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Economic Insight

The ASEAN Economic Community: A big bang for regional supply chains?

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Executive summary

- The AEC is a tremendous opportunity to strengthen the ASEAN block. Singapore, Thailand and Malaysia will benefit the most, already acting as springboards to international value chains.
- AEC companies will benefit from peer-pressure and synergies. First, they will access new markets and trade opportunities (+USD3.8bn in 2015 and +USD9.9bn in 2016 overall), second they should reduce their transaction costs (up to +USD7bn in savings on export costs), third they will attract fresh financing from investors (+USD8bn per year) and finally, they will benefit from better financing conditions.
- An interesting (and favorable) reshuffling of regional value chains is yet to come, including those including China. Electronics, chemical, automotive and agri-food will benefit the most while machinery and equipment, textile and energy may lag behind.
- Credit risk will certainly offer some surprises as competition, protectionism and sensitivity to regional (and global) shocks will disrupt the most vulnerable (textile, ICT) and most political (mining, automotive) industries.

Ready, steady, go? When the rubber meets the road

According to the Association of Southeast Asian Nations (ASEAN) blueprint (2007), Member States (Brunei, Cambodia, Indonesia, Lao, Malaysia, Myanmar, Philippines, Singapore, Thailand and Vietnam) committed to deepen economic integration by creating the ASEAN Economic Community (AEC). The successful gradual decrease of intra-regional tariffs (from 2.7% on average in 2007 to 0.5% end 2014) accelerated the launch of the AEC (initially expected in 2020). By the end of this year, a further tranche of trade barriers will be lifted enhancing intra-regional supply chains.

The AEC is characterized by four pillars: (i) the creation of a single market and production base; (ii) a competitive economic region; (iii) equitable economic development; and (iv) increased integration to the global economy. The first phase (2015-2018) will focus on the free movement of goods, services, investment, skilled labor, and freer capital flows (pillar 1) and certainly improve the region's competitiveness and participation to global supply chains (pillar 4).

Intended as more than a Free Trade Agreement (FTA), the AEC is still missing the building blocks to fully unleash its regional power. When compared to the European Union, a good example of a single market, pillars 2 and 3 are pivotal for success.

Figure 1: 4 pillars for growth

Pillar 1: Single market and production base	
Free flow of goods	Free flow of skilled labour
Free flow of services	Free flow of investment
Freer flow of capital	
Pillar 2: Competitive economic region	
Competition policy	Consumer protection
Taxation	Intellectual property rights
E-commerce	
Pillar 3: Equitable economic development	
SME development	
Initiative for ASEAN integration	
Pillar 4: Integration into the global economy	
Enhanced participation in global supply networks	
Coherent approach towards external economic relations	

Sources: ASEAN, Euler Hermes

To become more attractive and business-friendly, the AEC has to ramp up efforts to: (i) ensure economic convergence (taxation, competition policy); (ii) support legal revamps (consumer protection and intellectual property rights); and (iii) set-up regional support institutions for Members lagging behind (investment financing, capacity building and support to small and medium enterprises e.g.).

In addition, heated political debates on sovereignty have resulted in the absence of a common external tariff or a supranational body. Political hesitations in Thailand last year and Indonesia this year demonstrate that the political process will continue to negatively impact the image of the AEC as a stronger block to the rest of the world. Looking into the construction of single markets around the world, negotiations among Member States will be highly political and uncertain for years to come. Fortunately, companies can overcome political hurdles to benefit from the initial phase of the regional integration efforts.

Melting pot or salad bowl? From convergence to efficient specialization

The AEC will have to work on convergence and on efficient specialization across countries. What is each country bringing to the table when it comes to the business climate? There are three clear clusters: The MaSTers (Singapore, Malaysia, Thailand) with superior doing business indicators (see figure 3); the VIPs (Vietnam, Indonesia and the Philippines), very promising demand outlets; and the CLiMBers (Cambodia, Lao, Myanmar and Brunei) who are resource rich (workforce e.g.) but not globalized yet. Each cluster has a set of comparative advantages but all can benefit from the others.

The MaSTers. In Singapore, Malaysia and Thailand, the business environment and logistic infrastructure are superior to the rest of the region. Access to financing is broadly sound in Singapore (strong domestic credit and large Foreign Direct Investment inflows), Malaysia and Thailand. These countries have a diversified economic base and exporting companies are generally well positioned in the global value chain with larger exports of intermediate and final goods (close to 2% of global exports of intermediate and final goods each) and more innovative products (over 50% of their total exports; see chart 4). This is particularly true for the Electronic and Electrical Industry (Singapore, Malaysia and Thailand), Refined Petroleum, (Singapore and Malaysia) and the Automotive Industry (Thailand) where the countries have moved up the value chain.

The VIPs. Indonesia, Philippines and Vietnam have a good mix of favorable demographics (size and growth) and strong economic growth. These make them the biggest outlets of the region. The business environment and trade infrastructure continue to improve but slowly which somehow limits their trade potentialities. Peer-pressure from AEC Members should convince policy makers to accelerate their efforts to remedy these problems. Access to financing is improving (higher FDI inflows, development of banking system).

Figure 2: The AEC, between a classic FTA and a single market like the EU

	EU	AEC*	FTA**
Abolition of tariffs	✓	✓	✓
Common external tariffs	✓	✗	✗
Elimination of non-tariff barriers	✓	✓	!
Liberalization of trade in services	✓	✓	✗
Hamonization of rules/ standards	✓	!	✗
Liberalization of the movement of people	✓	!	✗
Trade facilitation	✓	✓	!
Flow of investment	✓	✓	✗
Flow of capital	✓	!	✗
Protection of intellectual property rights	✓	!	✗
Competition policy	✓	!	✗
Common currency	✓	✗	✗
Transfer of sovereignty	!	✗	✗

Notes
✓ indicates being included
! indicates being included in limited fashion
✗ indicates not being included.

* Whether or not the AEC will be able to implement measures towards its goals is a large issue, here we supposed that it is achieved.
** It is FTA's narrow definition. There are exceptions. Among FTAs, those signed by the U.S. stipulate wide-ranging liberalization of trade in services, protection of intelectual property rights and the like.

Sources: ASEAN, Aiming to Create an Economic. Community (AEC) by Professor Koichi Ishikawa, Euler Hermes

Figure 3: Leveling the playing field when doing business

		Doing Business (1=best, 189 = worst)	Logistics (1=best, 160=worst)	Financial market developpment (1=best, 144=worst)	Innovation (1=best, 144=worst)
The MaSTers	Singapore	1	5	2	9
	Malaysia	18	25	4	21
	Thailand	26	35	34	67
The VIPs	Philippines	95	57	49	52
	Indonesia	114	53	42	31
	Vietnam	78	48	90	87
The CLiMBers	Laos	148	117	101	84
	Cambodia	135	81	84	116
	Myanmar	177	147	139	138
	Brunei	101	n.a	56*	59*

** rank in 2013-2014 survey*

Sources: World Bank, World economic forum, Euler Hermes

The manufacturing sector is large and the combination of low labor cost and large workforce offers room for an industrialization hub. Exporters are very specialized: Electrical and Electronics in the Philippines (55% of total exports), primary commodities in Indonesia (40% of total exports) and light Electronics and Electric products, and Textiles in Vietnam.

The CLiMBers. Lao, Cambodia and Myanmar have the cheapest labor costs of the region, but the business environment is difficult and logistics infrastructures are underdeveloped compared to regional peers. Banking system is weak and external financing is critical (and volatile). Companies are mainly focused on low value-added products: raw materials and low-end manufacturing in textiles for instance. Brunei is energy-rich and finding its way into diversification.

Impact #1 for Companies: Stating the obvious – New market opportunities

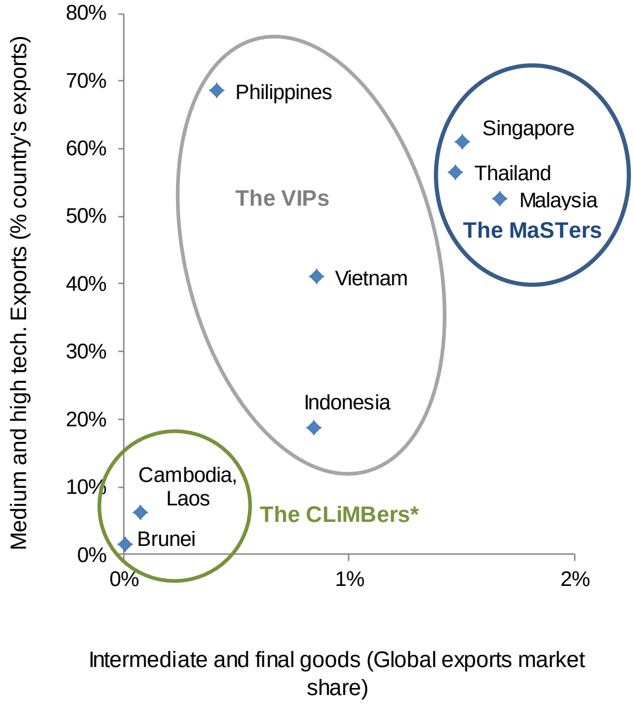
Through stronger economic integration (and lower tariffs), the AEC is often seen as a bonanza for companies' revenue growth, naturally increasing the size of the market to conquer. However, the growth potential has been around for quite some time as regional engines include: (i) the large population base (620mn people that is to say twice the U.S. population) expected to reach 670mn in 2020; (ii) the strong economic growth (USD2.4tn, higher than Italy's GDP) set to grow to USD3.8tn by 2020; and (iii) the expected catch up in nominal per capita income (+10% y/y on average over past 10 years similarly to India) from USD3,900 today to USD5,700 in 2020. The AEC will not be a game-changer in that respect, at least in the short-term.

A good example of that is the estimated impact of trade: a gradual increase in trade gains inside and outside the ASEAN, rather than a one-off boost. Though in April 2015, 90.5% of the prioritized trade enhancement measures have been implemented (and the target set to 95% by end-year), most goods already have a close to zero tariff in the ASEAN-5 (and this should be extended to other ASEAN countries). The problem remains non-tariff barriers (standards and regulation in the food sector for instance) and these efforts will take time and efforts. Assuming a reduction by 10% of existing trade barriers in both 2015 and 2016, we estimate that the total trade impact of the AEC over the next two years will be +USD3.8bn in exports in 2015 and +USD9.9bn in 2016.

The direct effect (intra-ASEAN) will be rather limited (+USD1.6bn in 2015 and +USD3.5bn in 2016) because of the already low tariffs in place, and the rather limited share of intra-regional trade (26% of total ASEAN trade). But the indirect effect (outside-ASEAN) is sizeable. Indeed, lower transaction costs will improve Member States' competitiveness as a global manufacturing hub, causing production to meet the anticipated increase in wider regional demand. Note that the +USD2.1bn in 2015 and +USD6.4bn appear to be limited by the ongoing deflationary and currency pressures in the region.

All countries are set to benefit from this demand effect but those with a stronger manufacturing base (Singapore, Thailand, Malaysia) will benefit more than those newly opened to trade (Laos, Myanmar).

Figure 4: It isn't just about high tech



** Figures for Myanmar were not available*
Sources: Chelem, Euler Hermes

Figure 5: Exports forecast over 2015-2016

Change in exports (USD bn)

	2015			2016		
	Total	Inside AEC	Outside AEC	**Total**	Inside AEC	Outside AEC
Singapore	**0.7**	0.3	0.4	**2.3**	0.8	1.5
Thailand	**0.7**	0.3	0.4	**2.1**	0.7	1.3
Malaysia	**0.6**	0.3	0.3	**2.0**	0.7	1.3
Indonesia	**0.3**	0.1	0.2	**0.9**	0.3	0.6
Philippines	**0.3**	0.1	0.2	**0.6**	0.2	0.4
Vietnam	**0.5**	0.2	0.3	**1.0**	0.4	0.6
Laos	**0.2**	0.1	0.1	**0.2**	0.1	0.2
Cambodia	**0.3**	0.1	0.2	**0.4**	0.1	0.3
Myanmar	**0.1**	0.1	0.1	**0.2**	0.1	0.1
Brunei	**0.1**	0.0	0.0	**0.1**	0.1	0.1
ASEAN	**3.8**	**1.6**	**2.1**	**9.9**	**3.5**	**6.4**

Sources: Euler Hermes

Brunei will benefit the least as exports are highly concentrated in the energy sector (96% of total exports).

Impact #2: Lower transaction costs, more investment flows and better financing conditions

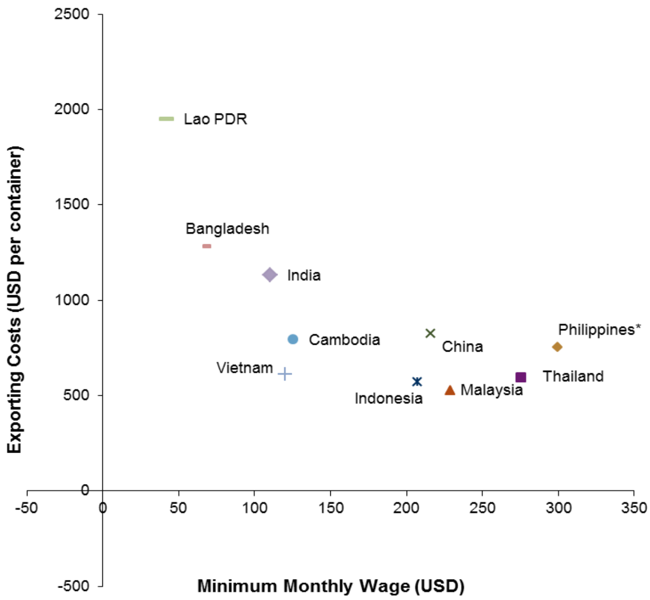
Beyond immediate sales opportunities, change could come from more efficient, better financed and certainly more specialized supply chains within the AEC.

Supply chain efficiency will indeed primarily improve by a reduction in transaction costs. First, lower tariffs and non-tariff barriers will reduce the administrative burden, enabling companies to save time and money. Second, Singapore is the corner stone of the ASEAN hub-and-spoke system: it offers the lowest costs to export: 1.7 times lower than Cambodia's. If all countries were to align with Singapore export costs, they would save USD187 per container or over USD6.7bn in total. Last, some Member States offer among the lowest labor costs of the region (Vietnam and Cambodia for instance, see figure 6). When combined, Member States offer major cost-optimization and give a clear signal to relocate manufacturing activities in the AEC.

Investment flows from neighbor countries should increase. We see a balanced, strong and stable economic outlook (+4.7% on average for ASEAN-5 over 2015-16). Further structural integration and less friction in investment flows will support greater investor confidence. The Foreign Direct Investment (FDI) stock has grown on average by +USD142bn per year between 2007-2014, we anticipate a rise of +USD150bn per year between 2015-2016. This will mainly be led by external investors from Japan (15.3% of 2012-2014 inflows) and China (5.8%), seeking new opportunities for their manufacturing base. We expect a gradual rise in the proportion of intra-ASEAN flows to 20% in 2016, up from 18% in 2014, thanks to greater home bias in the allocation of ASEAN national savings (32% of GDP).

Financing conditions for trade, investment and production should also improve. The cost of credit differs greatly in the region between countries like Singapore (5.4% on average in 2014) and Myanmar (13.0%). Deeper integration should allow companies to have access to cheaper credit as the barriers between countries decrease. Meanwhile, increased competition in the banking sector will also increase interest rate convergence. The impact is set to be progressive (i) as capacity building takes time in less developed markets, (ii) as authorities will want to retain control of capital flows to avoid sudden currency pressures and distortions in their domestic markets (housing bubble e.g.). Moreover, the absence of a monetary union, with a single currency, means currency risk will prevail and stay a serious risk in the longer-term for companies within the region.

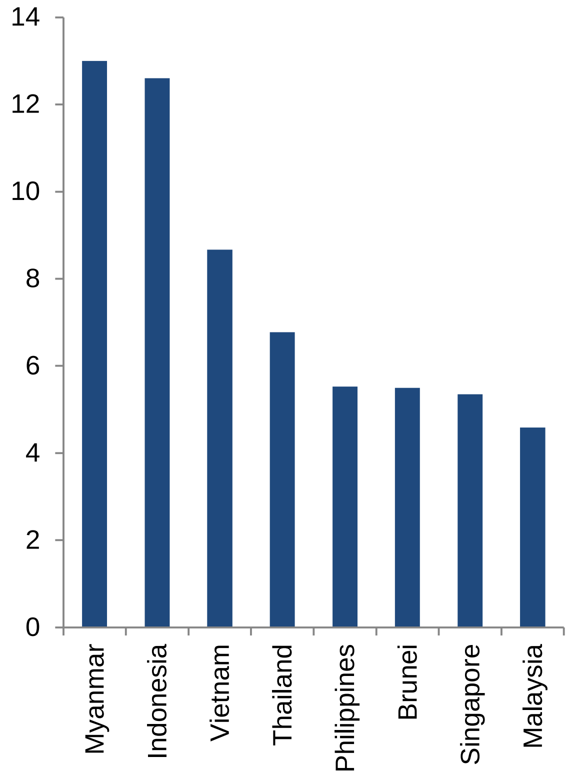
Figure 6: Exporting cost and minimum wages



For Philippines: Minimum Wage in Manila's region

Sources: World Bank, Department of Labor Employment of Philippines, Euler Hermes

Fig 7: Lending rates in 2014



N.B: For Laos, Cambodia, figures are unavailable

Sources: World Bank, Euler Hermes

Impact #3: Restructuring value chains – China beware?

There are natural synergies in some industries across AEC Member States, but also an opportunity to compete together, as a block, with China.

The sectors which will benefit the most are: electronics, chemical, automotive and agri-food. The electronic sector is already the ASEAN brand worldwide: 30% of all global electronic components are exported by AEC countries. Low labor costs have been a key driver for the sector and an efficient value chain is already in place. The chemical industry (see figure 8) is an important value chain for the AEC, which enjoys important natural resources: oil (Malaysia, Vietnam), gas (Malaysia, Indonesia) and coal (Indonesia, Vietnam). The sector is highly regarded and supported by national industrial policies: it is part of the twelve National Key Economic Areas in Malaysia and a priority for the Singaporean Government. The automotive sector has strong potential with key production hubs, and supportive government incentives (Thailand and Vietnam). Lastly, agri-food is expected to thrive. In addition to large agricultural commodities, the sector has a strong production base (food processing in the Philippines, Thailand, Indonesia and Vietnam) and demand is significant.

Conversely, some important sectors have not yet found the necessary synergies to overcome external competition: machinery and equipment (with industrialized countries), textile (with China and South Asia) and energy. Demand for Machinery and Equipment is set to increase with soaring spending in infrastructure. However, it is unlikely that ASEAN companies will be able to bridge the gap. Advanced economies are the most prepared to benefit from this demand due to their technological advantage. This will be particularly true for heavy machinery and transport equipment. The second laggard is the textile industry, which will suffer from fierce competition with South Asian countries such as Bangladesh and the strong dominance of China. Last, the energy is in need for a second wind as decreasing prices (oil) and demand for coal from China have halted further downstream developments and investments.

In the region, China will remain the biggest production base due to its large domestic market and significant export base in electronic and electrical equipment goods. However, the AEC could be stepping on their toes in this very sector and use China as a springboard for global market access (39% of ASEAN exports in electronic components go to China), eventually cutting the middleman as assembly lines would relocate. The main sectors where the AEC would compete with China (and the world) would be intermediate and final goods in the automotive sector and chemicals for instance (see chart 9): a playground for quality differentiation. Japanese companies have already outsourced part of the production in the region (in Thailand for example) and we expect further investment from these companies in other AEC countries such as Indonesia.

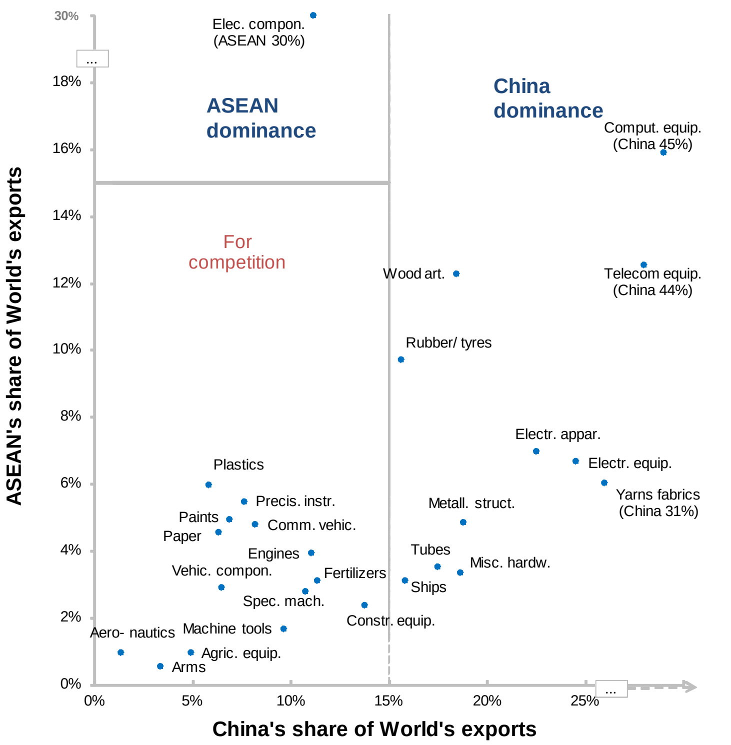
Fig 8: The regional chemical value chain

Primary products → **Final and high value added product**

Product	Uses	Top ASEAN exporters
Oil/Gas	Commodity	Malaysia, Indonesia
Petro-Chemicals	Refrigerants, Foils, Rubber	Thailand, Malaysia
Basic Chemicals	Fertilizers, Coolants	Indonesia, Malaysia
Polymers	Plastic Bottles, Plexiglass	Thailand, Indonesia
Pharmaceuticals/ Agro-Chemicals	Medicines, Herbicides, Food & Nutrition	Singapore

Sources: Chelem, Euler Hermes

Fig 9: ASEAN versus China exports (global share)



Source: Chelem, Euler Hermes

Competition, protectionism and dependency risks

The first risk is greater competition between AEC Members impacting company revenue growth. Downward price pressures are to be exerted by larger companies with enough financial strength, located in more competitive countries (easier to work in) and that benefit from higher value-added supply chains (differentiated products, more internationalized). Others, especially SMEs in less business-friendly environments and without extra support, will struggle and could disappear. The AEC intends a dedicated support structure for SMEs (an SME financing facility in each country and a regional SME development fund) and a technology and innovation sharing forum. But these tools are not concrete yet and without a supranational entity, there is little fiscal space (and execution capacity) for a small business act in each country.

The sector risk is evident in low-end manufacturing industries such as textiles or low value-added electronics (mobile phones manufacturing): both are very sensitive to price shocks. There is also a risk for some higher-value manufacturing such as the automotive industry for instance, where cannibalization across countries will become fiercer as already shown in other regional value chains (US-Mexico or Western Europe-Eastern Europe-North Africa). Production capacities migrate depending on quality standards, labor costs and fiscal incentives.

Dumping will be a major hurdle to levelling the playing field. Recently protectionism has resurfaced in AEC economies - those sectors particularly at risk include mining in Indonesia and agro-food Thailand. In addition, some AEC countries have tied bilateral links with neighboring countries: China and Japan are ASEAN's main partners and there is a risk that ASEAN countries such as Vietnam and Thailand, prefer to deepen their relationships with these two giants rather than the level of integration in the region.

Last, the risk of disruption due to increased integration means vulnerabilities will be higher as trade openness rises. Intra-regional trade represents only 26% of ASEAN total trade and diffusion risk is elevated as one fifth of this trade consists of intermediate goods. Cambodia, Laos and Myanmar will be the most vulnerable due to their dependency on external demand and foreign capital; they have weak domestic buffers (low national savings, low domestic consumption base). The sectors that will be the most sensitive to imported shocks are those which are most global: automotive and electronics.

All in all, credit risk is expected to increase in some sectors as supply chains will reshuffle in the first phase of this economic integration.

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