of the opportunities on offer. To bridge these variations, businesses looking to work out of Southeast Asia have to think about what connects these different opportunities. If policy makers and businesses find common ground across the variations, it will truly unleash the potential of the region and leave a transformative imprint on its economic development.

Tham Sai Choy

Chairman, KPMG's Asia Pacific Region

Introduction

The Association of Southeast Asian Nations (ASEAN) is a group of ten diverse nations — Brunei, Cambodia, Indonesia, Laos, Malaysia, Myanmar, the Philippines, Singapore, Thailand, and Vietnam — with entirely different languages, cultures, politics and levels of economic development, working collectively to expand their economic potential. What started in the form of a straightforward push to reduce trade tariffs, has evolved into a dynamic open market of over 600 million consumers and a production base that can transform Southeast Asia's role in the global economy.

In the past ten years ASEAN's international trade has tripled, with a steady inflow of foreign direct investments (FDI) and large multinational companies vying for the region's emerging middle class.

So how should we think about the ASEAN opportunity? The prospect of a single market, as promised by the ASEAN Economic Community (AEC) is certainly compelling and while the AEC may be only partially implemented, the region is now firmly on the path of greater integration.

Where does ASEAN stand today?

Between 2000 and 2010, ASEAN's global trade grew to US$2 trillion, a six-fold increase over the 1990's relatively low base of US$300 billion. This was largely a result of free trade agreements (FTAs) that ASEAN signed, over time, with various large and competing nations. China had first proposed and then swiftly concluded an FTA with ASEAN. To avoid falling behind, Japan and subsequently India, Korea, Australia and New Zealand all followed suit.

From 2010, growth has remained steady in the region. The future too looks steady as seen in the growth projections for the region, with slight variations in country to country numbers, according to the IMF and the World Bank.

Some of the larger ASEAN countries, such as Indonesia, have even seen growth in Tier 2 and Tier 3 cities, leading to increased demand and a need for outside investment. To draw FDI to the region, several ASEAN countries

Table 1: Growth Projections for Southeast Asian Economies, 2015-2020

	2015	2016	2020	2015	2016	2017
	IMF	IMF	IMF	WB	WB	WB
Brunei Darussalam	-1.2	3.2	5.0	-	-	-
Cambodia	7.0	7.2	7.3	6.9	6.9	6.8
Indonesia	4.7	5.1	6.0	4.7	5.3	5.5
Lao PDR	7.5	8.0	7.4	6.5	7.0	6.9
Malaysia	4.7	4.5	5.0	4.7	4.7	5.0
Myanmar	8.5	8.4	7.7	8.5	6.5	7.8
Philippines	6.0	6.3	6.5	5.8	6.4	6.2
Singapore	2.2	2.1	2.7	-	-	-
Thailand	2.5	3.2	3.2	2.5	2.0	2.4
Vietnam	6.5	6.4	6.0	6.2	6.3	6.3

Sources: IMF's World Economic Outlook, October 2015 & World Bank's Global Economic Prospects, January 2016

have embarked on domestic reforms by liberalising sectors that were previously closed to foreign investment, such as financial services and telecommunications.[1] This has also set the stage for change in interrelated sectors, such as education, to ensure that jobs created as a result of this liberalisation can be easily filled.

Construction and manufacturing, particularly those related to heavy metals and chemical industries producing petroleum products and machinery are also being seen as likely growth sectors[2]. Traditional sectors of growth, such as consumer goods and pharmaceuticals, continue to perform due to rising affluence and governments' commitment to provide affordable and accessible healthcare.

We see three factors that will determine the growing influence of ASEAN:

The first is economic, wherein China's domestic economy and efforts at regional integration will affect investor appetite and risk perceptions.

The second is geopolitical. So far, ASEAN has benefitted from regional competition but it will be worthwhile to plan ahead for possible adverse implications of the current political trends.

The third is internal factors within the countries of this region, such as new social, economic and environmental threats and rising socioeconomic inequality.

"The opening of sectors to foreign investors signals a country's readiness to join the global marketplace as well as a desire to move its economy up the value chain."

— Bob Yap, Head of Advisory
KPMG in Singapore

[1] World Investment Report (2015), United Nations Conference on Trade and Development.
[2] ibid

The China factor and its implications on ASEAN's future

In a lot of ways, China's domestic economy is in a position to influence Southeast Asia's overall economic outlook.

There are various examples of how China's influence has the power to divide ASEAN. In 2012, Cambodia, the ASEAN chair, did not allow the mention of several member states' maritime disputes with China. At the time, Cambodia had a close economic partnership with China and for the first time in ASEAN's history, the group failed to issue a joint statement. At the 24th ASEAN summit in Myanmar, despite harsh remarks by Vietnam's prime minister, the official ASEAN statement made no mention of the giant oil rig that China has placed about 150 miles from Vietnam's coast. While many ASEAN leaders shared Vietnam's view, they were unwilling to be drawn into a conflict with the region's largest power.[3]

To be close to China continues to be an economic necessity for Southeast Asian countries. Chinese assistance and investment into the region dictates this necessity.

One initiative, opportunities for Southeast Asia

China's One Belt One Road (OBOR) initiative has obvious commercial benefits not only for itself but also for Southeast Asia. OBOR focuses on connectivity and cooperation among countries – primarily between China and the rest of Eurasia – consisting of two main components: the land-based "Silk Road Economic Belt" and the 21st century "Maritime Silk Road". This connectivity will create new inroads into several ASEAN nations. A good example of how China's OBOR initiative has already benefited the region is the Bangladesh-China-India-Myanmar (BCIM) Economic Corridor, officially classified as "closely related to the OBOR Initiative."

Falling currencies and exchange rate volatility

Since last year, China's burgeoning economy has decelerated to its slowest pace since the global financial crisis. The 6.7% growth rate for 2015— falling below 7% for the first time since 2009 — renewed pressure on Beijing to enact more pro-growth measures and drop their GDP growth target for 2016 to 6.5%-7%[4].

One of the measures that China took to address their growth slump, was the People's Bank of China's decision to repeatedly devalue the Chinese Yuan. This shocked markets, especially those in Southeast Asia because, in contrast, during the 1997 Asian Financial Crisis the steady value of the Chinese currency had acted as a bulwark for regional stability.

This strategy to boost the competitiveness of Chinese exports and domestic economic growth, triggered fears that a weaker Yuan would drive the global economy towards a recession and start a regional currency war. It is after all, not only the Chinese Yuan, but also the U.S. dollar, Japanese Yen and Euro that have been in flux and impacting the regional currencies. While the recent round of easing measures adopted by central banks in Asia do not seem to indicate that the region is in the midst of a currency war, there are concerns that it might happen. Already, countries in Asia such as Japan, South Korea, China, as well as Taiwan, have been warned by the U.S. against any further currency devaluation that could worsen the global economy.[5] [6]

While most Southeast Asian governments have taken steps to reform their financial sectors, many of the

[3] Kishore Mahbubani, Rhoda Severino - Lee Kuan Yew School of Public Policy
[4] Wall Street Journal
[5] Talley, Ian (2016) U.S. chides five economic powers over policies, *The Wall Street Journal*, 30 April 2016
[6] Harding, Robin (2016) Japan warned not to devalue the yen, *The Financial Times*, 16 April 2016

region's emerging economies continue to remain prone to volatile movements of foreign capital. Openness to trade also means that the region is more vulnerable to the effects of global demand and supply. The global commodity slump and drop in oil prices, for example, have affected the performance of many of Southeast Asia's economies.

The rising U.S. dollar and an expected interest rate hike in the U.S. have put pressure on ASEAN currencies and domestic interest rates. Further implications for ASEAN include tightening liquidity, capital outflows, currency volatility and particularly, rising interest rates at a time when debt has increased substantially in households and companies. The main risk is for countries which have current account deficits, such as Indonesia, and which therefore need external funding. Nevertheless, there are grounds for confidence that Indonesia and other ASEAN economies can face down these challenges. ASEAN countries have made much headway in improving their resilience to external shocks with improving ability to bounce back from exogenous shocks. This improved resilience is a function of the following factors:

- By and large, ASEAN central banks and policy makers have built credibility with financial markets through maintaining low and stable inflation, and limiting fiscal and external deficits.
- Exchange rates are managed on a sounder basis than the informal pegs of the 1990s which invited speculative attacks. None of the regional currencies are misaligned with economic fundamentals and thus are less vulnerable to speculative pressures.

- Foreign exchange reserves have been built up significantly, providing a buffer which was weak in the 1990s.
- Banking systems are better capitalised and supervised more rigorously.[7]

Southeast Asia can no longer rely on China for growth

China's rapid and exponential growth, along with Southeast Asia's central banks' quantitative easing had obscured the need for arduous restructuring and upgrades for the Southeast Asian countries. Riding the wave of China's success, the governments postponed efforts to diversify growth sources, lower trade barriers and reduce corruption. Simply cutting interest rates would have worked in the past, but as in the case of Indonesia in the last quarter of 2015, it is no longer that easy. Indonesia's central bank had to choose between cutting interest rates to support growth and hiking them to prop up the rupiah, though they ultimately did not take either step.

Despite this vulnerability, Southeast Asian financial systems, debt markets and central banks are still staving off the current global weakness. It is just that a decade of relative ease may not have prepared the nations of Southeast Asia for this slow-growth period. So, the slump in the Chinese economy may just be the wakeup call the region needs.

- Countries, such as Indonesia, have been actively looking for alternative export markets other than China.
- Economic restructuring and liberalisation processes are also in motion in many Southeast Asian economies, in the attempt to attract a diverse portfolio of foreign investment.
- Governments need to have well-thought out strategies in place to deal with the potential backlash from domestic industries which will face increased exposure to foreign competition.

Small incremental steps in this direction for the long term will see a more resilient and stable Southeast Asia charting its own economic future.

[7] KPMG ASEANconnections

China vs. U.S. and Japan: Impact on Southeast Asia

The rising and ebbing tensions and competition in U.S.-China and China-Japan relations have promoted a deficit of trust among countries in Asia. There is not much that smaller countries in Southeast Asia can do to directly change the rivalry but the dilemma of economic interdependence and security between Southeast Asia and the major powers means that relations need to be continuously managed.

U.S.-China competition

It will be worthwhile to observe the tone of U.S.-China relations. U.S.-China relations are expected to remain stable, at least till the end of President Barack Obama's term in early 2017.[8] Currently, both leaders have expressed support towards building a new model of major-country relationship based on mutual respect and cooperation. The success of this will ultimately depend on the personality of America's next leader and the foreign policy he or she adopts.

China-Japan competition

Japan has been invested in the region for decades, and under Japanese Prime Minister Shinzo Abe, the country has pursued an active policy to deepen its economic presence in the region. This means going up against the Chinese to bid aggressively for large and strategic projects in ASEAN.

So far, China-Japan economic rivalry has benefitted the region. It has flushed ASEAN countries with much needed funds to develop the region's infrastructure and connectivity, and many welcome the attention from both. Already, the Japanese have moved manufacturing production bases to Southeast Asia due to more attractive labour costs and investor and industry-friendly policies.[9]

[8] Zhang, Zhexin (2016) China's international strategy and its implications for Southeast Asia, in *Southeast Asian Affairs 2016,* eds. Cook, Malcom and Singh, Daljit, pp.55-65, Singapore: ISEAS-Yusof Ishak Institute

[9] Abe, Tetsuya (2016) Japanese spending down 25% as manufacturers shift gears, *Nikkei Asian Review,* 21 January 2016, Available: http://asia.nikkei.com/Politics-Economy/Economy/Japanese-spending-down-25-as-manufacturers-shift-gears Retrieved: 25 April 2016.

Militarisation of the South China Sea

The past year has witnessed a sharp escalation in the militarisation of the South China Sea. The cause of this escalation is multifaceted and comes from both regional and international quarters. Potential territorial and maritime disputes could lead to the disruption of trade flows and supply chains in Southeast Asia.

The militarisation has been initiated and exacerbated by China and the U.S. Both bear responsibility for the current level of tension in the region which compromises the very peace and stability that has enabled US$5.3 trillion worth of trade to pass through the waters of the South China Sea.

The risks of socio-political changes

With more democratic and accountable regimes, attention has moved to new social, economic, and environmental threats. Evidence of such trends is already seen in countries such as Indonesia, Myanmar, and the Philippines where elected politicians are implementing populist policies, especially for rural areas. This will increase the region's investment needs, and in turn, the number of greenfield investment opportunities is likely to go up.

Investment opportunities, especially those related to retail and the fast moving consumer goods sector, are also likely to grow. The growing middle-class in Southeast Asia will make it one of the world's leading consumption hubs. These numbers are expected to rise even further if widening economic gaps are bridged by a more equitable spread of wealth and development.

The rise of economic nationalism

Leadership and government changes can slow or even reverse the momentum of trade and investment liberalisation of a country. It can also lead to a rise of economic nationalism tendencies in a country.

Increasingly, governments are faced with the challenge of opening up their economies at a pace which balances the need to move fast enough to ensure strong economic growth, and slow enough that it allows domestic businesses to reform and catch up.

Balancing foreign investment with domestic business

National priorities are likely to continue to take precedence, especially if business stakeholders are influential enough to shape government policies.

For example, Myanmar currently shows signs of leaning towards economic nationalism despite its rhetoric of welcoming foreign investment and supporting an open economy. This is especially in the form of providing small and medium-sized enterprise (SME) access to international markets, jobs for its large rural population, as well as skills training and development.

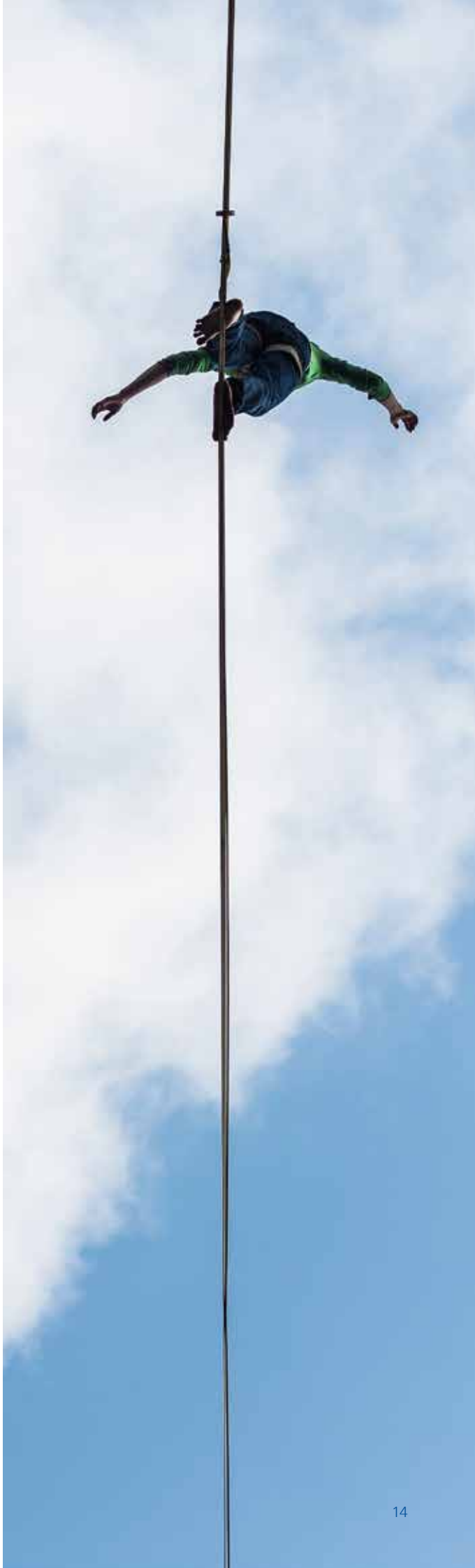
Still, having a steady government hand in guiding a country's economic reforms has its benefits. This is especially true if new economic policies and plans align the country's needs with the expectations of foreign investors. Like in Yangon, a fast-modernising city, where the real estate sector and demand for services such as healthcare and education have opened up investment opportunities. Many other sectors with investment potential such as those in power and infrastructure remain largely untapped and are potential drivers of growth. Indonesia, which plans to restructure the economy to be more open to foreign investment and trade is another example of ASEAN's reform potential.

> "Amidst this push for economic growth, governments must invest in and strengthen their regulatory and governance framework to foster confidence in the country."
>
> — Irving Low, Head of Risk Consulting
> KPMG in Singapore

Need for long-term planning and better governance

Accelerating economic reforms will require clear, multipronged planning and development that produces quality jobs and reduces poverty. Restructuring of an economy provides the golden opportunity to develop integrated, comprehensive, long-term plans and policies. Getting them right, by learning from the successes and failures of neighbouring countries — and adapting those lessons to the country's specific contexts — carries enormous advantages. Over the medium and long term, the development of a competitive, export-oriented industry, assisted by opening opportunities for FDI and entry to global value chains could help provide sustained economic growth.

Charting a successful course will involve considerable care in sequencing policies and programs in the right sectors at the right time and addressing policy challenges such as strengthening market institutions, enhancing governance and institutional capacity, improving infrastructure, developing human capital, and promoting regional integration.[10]



[10] Asian Development Bank

Country Case Study

Powering up Myanmar

Unreliable power supply remains the biggest hindrance to Myanmar's rise as an industrial base in ASEAN. A severe lack of investment in the sector for decades has resulted in a low installed capacity and significant transmission and distribution losses. Over-reliance on hydropower has also led to interruptions in industrial production and periods of blackouts during dry seasons.

Since the re-opening of the country a few years ago, the government has acknowledged the role a robust power sector in Myanmar has in achieving the ambitious economic development goals it had set for itself. With help from multilateral agencies such as the World Bank and the Asian Development Bank (ADB), Myanmar's Ministry of Electric Power developed a road map for the sector. Recognising that it would not be possible for the state alone to make the investment required – estimated to be around US$50 billion over the next two decades – the road map includes taking steps to strengthen the institutional and regulatory framework to encourage private sector participation.

Some of these early efforts have come to fruition in the recently awarded 225MW Myingyan Independent Power Producer (IPP). It signifies the government's efforts to secure more gas and coal fired generation capacity to reduce reliance on hydropower. It also demonstrates the state's willingness to involve the private sector in

its development efforts. A foreign investor-developer was selected through a transparent process supported by the World Bank including the Multilateral Investment Guarantee Agency. Clearly, this IPP can provide a template for structuring bankable IPPs in Myanmar. It can even provide a blue-print to invite the private sector to refurbish and repower existing government-owned power plants.

The newly formed Ministry of Electricity and Energy has released its 100 day plan in which it says it will continue to build generation capacity, improve transmission and distribution infrastructure, and develop the renewable sector. While it is still early days, industry observers hope that the new government seizes the initiative to come out with a structured IPP programme to invite foreign and domestic private sector to invest not only in power generation, but across the power value chain, including transmission and distribution.

The availability of adequate electric power will help close the country's wide development gaps and encourage investors to allocate much-needed capital and resources to areas outside Yangon and Mandalay. Investment into other sectors such as agriculture, manufacturing and telecommunications are also likely to receive a boost if Myanmar's electrification plans are successful.

Growing threat of terrorism

Recent terror attacks and terrorism-related arrests in countries such as Indonesia, Thailand, Malaysia and Singapore have raised fears that parts of Southeast Asia are open to threats from religious extremist groups.

Views on whether a heightened risk of terrorism reduces foreign investment into a particular country remain mixed. How Southeast Asian governments manage such risks is important. It would require further international cooperation, the putting in place of effective government measures to ensure political stability, such that macroeconomic operational risks for businesses continue to remain low.

The rise in populist policies or possible threats of terrorism may not directly impede FDI flows into the country. But a country's ability to react and recover quickly from external shocks determine whether the knock-on effects on the economy and foreign investor confidence are contained or magnified.

KPMG's Change Readiness Index

KPMG's Change Readiness Index (CRI) is a global study that measures the capability of a country to anticipate, mitigate and react to sudden external shocks or longer term trends that have the potential to negatively impact economies. This is based on the analysis of three key pillars:

- Enterprise Capability (quality of business environment)
- Government Capability (fiscal, regulatory and security capacity)
- People and Civil Society Capability (inclusiveness of growth strength of civil society institutions).

Countries that rank higher on this index are more likely to be resilient and adaptable to external factors. Today, both businesses and the public sector want to pre-empt risk and handle it better. The indicators of change readiness can help analysts and policy makers understand, manage and mitigate risk across different geographies. The CRI empowers decision-makers to be both responsible and innovative.

Table 2: KPMG's Change Readiness Index Scores (2013 and 2015)

Country	Overall CRI Score 2013	Overall CRI Score 2015	Enterprise Capability	Government Capability	People and Civil Society Capability	Overall 2015 CRI Rank
Brunei Darussalam	-	-	-	-	-	-
Cambodia	0.580	0.548 ▼	0.612 ▼	0.548 ▼	0.485 ▼	50
Indonesia	0.523	0.564 ▲	0.602 ▲	0.538 ▲	0.550 ▲	43
Lao PDR	-	0.368	0.380	0.367	0.355	115
Malaysia	0.587	0.653 ▲	0.743 ▲	0.612 ▲	0.605 ▲	24
Myanmar	0.468	0.429 ▼	0.482 ▼	0.408 ▼	0.398 ▼	97
Philippines	0.597	0.609 ▲	0.627 ▲	0.613 ▼	0.585 ▲	33
Singapore	0.823	0.838 ▲	0.904 ▲	0.854 ▲	0.757 ▲	1
Thailand	0.607	0.603 ▼	0.672 ▲	0.578 ▼	0.560 ▲	34
Vietnam	0.411	0.429 ▲	0.465 ▲	0.394 ▲	0.427 ▼	98

Singapore leads the rankings, while smaller open economies such as Philippines have steadily climbed up the index in the past few years. The economic, geographic, political and cultural diversity of these countries shows that no single factor determines change readiness. Some countries perform better on people and civil society, while others lead on government and/or economy, showing that, within the excellent performers, there can be a diversity of relative strengths but overall most ASEAN countries have moved up in CRI ratings since 2013.

"Most ASEAN economies have been adopting more prudent fiscal policies and moving towards more market-friendly reforms. When we turn KPMG's Change Readiness Index (CRI) lens on these economies, what we see justifies growing confidence in ASEAN."

— Ong Pang Thye, Deputy Managing Partner KPMG in Singapore

Opportunities within the risks: Future of ASEAN integration

The AEC and regional integration

As a response to competition from China and India, ASEAN launched the ASEAN Economic Community (AEC). Right now, ASEAN runs the risk of failing to convince potential investors, especially leading multinational companies, that the AEC will be meaningfully implemented. ASEAN's ambition to create the AEC is upheld as an eventual goal, but not all countries are driving and demanding its speedy and even-handed implementation.

This is in part because of the concern over its impact on SMEs, but mostly because the benefits of the AEC may not be immediate and at times may be difficult to quantify, especially in the short term.[11]

The integration efforts do not rest on the AEC alone. There are numerous smaller scale projects and bilateral ties that exist in ASEAN, and these have enhanced the growth that the region has enjoyed over past decades. The integration efforts will also act to further increase this growth by providing opportunity for middle income economies to grow. It may be through contributing to the skills shortage which is considered one of the biggest gaps in achieving faster economic growth. For example, Malaysia and Philippines, can play an important role in addressing the skilled white collar workforce gap.

In the longer term, factors such as fewer investment restrictions, reduced transaction costs, an enlarged market size, as well as the opening of more sectors to investors[12] will make ASEAN an attractive destination for investors from both within and outside the region.

Trans-Pacific Partnership, Regional Comprehensive Economic Partnership : Opening new doors

The Trans-Pacific Partnership (TPP) and Regional Comprehensive Economic Partnership (RCEP) trade agreements are seen as mutually reinforcing platforms towards building a larger Free Trade Area of the Asia Pacific, of which the whole of ASEAN will be a part.

The ASEAN-led RCEP has the potential to transform Asia into an integrated market of more than 3 billion people. This accounts for 45% of the world's population with a combined GDP of about US$17.23 trillion, or about a third of the world's current annual GDP.[13] The trade agreement, which includes 16 countries, is set to broaden and deepen the current economic partnership agreements among all of the ASEAN member states and their FTA partners. It is also seen as a vehicle that will help strengthen ASEAN's goals of forming a highly competitive economic region in the form of the AEC.

The U.S.-led TPP is seen as a landmark trade pact that will set new high standards for future free trade agreements, and become a bulwark against Chinese influence. The Asia Pacific trade deal brings together 12 economies from both sides of the Pacific. Its members collectively represent 40% of global GDP and one-third of the world's trade.[14]

[11] Tay, Simon and Kiruppalini, Sivashangari (2015) Moving ahead with the ASEAN Economic Community: Business initiatives across borders, *Singapore Institute of International Affairs Special Report,* October 2015, Available: http://www.siiaonline.org/page/PublicationDetails/id/129/ArticleCategoryId/3/#.VyyDN3qHjf0 Retrieved: 6 May 2016.
[12] World Investment Report 2015, *United Nations Conference on Trade and Development (UNCTAD),* Available: http://unctad.org/en/PublicationsLibrary/wir2015_en.pdf Retrieved: 6 May 2016.
[13] Ministry of Trade and Industry, Singapore
[14] ibid

Similar to the RCEP, the TPP aims to significantly lower the costs of trade through greater tariff elimination, as well as to facilitate trade among its members. This will also strengthen regional production and supply chains, and open up market access across TPP countries.

For countries that are not part of this agreement, there is a fear of being left behind. This fear could push more countries in the region to adopt progressive measures to liberalise and restructure their economies along the lines of TPP's high trade standards and requirements. It will help narrow the gaps in the region's diverse mix of economies and could speed up the region's economic integration efforts.

"The AEC is a work in progress. Businesses should not wait for it to be completed. Instead, they should continue to invest in ASEAN."

— Tay Hong Beng, Head of Tax
KPMG in Singapore

Country Case Study

Manufacturing in Vietnam: TPP and new opportunities

Vietnam's attractiveness as an investment destination is characterised by strong GDP growth potential, and a young, literate and growing population. In 2015, the vigorous expansion of Vietnam's manufacturing and construction sectors spurred the country's fastest economic growth in 7 years.[15]

The country is projected to sustain its expansion of 6.7% growth in 2016 with at least 70% of its GDP now generated in cities.[16]

It also looks set to become the biggest beneficiary of the U.S.-led TPP trade deal among the current signatories, particularly in the manufacturing sector.

Once ratified, the TPP will grant Vietnamese companies tariff-free access to the U.S., with which it does not presently have a free trade deal. The pact will also grant Vietnam access to other large markets such as Japan and Australia.

At present, U.S. import tariffs on Vietnamese-made items of clothing can face tariffs of up to 20%. The TPP is expected to cut these tariffs to zero or close to zero, depending on the goods. This is estimated to boost Vietnamese exports of apparel, which were already up by 14% in 2015, even further.[17]

[15] Viet Nam:Economy, Asian Development Bank, Available: http://www.adb.org/countries/viet-nam/economy Retrieved: 13 May 2016.
[16] ibid

With enhanced access in key export markets, the pact will create opportunities for Vietnamese manufactured exports to replace Chinese exports in some places – notably the major markets of the U.S. and Japan. To be sure, this trend started before the conclusion of the TPP negotiations and the new agreement is expected to lift the manufacturing sector.[18]

Even if the TPP does not come to pass, Vietnam has been seeing strong in-bound mergers and acquisitions (M&A), primarily led by buyers from the Asia Pacific region. Key sectors of interest include fast moving consumer goods (FMCG), pharmaceutical, agribusiness and retail.[19]

Japanese firms ranked first in terms of M&A activity and deal value with investment interests in banking, FMCG and food and beverage sectors. Other countries entering Vietnam via M&A include Singapore, U.S. and Thailand.[20]

Vietnam is also taking steps to improve the transparency of its investment regulations in a bid to attract foreign investors. In December 2015, the government published a list of 17 business sectors that are open to foreign investors.

The list includes real estate and providing services in tourism, entertainment, computing, research and development, information, leasing, transportation, construction, health care and trading.[21] The conditions include a foreign ownership ratio, the form and scope of investment, Vietnamese partners and other conditions subject to international treaties on investment.[22]

[17] Robinson, David (2016) TPP may help Vietnam sew up clothing exports, Financial Times, 24 February 2016, Available: http://www.ft.com/cms/s/3/4362d412-db10-11e5-a72f1e7744c66818.html#axzz48V7Z3esj Retrieved: 13 May 2016.
[18] Impacts of the TPP on Vietnam – Opportunities and challenges, World Trade Organization, Available: http://wtocenter.vn/tpp/impacts-tpp-vietnamopportunities-and-challenges Retrieved: 13 May 2016
[19] Vietnam: Opportunities Amidst Challenges, IE Singapore, Available: http://www.iesingapore.gov.sg/~/media/IE%20Singapore/Files/Publications/IE%20Insights/Vol%2011_1%20Vietnam%20Opportunities%20Amidst%20Challenges%20Sep%2014.pdf Retrieved: 13 May 2016
[20] Ibid.
[21] Ho, Binh Minh (2015) Vietnam lists 17 sectors open for foreign investment, 29 December 2015, Available: http://www.reuters.com/article/vietnam-economy-investment-idUSL3N14J14420151230 Retrieved: 13 May 2016.
[22] Ibid.

China-Japan competition: Driving ASEAN integration

Rivalry and competition between Asia's giants, China and Japan, will play a key role in driving regional integration forward. Investment in infrastructure and projects such as power and transport can be expected as both countries push forward aggressively with their own visions and plans to boost infrastructure and connectivity across Southeast Asia.

Competition between China and Japan is already most visible over plans to build large infrastructure and energy projects such as railways and power plants in the region. Chinese and Japanese companies have either set up or are exploring setting up their regional/international hubs in the more developed markets of Singapore and Malaysia in order to demonstrate commitment to ASEAN. This also applies to special economic zones in ASEAN countries, and even sub-regional economic zones, such as the Greater Mekong Subregion (GMS).

The combination of special economic zones and sub-regional economic zones will ultimately help to pull the region closer together, linking up production networks and supply chains between traditional urban growth centres and the peripheries. The location of such economic zones away from a country's urban centres opens up new centres of growth. These centres can help boost economic growth as well as encourage more foreign investment into the region.

Country Case Study

Building infrastructure in Indonesia

Indonesia is working to tackle its weak infrastructure problem. The uneven spread of connectivity has widened development gaps across the archipelago. Foreign investors and businesses have also identified Indonesia's weak infrastructure and connectivity as a constraint on their operations and investments.[23]

It is estimated that Indonesia will require about 6,500 trillion rupiah in investments to fulfill its infrastructure plans by 2019.[24] This will need to be financed with the help of a combination of stakeholders, including the State-Owned Enterprises (SOE), local authorities, the private sector and FDI.

Both Chinese and Japanese investors have been actively bidding for projects in this sector. Competition between the two Asian powers has been stiff. China views Indonesia as a key strategic partner in its OBOR initiative and hopes to dovetail this initiative with President Jokowi's ambitions of establishing a Global Maritime Axis strategy.[26]

With this in view, China is financing and building some of Indonesia's largest and most strategic projects. This includes the development of ports, rail links and several major coal-fired power plants.

The Japanese, who have been long-time investors in Indonesia, are also playing in the same space. Japan recently committed more than US$100 billion in new funds to the ADB to fund high-quality infrastructure in ASEAN within the next five years.

[23] Investing in Indonesia 2015, *KPMG Indonesia.*
[24] The Report: Indonesia 2015, *Oxford Business Group.*
[26] (2016) China and Indonesia to further deepen cooperation and achieve mutual benefit win-win results and development – Yang Jiechi answers questions from journalist, 10 May 2016, Ministry of Foreign Affairs of the People's Republic of China, Available: http://www.fmprc.gov.cn/mfa_eng/zxxx_662805/t1362195.shtml Retrieved: 15 May 2016.

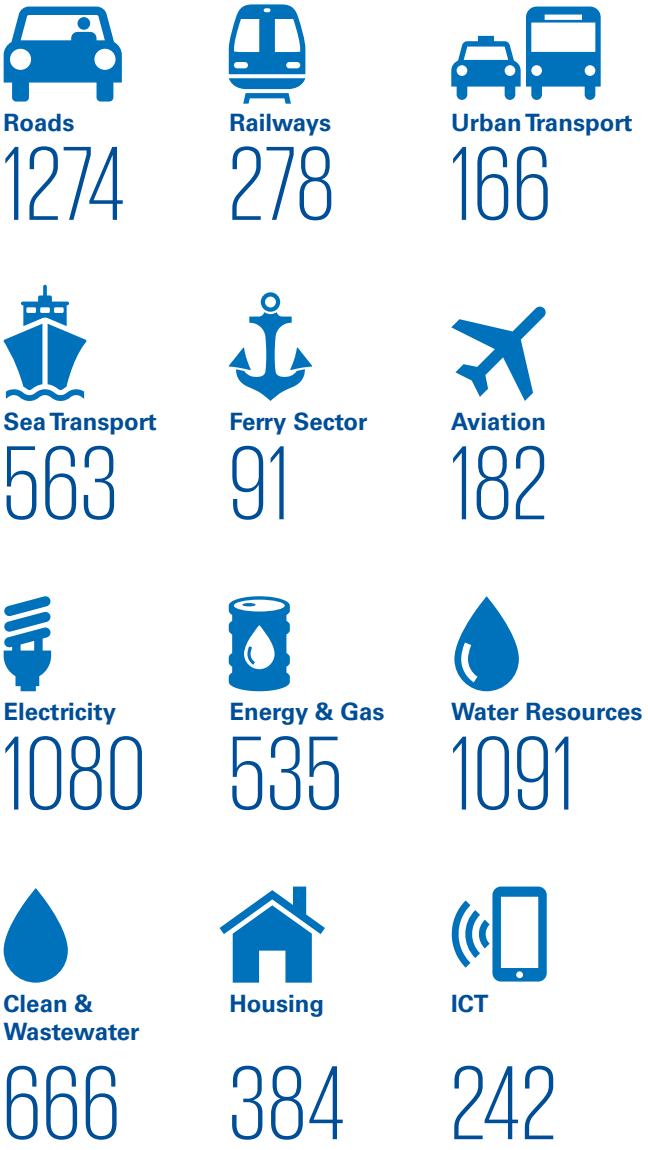
Japan's major trading houses have also made significant inroads into Indonesia's infrastructure sector by aggressively bidding for and winning projects to develop ports and major power plants.

Commenting on Indonesia's infrastructure sector development projects being awarded to foreign investors, President Jokowi has made it clear he wants to see fast results, preferably within his presidential term. He has also stressed his preference for investments that are non-exploitative and have the potential to provide the most benefits to Indonesians. Rural development and job creation are likely to continue to top the list of the President's priorities.

In the long-term, China-Japan competition in Indonesia may end up helping to improve the overall trading infrastructure and potential for economic development in Indonesia. This will pave the way for more investment opportunities to open up in other sectors.

[25] The Report: Indonesia 2015, *Oxford Business Group.*

Indonesia's infrastructure investment needs (2015-2019) in trillion rupiah



Source: BAPPENAS, Oxford Business Group[25]

Aligning business strategy to tap opportunities

The combined GDP of ASEAN is projected to nearly double by 2020. As regional integration continues, ASEAN governments are set to achieve the free flow of goods, capital, and labour. Companies both within and outside the region are remarkably positive about what the region will mean for their businesses as well as for Southeast Asian economies. In fact, most are actively taking steps towards the right strategy to tap into this opportunity. But there are also challenges in building regional strategies given the differences between individual markets, whether they relate to consumer preferences or regulatory imperatives.

Companies will find it difficult to strike the right balance between regional and individual country strategies to operate across Southeast Asia seamlessly. In each country, they will face varying business risks that are unique to that economy. It will require:

- Understanding the local business ecosystem consisting SOEs and local private business conglomerates
- Ability to stay competitive in the medium term
- Willingness to build global minded, culturally diverse organisations
- Customising products/services and business models to local conditions.

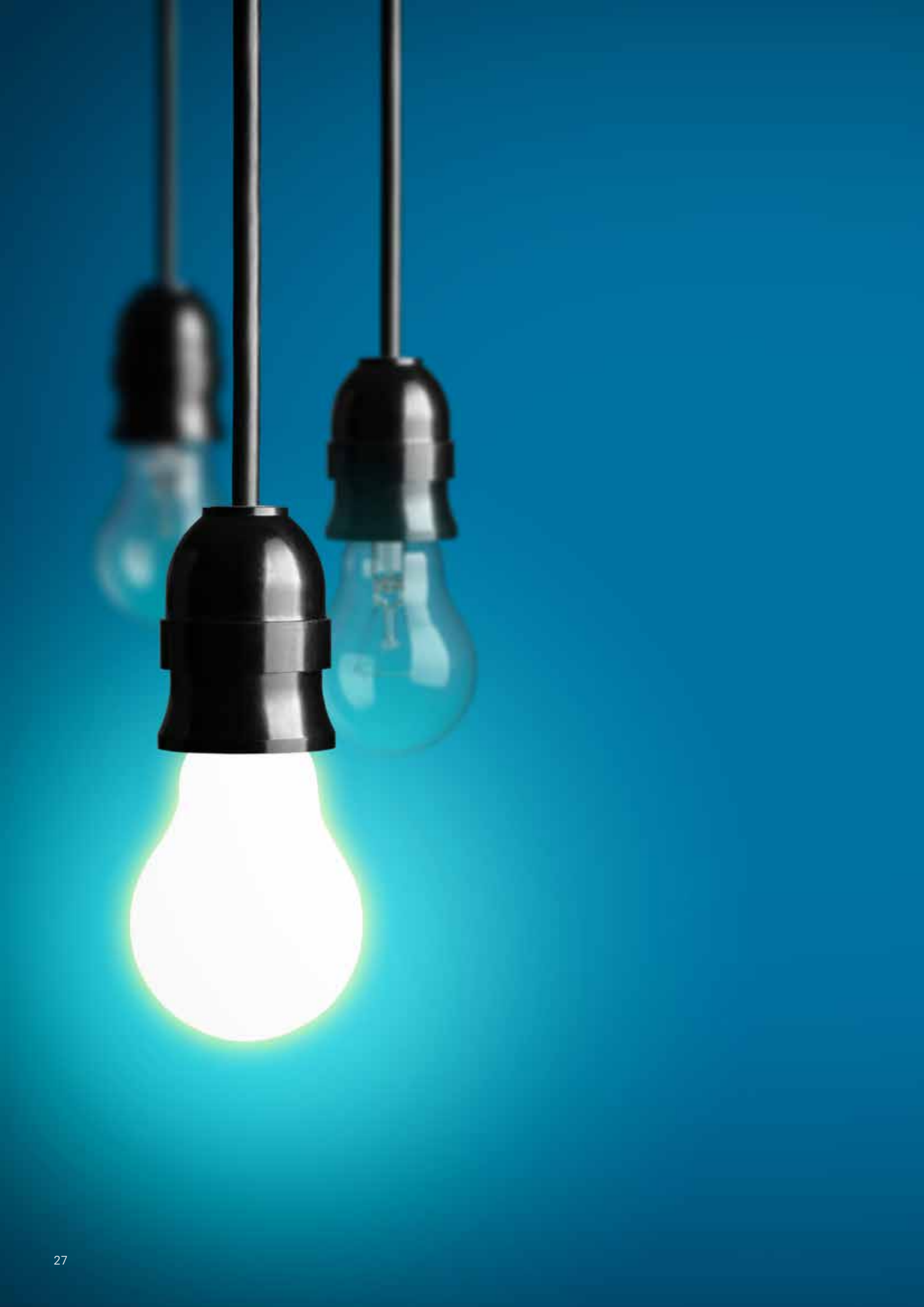
Businesses that are adept at risk evaluation and are able to update themselves on the socio-political implications of working in the region, will be best positioned to take advantage of the opportunities. The main challenge will be to understand the correct positioning within the local business ecosystem, which cannot be achieved by adopting blanket ASEAN-wide strategies. Because what works in one ASEAN country may not in another. Similarly, it will be unsafe to assume that strategies which have worked in, say Western Europe, can be successfully applied to this region. Those with the foresight and flexibility to forge both formal and informal

"Localising business plans may be the way to go as it strengthens alignment of business and country goals and creates an ecosystem that is conducive for sustained growth."

— Satya Ramamurthy, Head of Strategy
KPMG in Singapore

business-to-business relationships, and remain open to collaborating with local companies in the region are also likely to emerge as frontrunners in Southeast Asia.

There is no doubt that ASEAN presents an unprecedented opportunity for the world and for ASEAN countries themselves. The region's combined efforts to drive greater efficiency, productivity, and living standards are already creating a more attractive destination for investment. This is an opportunity to engage not only with the economic story, but also with the incredible social change that is set to transform the region.



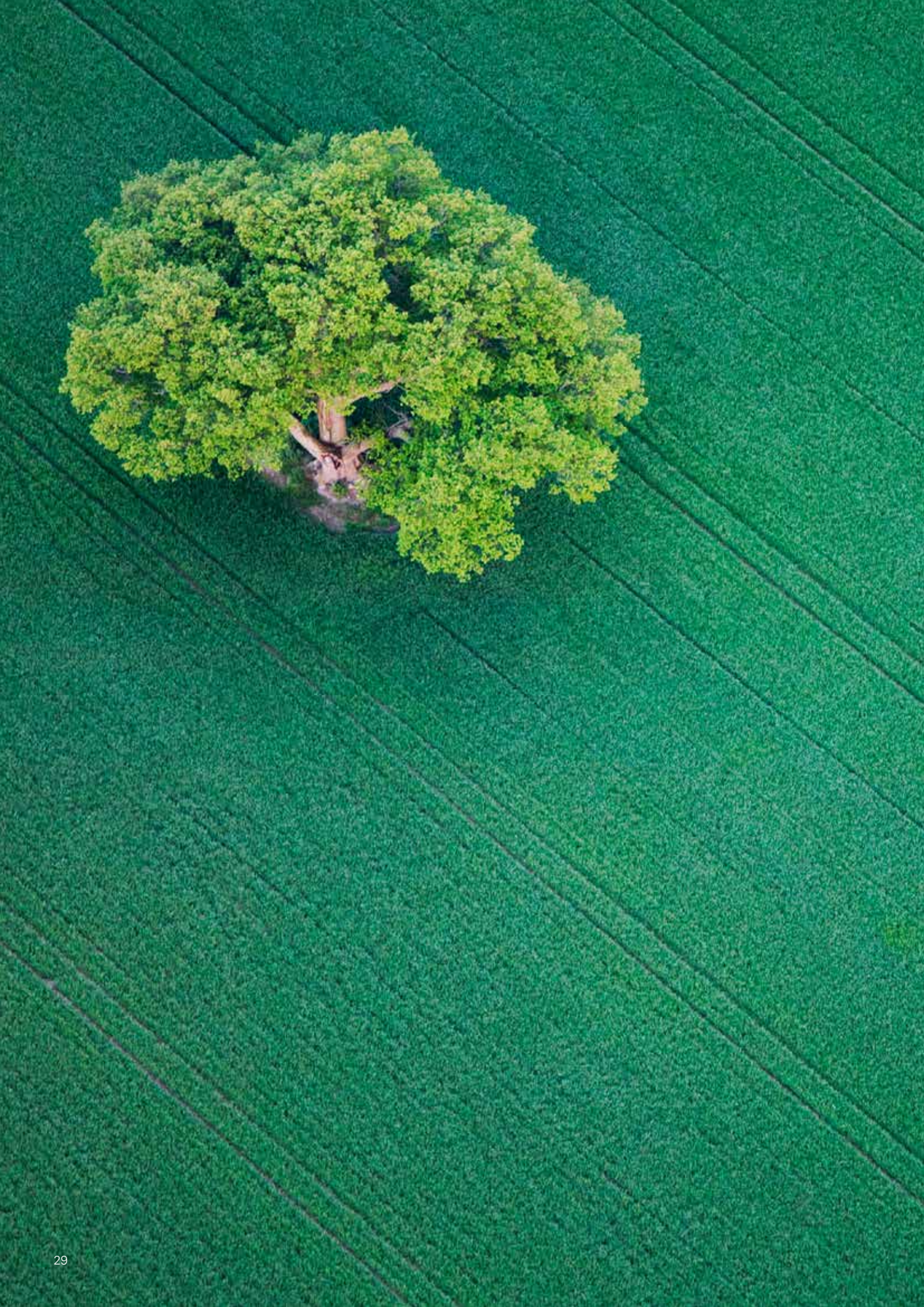
About KPMG

KPMG operates as a network of member firms offering audit, tax and advisory services across 155 countries.

Collectively employing more than 174,000 people across a range of disciplines, KPMG member firms work closely with clients, cutting through the complexities of the global business environment, and capitalising on business opportunities while mitigating risks.

In Southeast Asia, KPMG member firms are taking the lead in serving the varied and growing needs of this region while leveraging the benefits brought about by ASEAN integration. KPMG member firms support clients in their pursuit of business growth, enhanced performance, sound governance and compliance objectives.

KPMG member firms are present in all 10 countries across ASEAN. Our offices are staffed by 8,600 professionals and 300 partners, serving all major industries.



About the Singapore Institute of International Affairs (SIIA)

The SIIA is an independent think tank dedicated to the research, analysis and discussion of regional and international issues, and plays a key role in Track II diplomacy, supplementing official dialogue between governments. Founded in 1961 and registered as a membership-based society, the SIIA is Singapore's oldest think tank that aims to help Singapore become a more cosmopolitan and global society through public education and outreach on international affairs.

Since 2013, the SIIA has ranked highly as one of the top think tanks in Southeast Asia and the Pacific, in the Global Go To Think Tank Index done by the University of Pennsylvania. In the index, SIIA has consistently ranked among the top 100 think tanks in the world.

Contact us

KPMG

Tham Sai Choy
Chairman, KPMG's Asia Pacific Region
T : +65 6213 2500
E : saichoytham@kpmg.com.sg

Ong Pang Thye
Deputy Managing Partner
T : +65 6213 2035
E : pong@kpmg.com.sg

Irving Low
Head of Risk Consulting
T : +65 6213 2071
E : irvinglow@kpmg.com.sg

Satya Ramamurthy
Head of Strategy
T : +65 6213 2060
E : sramamurthy@kpmg.com.sg

Tay Hong Beng
Head of Tax
T : +65 6213 2565
E : hongbengtay@kpmg.com.sg

Bob Yap
Head of Advisory
T : +65 6213 2677
E : byap@kpmg.com.sg

www.kpmg.com.sg

16 Raffles Quay #22-00
Hong Leong Building
Singapore 048581

T : +65 6213 3388
E : asean@kpmg.com.sg

SIIA

Associate Professor Simon Tay
Chairman
E : simontay.network@siiaonline.org

Cheryl Tan
Deputy Director (ASEAN)
E : cheryl.tan@siiaonline.org

Amy Tan
Assistant Director
(International Affairs and Media)
E : amy.tan@siiaonline.org

www.siiaonline.org

60A Orchard Road, #04-03, Tower 1,
The Atrium @Orchard
International Involvement Hub
Singapore 238890

T : +65 6734 9600
E : advisory@siiaonline.org