



# ASEAN: POISED FOR ACCELERATED ECONOMIC GROWTH



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## FOREWORD

**The Association of Southeast Asian Nations (ASEAN) is a region of great diversity. Despite the differences in culture, socio-economic status and political systems, as an economic bloc, ASEAN is to be reckoned with.**

It has a combined gross domestic product (GDP) of US\$2.4 trillion, and ranks as the world's seventh largest economy.

As the ASEAN Economic Community (AEC) takes shape, the journey to closer economic cooperation is creating even more opportunities for growth. The freer movement of goods and investment, and inevitably of labour and capital too as a result of AEC, will further boost the region's economic profile.

As elsewhere, there are geo-political risks in the South China Sea and country-level political and monetary challenges. But with a deeper understanding of these risks and a considered strategy, well-equipped indigenous businesses and foreign companies alike will do well to ride the wave of growth in ASEAN.

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# INTRODUCTION

## This report assesses the prospects for ASEAN economies in the medium to long-term.

In essence, the report finds a strong case for an acceleration in economic growth in ASEAN countries over the next decade as a result of the confluence of several positive drivers:


1. we see rising synergies from multiple forms of integration that are proliferating in the region
2. ASEAN's competitiveness is improving
3. fundamental turnarounds in once-laggard economies such as Myanmar and the Philippines also help the region.

These positive drivers together with ASEAN's demographic advantages are likely to translate into rising investment rates. So long as investment remains productive, this should then translate into higher economic growth.

This report also assesses the major risks to this assessment. There are two sets of risks that are of particular interest:

- First, political challenges such as the disputes in the South China Sea and domestic political stresses need to be managed.
- Second, there are financial and policy issues that could emerge as the global financial markets digest a period of rising United States (US) interest rates.

On balance, these challenges can be mitigated or contained but nevertheless, the way they unfold will impinge on the economic outlook.



# SECTION 1: THE POSITIVE CASE FOR ASEAN





**While enjoying reasonable economic growth in recent years, the ASEAN economies have not been able to return to the high growth that preceded the Asian financial crisis of 1997-98.**

One major reason for this lower growth has been a lower investment rate. However, of late, several factors as explained below, appear to be coming into play. These factors could raise the investment share of gross domestic product (GDP) which in turn will help raise economic growth in the region as a whole.

### **1.1 Rising synergies from economic integration**

Economic integration expands the market available to companies within the integrating region, offering economies of scale and scope that would not otherwise exist. By encouraging greater division of labour, integration allows for a more efficient allocation of resources. Though ASEAN integration has taken a while to gain traction, it is encouraging

to see multiple modes of integration in the region, each yielding positive synergies.

#### **The ASEAN Economic Community (AEC) taking shape will have increasingly powerful impact**

The AEC was endorsed by ASEAN leaders at the Bali Summit in October 2003 with the aims of integrating ASEAN into the global economy and creating a single market and production base where goods, services, capital and labour flow freely so that equitable development can be realised. The AEC, scheduled to be fully implemented at the end of December 2015, has four major components:

- **Single Market and Production Base** allowing for the free flow of goods, services, investment, capital, skilled labour and rapid liberalisations of 12 priority sectors<sup>1</sup>. Freer flows will entail the elimination of tariffs, liberalisation of financial services and improved regulations to ensure investment protection and maintain stability in light of greater capital mobility.
- **Competitive Economic Region** under which a clear competition policy will ensure a level playing field in the integrated ASEAN market, infrastructure development within the region, sectoral cooperation in energy and approaches to e-commerce. A crucial development in the component is taxation rationalisation which features a bilateral network that would avoid double taxation.

1. These include wood-based products, automotives, rubber-based products, textiles and apparels, electronics, agro-based products, fisheries, e-ASEAN, healthcare, air travel, tourism and logistic.

- **Equitable Economic Development** which will emphasise small and medium-sized enterprises (SME) development, with an emphasis on taking advantage of ASEAN's diversity. Efforts will be stepped up to narrow development gaps between older ASEAN-6 members and the newer ASEAN members.
- **Integration into the Global Economy** sees ASEAN working towards "ASEAN Centrality" in external foreign economic relations (including free-trade areas and other preferential arrangements with non-partners). Enhanced participation in global supply networks, with a strong dedication to the adoption of best international practices and standards.

The AEC is likely to yield considerable synergies that will promote economic growth and the region's attractiveness to investors.

First, dismantling tariff and non-tariff barriers reduces costs, facilitating intra-regional trade. It also paves the way for the proliferation of cross-border production networks that can fully exploit the diverse range of comparative advantages across ASEAN member states.

Second, sectoral cooperation will allow ill-equipped countries to learn and absorb technology from more developed members, increasing both its human and capital stock. A single market and production base will allow for more efficient allocation of resources through the phasing out of uncompetitive firms and better flow of information, and increase potential economies of scale through a bigger market.

Third, companies can draw upon the different competitive advantages of the various ASEAN economies in their operations. For example, conducting labour-intensive activities in Myanmar and Vietnam, doing more complex assembly in Thailand and Malaysia, and conducting high-end research and development (R&D) activities in Singapore. By creating new markets and improving productivity, further integration can boost the

creation of better-quality jobs as well as generate widespread economic benefits.

Fourth, integration allows ASEAN economies to overcome their disadvantage in terms of scale. ASEAN needs to offer scale economies for businesses that are unique or competitive with those offered by China and India. Individually, each ASEAN economy cannot provide anything close to the market size that the two Asian giants can offer businesses. Consequently, costs of trading across borders and inefficiencies in customs procedures are substantially worse in ASEAN than in China. Once integration gains traction and produces scale economies, ASEAN economies can reduce their unit trading costs and gain competitiveness.

The AEC Blueprint provides a comprehensive framework to increase investment because it contains many mutually reinforcing measures that will improve the investment climate of individual countries and the region as a whole. This increased investment should set the tone for accelerated economic growth.

The AEC is behind its targets in some areas such as reducing non-tariff and regulatory barriers in goods, services and investment, which could well prevent the full realisation of the AEC vision by the planned date of December 2015. However, the better way to view ASEAN integration is as a marathon, not a sprint. Our view is that the glass is half full rather than half empty. It is important to remember that the AEC Blueprint has a greater likelihood of producing positive effects compared to previous ASEAN initiatives. This is because of its comprehensiveness and the disciplines, such as the ASEAN Scorecard, that have been put in place to ensure implementation. The ASEAN Scorecard provides a detailed assessment of each country's implementation of the myriad of actions required to make the AEC real. Over time, the AEC will become more effective and yield synergies.

In the meantime, ASEAN is fortunate to have other forms of integration which are already yielding benefits.





### **Greater Mekong Sub-Region (GMS) is already emerging as a more integrated region**

The GMS programme which began in 1992 comprises Thailand, the newer ASEAN members, namely Cambodia, Lao PDR (Laos), Myanmar and Vietnam (CLMV) as well as the two southern-most provinces of China - Yunnan and Guangxi Zhuang. The aim of the programme is to foster economic cooperation to enhance the living standards and economic prosperity of the collective region. It will be achieved through a three-pronged strategy of increasing connectivity, improving competitiveness and building a greater sense of community.

An “economic corridor” approach has been adopted by the GMS governments. The intent is to achieve more equitable development for poorer locations through better integration with their more prosperous neighbours. Three such economic corridors have been identified: the East-West Economic Corridor (EWEC), the North-South Economic Corridor (NSEC) and the Southern Economic Corridor (SEC). The key to achieving the GMS goals is to leverage each region’s strengths to compensate for its weaknesses. Priority infrastructure projects worth around US\$11 billion have either been completed or are being implemented.

A prominent corridor is the SEC which covers six provinces in eastern Thailand, 21 provinces and municipalities in Cambodia, four regions in Vietnam and six provinces in Laos. These areas contain established manufacturing and agricultural hubs, rich natural resources, big consumer markets and tourist attractions that provide the SEC with great potential for economic development.

In terms of connectivity, close to US\$11 billion has been injected into infrastructure investment in the GMS over the last decade. The completion of the 1,450km EWEC saw significant benefits in the region. It reduced travel time, increased foreign direct investments (FDI), expanded employment and improved access to secondary schools for rural students. The NSEC was reported by the Asian Development Bank (ADB) in 2012 as virtually completed. The SEC, which connects Bangkok with Phnom Penh, Ho Chi Minh City and Vung Tau, has also been completed.

As a result, GMS economies are growing rapidly and delivering significant improvements in living standards to their citizens through infrastructure projects and members leveraging each other’s comparative advantages. The annualised growth rate of FDI inflows in the CLMV economies have exceeded the Southeast Asian average rate, indicating interest in the region and the impact it will have on GMS economies in the long run. The International Monetary Fund (IMF) projects that the CLMV economies will be the fastest growing ASEAN countries over the period to 2017.

The integration efforts of the AEC and GMS are amongst numerous smaller scale projects and bilateral ties that already exist in ASEAN, and have enhanced the robust growth the region has enjoyed over past decades. These integration efforts in ASEAN have been constantly increasing, while measures like the AEC, Regional Comprehensive Economic Partnership (RCEP) and Trans-Pacific Partnership (TPP) will only increase this further.

### Cross-border trade flows also enhance integration

Encouragingly, there are more examples of increased interaction across national boundaries. This has resulted in more trade and investment which in turn have prompted expanding economic opportunities:

- **Thai-Laos border trade:** There has been an increase in cross-border economic activities between Thailand and Laos, with several towns in the northeast of Thailand such as Nong Khai and Khon Kaen benefitting from increased Laotian demand for services of all kinds.
- **Cooperation between Singapore and the Iskandar Region of Malaysia:** The Iskandar Region (IR) is three times the size of Singapore and located just across the Johor Straits from Singapore. The IR was developed with the clear aim of integrating with Singapore - offering Singapore greater economic space with its abundant land and better labour endowments compared to Singapore. Land and labour intensive activities in high-cost Singapore are consequently being relocated to the IR, allowing Singapore to benefit by concentrating on even higher-value activities domestically while the IR benefits from huge investments. This mutually beneficial arrangement is proving successful and could well be a template for future cross-border ASEAN integration.

### Supply chains also weave the ASEAN economies together

ASEAN has become a regional production hub for parts and components in the global manufacturing supply chains of multinational companies. While this has been the case for some years now, a new element is the increased incentive for Japanese companies to expand their outsourcing to ASEAN.

Realising the need to build supply chains closer to end markets and to mitigate the risk of natural disasters, Japanese companies have stepped up the shifting of production to diversify supply chains, to the benefit of ASEAN countries. With production sliced finely and allocated to different countries within ASEAN, this structure results in considerable trade in components within the region.





## 1.2 ASEAN's improving competitive position

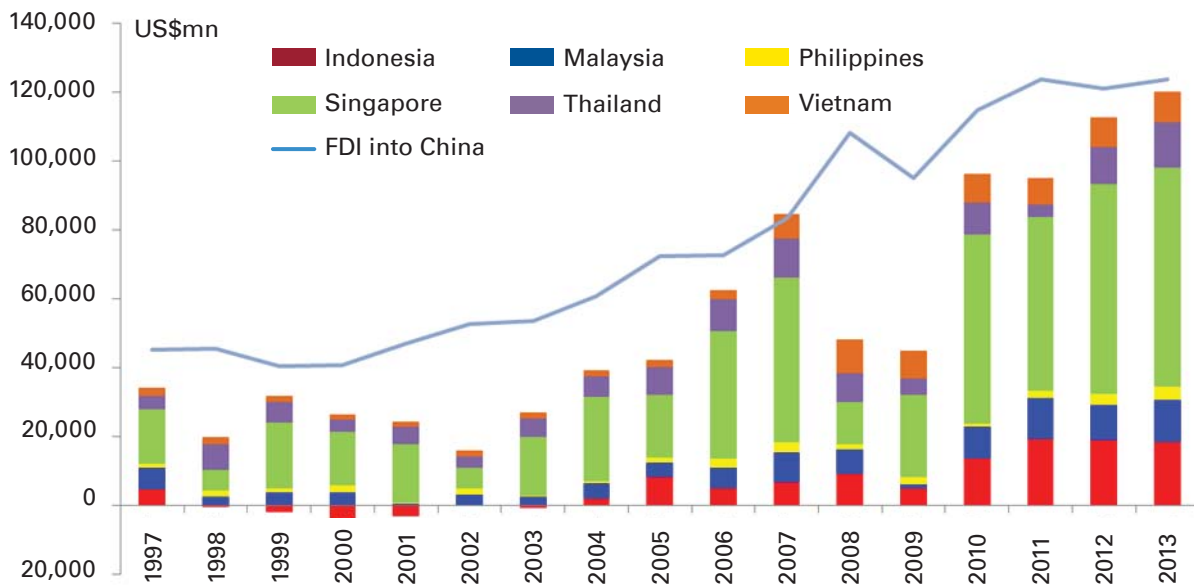
### ASEAN's position relative to China has improved recently

As China opened up to FDI in the 1990s, global companies which had already been investing heavily in Southeast Asian economies realised that their investment portfolios were under-invested in China relative to Southeast Asia. Consequently, particularly with the impending entry of China into the World Trade Organisation, there was a re-adjustment of their portfolios to increase the under-represented stock of Chinese investment, which partly explains the reduced flow of FDI to ASEAN. With the stock of FDI in China now substantial and more reflective of its size, competitiveness and other economic fundamentals, this re-adjustment process has essentially been completed, allowing some recovery in FDI into ASEAN.

Figure 1 below maps FDI into six ASEAN countries compared to FDI into China. FDI into ASEAN is clearly gaining pace and catching up with China. With the lack of figures for Myanmar, Laos, Brunei and Cambodia, overall FDI into ASEAN could be above FDI into China.

In addition, ASEAN offers low cost labour in market-friendly policy environments. Where a Chinese factory worker earns an average of US\$28 per day, wages in Indonesia and Vietnam are around US\$9 and US\$7, respectively. MNCs are trimming production in China in favour of producing components in others such as Myanmar and the Philippines, with China still as a centre. ASEAN countries are visibly making infrastructural improvements and easing restrictions to attract FDI and MNC relocation to reap the benefits their demographic offers.

**Figure 1: ASEAN has a good share of global stock of foreign investment**



Source: Calculated by Centennial Asia Advisors using CEIC Database



**Reforms are improving investment attractiveness**

Aldaba et al (2009)<sup>2</sup> identified transmission channels that positively impact FDI flows.

- The ASEAN Comprehensive Investment Agreement, ACIA, is more comprehensive than previous agreements. It provides for investment liberalisation, most-favoured-nation and national treatment, as well as investment protection, promotion and facilitation. The lifting of foreign ownership and sector restrictions and the elimination of performance requirements are expected to increase FDI. Similarly, deeper integration features such as the legislation and harmonisation of standards, competition and customs laws, intellectual property rights and dispute settlement mechanisms can improve the regional investment climate, particularly in services.
- Also, the larger market that will be formed through the AEC will prove more attractive for foreign MNCs. The economic integrations of European Union (EU), North American Free Trade Agreement (NAFTA) and Mercosur saw

significant FDI inflows and similar actions are expected for the AEC.

Beyond region-wide initiatives at the ASEAN level, individual countries are also stepping up reforms to improve their competitiveness. Examples include the following:

- At the start of 2015, Indonesia implemented one-stop integrated services (PTSP) for investors. The PTSP system consolidates multiple licenses into one administrative step, cutting the processing time and significantly improving predictability and transparency in investment registration. Indonesia also provides fiscal incentives for investment in several business fields and locations regardless of the ownership of enterprises.
- Vietnam has taken major steps to increase FDI through its Bilateral Investment Treaty (BIT) with the United States and through amendments to its Foreign Investment and Enterprise Laws which have significantly improved the business environment.

2. Aldaba, R. and Yap, J. 'Investment and Capital Flows: Implications of the ASEAN Economic Community.' Philippine Institute for Development Studies (2009)



### Shift of Japanese investment towards Southeast Asia

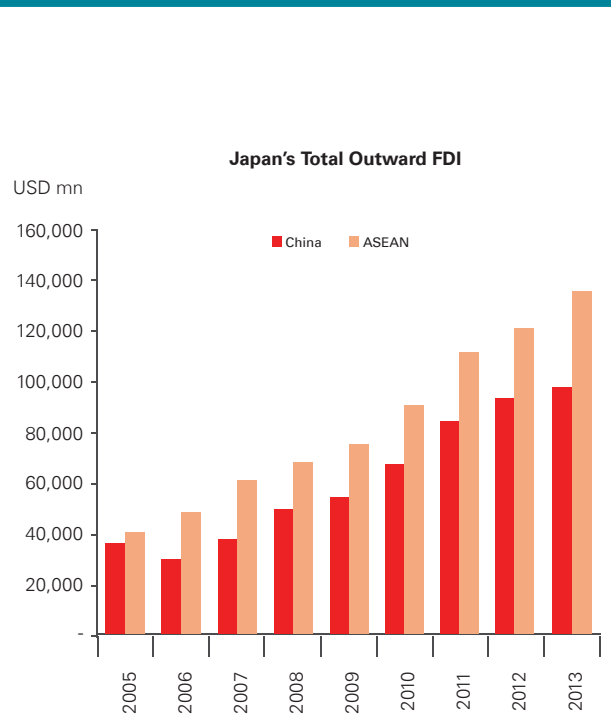
Japanese companies have been investing heavily in China, however this trend is now seeing a shift to ASEAN. Figure 2 illustrates Japan’s withdrawal from China which is underlined by political reasons as well as rising production costs and increased difficulty in managing factories in China. This has pushed up overall Japanese FDI into ASEAN, which boasts cheap labour and a young demographic dividend.

ASEAN is regaining its edge as a choice investment destination. With some factors and structural changes coming into place, ASEAN’s investment attractiveness is improving which will in turn translate to economic growth.

### 1.3 Positive demographics and urbanisation

On a larger scale, China’s competitive edge over ASEAN in labour-intensive industries is unlikely to continue due to its changing demographics and increased costs. Figure 3 maps China’s working age population as a proportion of total population, showing how China’s working age population peaked in 2010. In addition, while urbanisation continues in China, the pace is slowing and with wage increases, factory profits are being squeezed to maintain competitiveness. With China’s baby boom cohort aging and policies struggling to normalise fertility rates to replacement level, China’s demographic dividend is nearing its end - unlike in most parts of ASEAN (Figure 4).

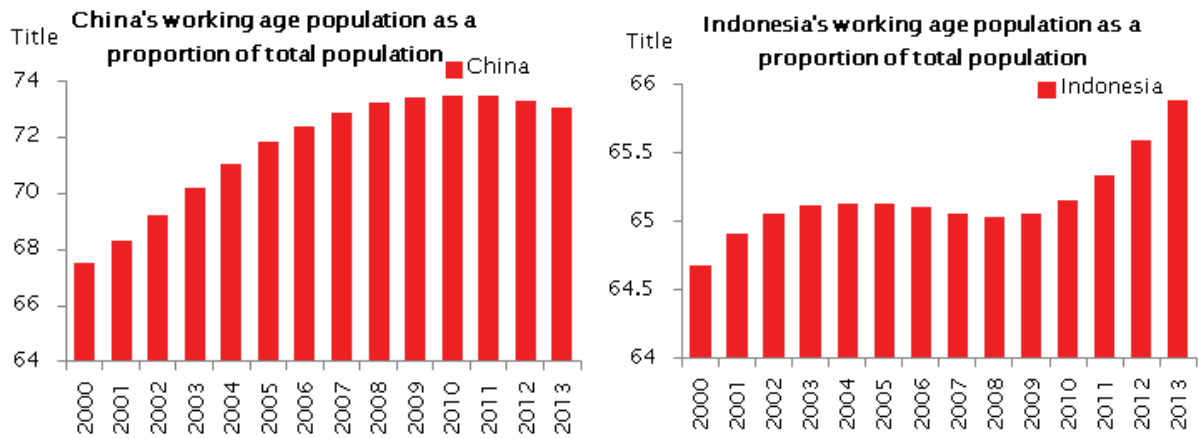
**Figure 2: Japanese companies increasingly favour ASEAN**



Source: Calculated by Centennial Asia Advisors using JETRO Statistics

Note: ASEAN FDI represents Malaysia, Singapore, Thailand, Indonesia, Philippines and Vietnam

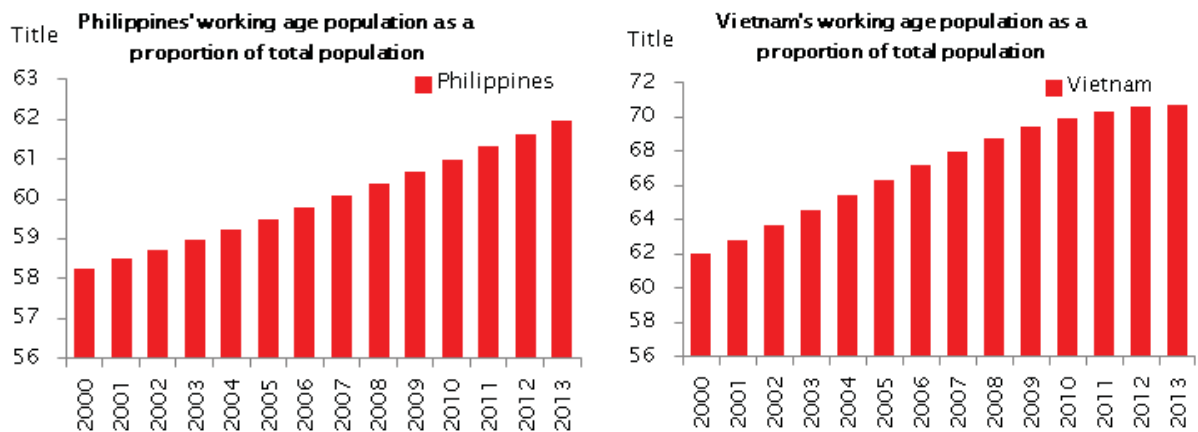
**Figure 3: China's once competitive demographic dividend is nearing an end**



Source: Calculated by Centennial Asia Advisors using World Bank Data

Note: Working age population represents population between ages 15-64

**Figure 4: ASEAN's demographic dividend is visibly increasing**



Source: Calculated by Centennial Asia Advisors using World Bank Data

Note: Working age population represents population between ages 15-64

As of 2013, China's working age population as a proportion of total population stood at 73%, ahead of Indonesia, the Philippines and Vietnam at 66%, 62% and 70%, respectively. However, the charts on the preceding page depict ASEAN countries visibly producing a demographic dividend. With the world's third largest labour force, 60% of ASEAN's population is below the age of 35. While both young and old require healthcare and income, it is working age population that supplies the economy with labour and savings to support dependent groups while driving economic growth. The rapidly growing population of working age adults in ASEAN will provide the region with the opportunity for accelerated GDP growth:

- In Vietnam, 2011 market reforms have attracted FDI to capitalise on the nation's growing demographic dividend and falling dependency ratios. Vietnam is already reaping the benefits from its demographic dividend, recording growth at 6%. It is expecting to extract higher rewards from its demographic transition as it continues to liberalise and invest more in healthcare and education.
- The Philippines' positively increasing working age population stands at almost 62% of the total population in 2013. With a 3.1 fertility rate, the highest in ASEAN, the nation will see an extension

in its competitive demographic transition, giving it the opportunity to expand its GDP growth.

Complimenting ASEAN's demographic dividend is urbanisation, which will usher a larger share of the population to more productive sectors.

Currently ASEAN's urban share makes up about 36% of its 600 million population. This share is expected to increase to 45% by 2030 allowing ASEAN to continue enjoying urbanisation gains beyond 2030. ASEAN's young demographic continues to attract MNCs to invest heavily in the region while governments follow through on infrastructure improvements to support increasing urbanisation.

This investment helps to facilitate a shift in countries from low to middle income status, and creates millions of jobs, attracting new technology that disperses education and healthcare across both urban and rural areas. Further economic and societal enhancements associated with urbanisation are expected to resonate throughout the ASEAN region surpassing the year 2030.

With ASEAN's urban share set to grow, it is crucial for ASEAN producers to exploit the spur of demand that will follow in order to enjoy accelerated economic growth.







## 1.4 The resurgence of laggard economies: Philippines and Myanmar

### After decades of underperformance, the Philippines is set to grow faster than China

Once characterised by sub-par infrastructure, political instability and widespread corruption, the Philippines economy is now surging with growth, overtaking Asia's tiger economies. In 2014, growth in the Philippines stood at 6.1% and ADB forecasts this to grow to 6.4% in 2015, holding the key to drive ASEAN's growth.

Good governance has been key to the Philippines' economic resurgence. Better governance has allowed the gaining of more confidence from the financial markets and lowered borrowing costs across public and private sectors. Stability has seen a surge of FDI into the economy with FDI levels tripling since 2010.

FDI has had spillover effects to the rest of the economy; a noticeable increase in infrastructure spending and reforms to maintain economic growth. The Philippines has an estimated 57 infrastructure projects in the pipeline and its 2015 infrastructure budget stands at US\$12.8 billion, around 4% of its GDP. This figure is expected to increase in 2016.

Foreign investment has also given rise to a rapidly growing business process outsourcing (BPO) sector. This sector is an important growth driver for the Philippines, creating positive transmission effects for the rest of the economy.

FDI into the Philippines is expected to grow as businesses seek to diversify to cheaper destinations given rising wages in China. The large Filipino diaspora contributes greatly to the country's favourable balance of payments.

While a lot of progress has been made to remove barriers to investment and attract foreign investment, the Philippines still falls in the bottom half of Transparency International's Corruption Perceptions Index. Foreign investors are limited to 40% ownership in local firms. However, the outlook for the Philippines remains bright. Jim Yong Kim, the president of the World Bank Group said the Philippines could be the "next economic miracle in Asia". With spending and reforms aimed at improving stubborn poverty rates, the Philippines' growth and resurgence can be well sustained over the years.

With the AEC on the horizon, less developed ASEAN countries will be able to leverage their ties with the Philippines through transferring benefits including knowledge and skills, and in turn embark on a growth trajectory similar to the Philippines.

## Myanmar's economic reforms lay the foundations for a new surge of growth

Myanmar's transition from an authoritarian military system to democratic government has paved the way for economic reforms and the easing of sanctions allowing the country to regain its economic lustre.

Since 2011, ambitious reforms have included stimulating FDI, developing the private sector, increasing access to finance, liberalising sectors, and promoting job creation. These reforms have seen rewards with 2014 economic growth at 7.8% underpinned by strong investment, improved business confidence, commodity exports and credit growth. 2015 brings forecasted growth of 8.3% ahead of its ASEAN counterparts and China.

In December 2014, FDI into Myanmar was recorded at US\$6.2 billion, with the telecommunications sector accounting for 20% of this total, followed by manufacturing. Strong growth in FDI is likely to continue in Myanmar with regional and international institutions competing to set up operations in one of the fastest growing economies in the ASEAN region.

Myanmar benefits from its geographic location between China and India, positioning it as a regional trading hub and a key supplier of minerals, natural gas and agricultural output. This has attracted attention from China, Japan and even the US viewing Myanmar as an economic base for investment. Myanmar is also increasingly viewed as Southeast Asia's link to India.

With all these positives, sustaining growth for Myanmar is dependent on continued reforms aimed at upgrading the economy as a whole without widening income disparities; strengthening institutions and improving infrastructure, among important measures. Other challenges include the conduct of the country's upcoming general election later this year and the signing of a nationwide cease-fire agreement to put a stop to ethnic conflicts in the country, furthering the government's administrative reforms to include greater cooperation and transparency.

## 1.5 Rising investment rates

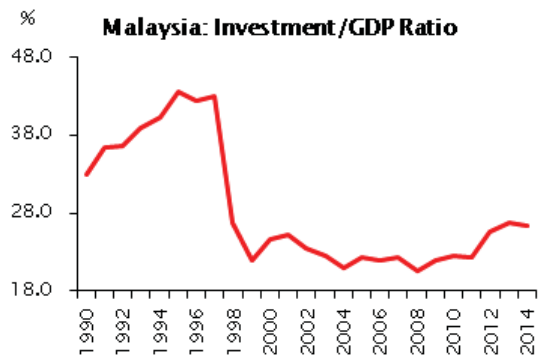
The positive drivers above should result in a boost to growth-enhancing investments in ASEAN. In addition, efforts are underway to increase infrastructure spending across the region. As spending on infrastructure is ramped up, there is an immediate boost to demand and economic growth. More importantly, better infrastructure and connectivity - power supply, roads, ports, and airports - will ease constraints on growth, allowing economic growth to accelerate.

Infrastructure investment in ASEAN is poised to pick up in order to rectify a long period of under-investment. The ADB estimates that ASEAN countries have spent only about 4% of their GDP on infrastructure, with an average of 5%-10% being estimated as needed for higher long-term growth. The ADB estimates ASEAN's infrastructure needs at US\$60 billion a year from 2010-2020.<sup>3</sup> For example, Thailand plans to spend an estimated Thai Baht 2.4 trillion from 2015-2022 on upgrading its transportation infrastructure and establishing logistics connectivity to the CLMV countries. It has planned investment projects to revamp rail networks, ease traffic congestion and increase connectivity to rural areas, neighbouring countries and others in order to capitalise on opportunities arising from the AEC.

As Figure 5 shows, investment shares of GDP for Malaysia and Thailand fell significantly after the 1997-98 financial crisis and have yet to fully recover. As the positive drivers of investment described above kick in, ASEAN countries will enjoy a rising share of investment in GDP, driving acceleration in economic growth.

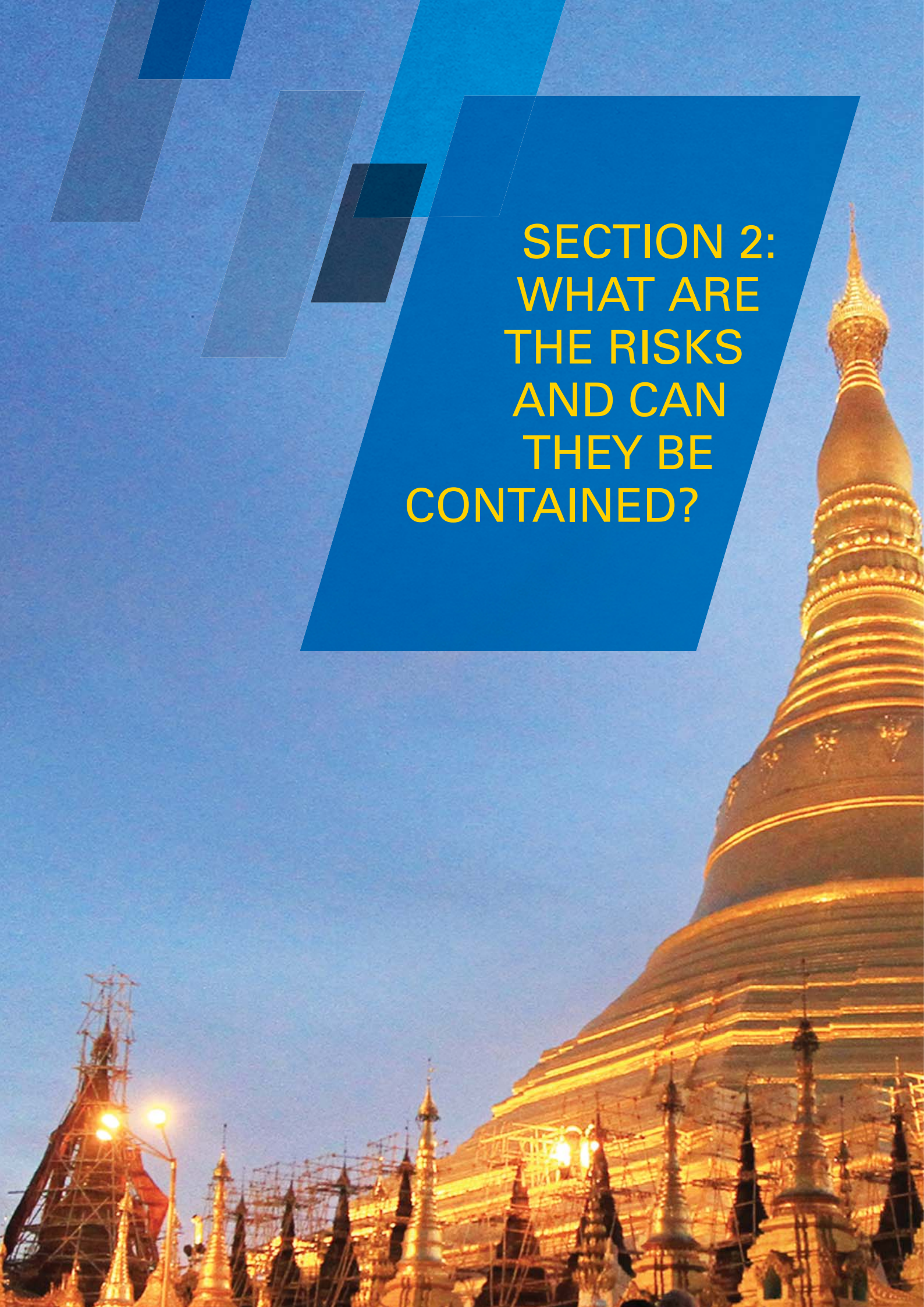
In essence, this section has argued that ASEAN is enjoying a confluence of positive growth drivers that will help boost the investment share of GDP and by doing so, raise economic growth. The next section will examine where the downside risks are and how they can be contained or mitigated.

**Figure 5: Still no recovery from sharp fall investment ratios after financial crisis**



Source: Calculated by Centennial Asia Advisors using CEIC





**SECTION 2:  
WHAT ARE  
THE RISKS  
AND CAN  
THEY BE  
CONTAINED?**



## 2.1 Geo-political risks: a new balance of power emerges in Southeast Asia

The Southeast Asian region is once again the cockpit of big power contestation for influence. Not only is it a region with massive endowments of energy and other raw materials, it also sits astride sea lanes of communications that are of vital interest to virtually all the major military and economic powers in the world. The region is prized for its huge economic potential - a consumer market that is large and growing rapidly as well as a production base for a variety of manufacturers, including components for high technology and defence equipment. Thus, for a range of reasons, Southeast Asia is a region in which all the world's major powers feel they have a stake.

Following the end of the Vietnam war, the region experienced a period of peace and stability as tensions receded and the big powers found an accommodation. Of late, however, a rising China has changed the picture. China has reached a stage of political and economic development where its legitimate interests have changed and where its national ambitions are also adjusting to the new reality of a much more powerful China. China is beginning to assert these interests more vigorously. Where these interests impinge on the territorial or other interests of its neighbours or other big powers with interests in the region, frictions arise. The incumbent big powers with interests in the region such as the US and Japan believe that their interests require them to also assert their interests in the face of a rising China. There are also middle powers such as India and South Korea who have interests in the region and who have to project these interests in some ways.

Thus, we are in a new period of greater contest for influence within the region.

### Competing territorial claims in the South China Sea need to be managed

One major area that investors need to watch is the disputes over conflicting territorial claims in the waters of the region, especially in the South China Sea.

In recent years, China has extended its military reach and asserted its territorial claims more vigorously than before. For ASEAN, the key area of possible concern is the part of the South China Sea where China, Vietnam, the Philippines, Malaysia and Brunei have competing claims. There are several factors driving this higher risk:

- As claims and counter-claims were made, China believed it necessary to strengthen its claims more forcefully by occupying some of the rocks and shoals that make up the Spratly Islands. It has taken over shoals and rocks in the region claimed by Vietnam and the Philippines. In some cases, some ASEAN countries have accused China of aggressive actions around shoals and rocks which these countries still occupy, raising the risk of naval clashes in the area. China has also begun to reclaim land around some of these shoals with the apparent aim of building military facilities which could alter the balance of military power in the area.
- The US is concerned about the South China Sea, which they see as a strategically important sea-lane of communication as well as an area with potential energy resources. The US sees itself as a Pacific power with legitimate interests in the region and believes it has to adjust its strategy to address China's growing projection of influence. Thus, the Obama Administration has embarked on a new strategy of greater engagement in the region which involves the deployment of marines in Darwin, Australia as well as the more frequent deployment of military forces in the region.

- Japan also has substantial interests in Southeast Asia, a region from which it imports large amounts of energy and raw materials, and one where it has invested massive amounts of FDI. Since Japan, too, has territorial disputes with China, it has sympathised with Vietnam and the Philippines in the latter's disputes with China. It is also stepping up its diplomatic and strategic engagement in the region in direct response to China's assertiveness.

Thus, the South China Sea disputes have become a focal point for rivalry among big powers.

### Nevertheless, there are several reasons why this potential flash point can be contained

First, China and ASEAN countries understand the need to further strengthen strategic trust and forge a security partnership and maritime cooperation. Fortunately, there are efforts in this direction even if the progress has been slow. In 2002, China accepted a Declaration on the Conduct of Parties in the South China Sea (DOC) suggested by ASEAN. The parties pledged to seek peaceful solutions to disputes and conduct maritime cooperation in order to maintain regional stability. There are continuing negotiations to transform this understanding into a full-fledged code of conduct, which would reduce the risks of accidental military clashes, and build the confidence and trust needed for an eventual compromise to evolve.

Second, a healthy balance of forces within the region acts effectively as a check against any one country making aggressive moves which could destabilise the region. While China is raising its military profile, the US has re-engaged in its historic role of providing the underpinnings of the regional security order in Southeast Asia. Middle powers such as Japan, South Korea and India are also stepping up their presence and cooperation with several ASEAN countries.

Third, ASEAN countries have China as a major trading partner and foreign investor while China needs ASEAN as a market, source of raw materials and energy and as a security partner. This "dual dependency" dynamic reduces the risk that competing territorial claims might escalate into anything more serious.

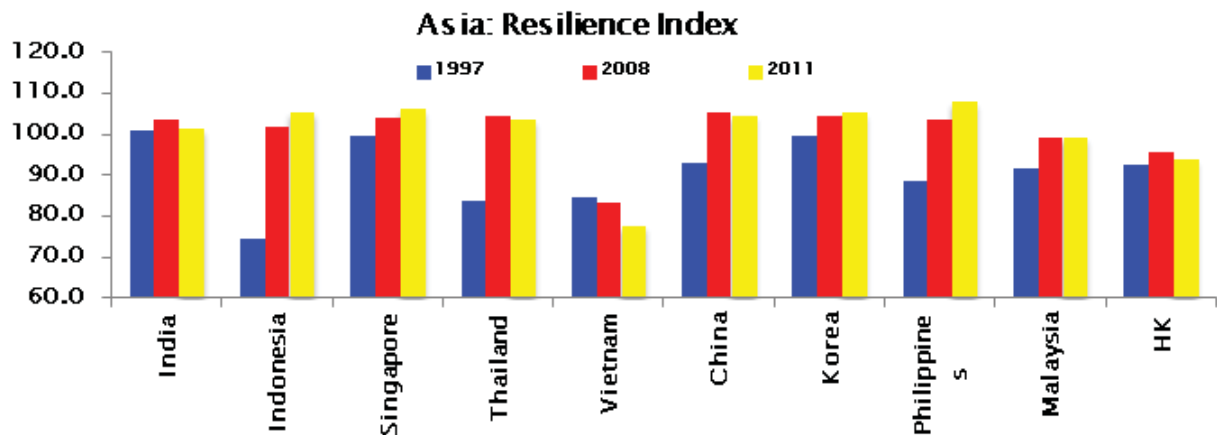
## 2.2 Country political risks

While region-wide tensions have yet to subside, on a domestic level, political instability surrounding elections, coups or peace agreements bring with them uncertainty, hindering investment and growth prospects. Preoccupation with political issues present a hurdle for ASEAN being able to enjoy the fruits of accelerated growth should they escalate.

- Thailand has endured political turbulence for almost ten years now, a period marked by two military coups, violent protests and considerable uncertainty. However, with a new constitution being drafted and elections scheduled for early next year, there is increasing hope of a resolution.
- In Myanmar, talks are underway to ensure a smooth election in late 2015, one that should mark the transfer of power from the army's representatives to a popularly elected government. Ceasefires and formal peace talks to end decades of insurgencies involving ethnic minorities are also gaining momentum.
- An area of concern for the Philippines is the upcoming presidential elections in June 2016 which will see President Aquino stepping down from office. Businesses are unclear as to whether the next government will be able to drive forward further economic reforms and improve the economy's competitiveness. But much of the progress in recent years is now entrenched. In particular, President Aquino has succeeded in bringing the major insurgency in the south of the country to a final resolution.

There certainly are domestic political challenges in the region but the good news is that each ASEAN country has been evolving its own way of addressing and resolving political issues. The general picture is one of political successes. In the past two decades, Indonesia and the Philippines have made successful transitions to democracy with Myanmar taking a similar path. Other countries such as Cambodia have learnt to create systems which accommodate divergent political interests. Overall, we are confident that domestic political risks can be contained.

Figure 6: ASEAN economies have mostly improved their resilience



Source: Calculated by Centennial Asia Advisors

## 2.3 Financial and monetary challenges

The rising US dollar and an expected interest rate hike in the US 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, as shown in Figure 6 which depicts the resilience

index that measures the ability of economies 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.







## CONCLUSION

On the whole, the path ahead for ASEAN could be bumpy as some of the political and financial risks could materialise.

However, with its improved resilience, these risks can be managed. Given the growth drivers coming into place as explained in Section 1, the overall trajectory for ASEAN is likely to be a rising one.

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