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Reimagining ASEAN:
Are we on track for ASEAN economic integration?

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Economic integration is vital for the Association of Southeast Asian Nations (ASEAN) to achieve sustained growth and shield itself from external threats. With ASEAN's 50th anniversary approaching in August, now is a good time to take stock of its progress and assess what the road towards further economic integration looks like. Is ASEAN on course to achieve the 10-year goals it set in 2015 and, if not, what needs to be done? We speak to some of the region's leading experts to map a way forward

The Association of Southeast Asian Nations (ASEAN) comes from humble beginnings: five nations and one declaration focused almost exclusively on security and diplomacy. Fifty years on and, today, the regional organisation includes ten countries comprising 630 million people and GDP of USD2.5 trillion. It has come a long way.

While politics is rarely far from the surface, the future of ASEAN rests on business, investment and, most importantly, economic integration – especially at a time when global growth is sluggish and many governments are becoming, at best, inward-looking and, at worst, protectionist.

If ASEAN were one economy, it would now rank as the world's sixth largest, which speaks to its potential. Yet, for that potential to translate into tangible growth and prosperity, new approaches and economic models will be required. Certainly, the current economic and political landscape poses new and increasingly complex challenges.

As Deutsche Bank economist Diana del Rosario explains in her report, Reimagining ASEAN: What might the next decade look like for the region?, policymakers have arrived at a fork in the road. On one side lies the conservative path: focusing on reactivity and protecting domestic economies from downside risks. On the other lies the progressive path: moving to seize the opportunities presented by an evolving economic and geopolitical landscape to advance critical economic reforms and drive growth.

Most governments appear to be turning towards the latter path – the more ambitious, if onerous, of the two. The ASEAN Economic Community was established at the end of 2015 to help in this endeavour, guided by the AEC Blueprint 2025, which seeks to facilitate the free flow of goods, services, investments, capital and skilled labour. In short, it seeks a highly integrated and cohesive ASEAN – with significant intra-Asian trade and investment – that is competitive, innovate and dynamic. Indeed, at the time of its launch, the Minister for International Trade and Industry of Malaysia stressed that it should promote "inclusive growth" and "strengthen linkages with trading partners, regional and international economic groupings".

But, is this truly feasible? Can ASEAN and the AEC deliver on the promise of economic growth for all? Can free trade and investment be made a reality by 2025? Almost everyone would accept that we are still in the early stages of such a journey. We must examine how far along we are in this process, what potential roadblocks might impede further progress, and how these can be overcome. Of course, these are vast areas of focus: here we touch upon trade – one of the most important pillars of the AEC's vision – which together with the cash management, payments and investment landscapes (see sidebox on page 6), we will cover in more detail in later features.

Key objectives on the AEC 2025 roadmap

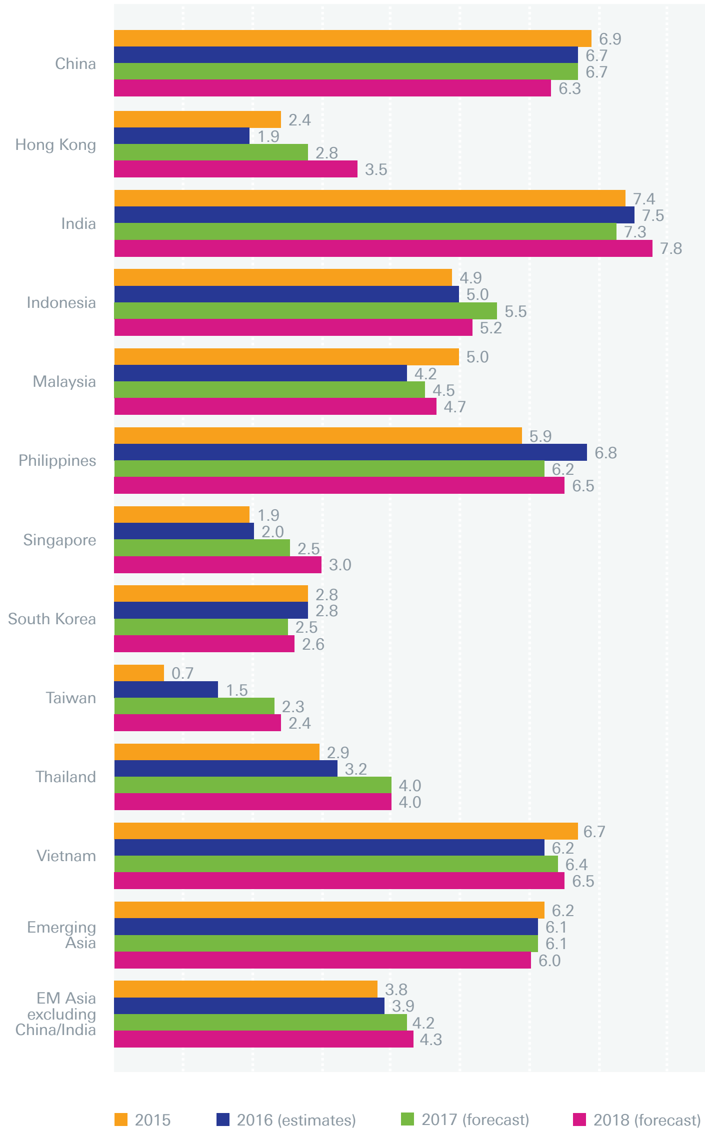
The AEC Blueprint 2025 consists of five interrelated and mutually reinforcing characteristics, namely:

1. A highly integrated and cohesive economy;
2. A competitive, innovative, and dynamic ASEAN;
3. Enhanced connectivity and sectoral co-operation;
4. A resilient, inclusive, people-oriented, and people-centred ASEAN;
5. A global ASEAN.

Plotting ASEAN's current co-ordinates

As has been widely reported, economic development in ASEAN over the past 50 years has been astounding. As the region's GDP more than doubled over the past decade, income per capita has also grown by as much to reach USD4,000 in 2016. The future looks just as dynamic: Deutsche Bank predicts emerging Asia (excluding China and India) to grow 4.2% in 2017 and 2018, up from 3.9% in 2016 (see figure below). Much of the region's expansion is expected to come from ASEAN, with Indonesia, the Philippines and Vietnam all expected to post growth exceeding 5% this year and next.

Expected GDP growth in Asia 2015-2018



Note: Forecasts are based on assumptions, estimates, opinions and hypothetical models or analysis which may prove to be incorrect.
Source: CEIC and Deutsche Bank, as of February 2017

And yet, "ASEAN is not completely in control of its own economic destiny," suggests Dr. Denis Hew, Director of Asia-Pacific Economic Co-operation (APEC) Policy Support Unit. "Its success will depend on the strength of economic recovery globally, and particularly in the US and China. China is making a transition from an export-driven economy to a much more balanced economy, but it's not growing at 10% per annum anymore; more like 5-6%. That will naturally impact on the many ASEAN economies that rely on Chinese demand."

He adds: "ASEAN is more vulnerable to external risk than Asia-Pacific as a whole, largely because of the fact that three-quarters of its trade is conducted with partners outside of the region. I think that is one of the reasons why the AEC makes such a compelling story."

Economic integration: A story of untapped potential

The AEC is often described as such: a compelling story, a fantastic idea, and a potential silver bullet in the fight against global protectionism. But, practically, what are the key markers of progress?

The level of intra-ASEAN trade is, of course, one oft-used barometer; according to the ASEAN Trade Statistics Database, it has remained fairly stagnant at around 25% of total ASEAN trade for over a decade – a low share by the standards of other regional trading blocs such as NAFTA and the EU.

"There is much scope for increasing the share of total ASEAN trade that comes from intra-ASEAN movements. As the AEC continues to develop, and as, hopefully, customs procedures across the region become easier, we should see intra-ASEAN volumes increase further," states Chris Humphrey, Executive Director at EU-ASEAN Business Council (EU-ABC).

Underlying any successful economic union is a

framework with the lowest possible barriers to trade, services and investment. Dr. Alan Bollard, Executive Director of the Asia Pacific Economic Co-operation (APEC) secretariat, explains: "There are huge trading possibilities in manufacturing, services, finance and tourism. But the AEC and individual governments must make sure there are no unnecessary barriers restricting integration – neither tariffs nor unnecessary regulations that stop the opening up of supply chains."

In this respect, there has been major progress – especially when it comes to trade of goods. By early 2010, Brunei Darussalam, Indonesia, Malaysia, the Philippines, Singapore, and Thailand had cut tariffs to 0-5% on 99.7% of their tariff lines. As of early 2015, Cambodia, Laos, Myanmar, and Vietnam had reduced or eliminated tariffs on 98.9% of their tariff lines.[1]

[1&2] https://www.oecd.org/dev/asia-pacific/SAEO2017_PV.pdf

Yet statistics show that intra-regional trade remains heavily concentrated in goods – meaning there is much work to do with respect to services, which account for between 35-60% of GDP in ASEAN economies and are especially important to Singapore, Malaysia, and the Philippines.[2]

Ambassador Michael Michalak, Senior Vice President and Regional Managing Director of the US-ASEAN Business Council, says: "The integration of services are a trickier piece of the AEC puzzle. While Singapore, Malaysia, and Thailand are comfortable with the development of their national service sectors – and willing to open them up to foreign competition and integration – others are not. The services industry therefore needs to mature across the whole region before we see significant integration. Capital markets integration is also a key long-term goal."

"Opening up services and developing the financial infrastructure across the region is essential to AEC succeeding," states Humphrey. "At the moment, the financial infrastructure across much of the region lacks maturity. Cross-border payment and settlement systems are inefficient, adding costs and time for transactions; long-term investment vehicles are insufficient in many countries; and competition in key sectors, such as banking and insurance, is lacking resulting in decreased levels of products and low levels of insurance coverage and access to banking facilities." So, while progress is being made, we remain some way away from the final destination. This does, however, prompt a very important question for consideration: how do we define and measure this progress with respect to integration of trade and services? Should we focus on levels of tariffs, GDP from cross-border trade, or another measure altogether? This is something we will address in more detail in future features.

RCEP: A bump in the road?

There has been much talk of the impact of global free trade agreements (FTAs) on ASEAN – specifically the Trans-Pacific Partnership (TPP) and the Regional Comprehensive Economic Partnership (RCEP). Indeed, the absence of six ASEAN member states from TPP talks posed a possible threat to the internal economic integration of ASEAN. With TPP in the deep freeze, this seems less likely.

RCEP, on the other hand, as an expansion of the five existing FTAs that already exist between ASEAN and its six partners – China, India, Japan, South Korea and Australia, and New Zealand – may expedite ASEAN co-operation and integration. With ASEAN very much at the centre of the discussions, the region can act as a platform for co-operation and, at the same time, wield significant negotiating power, securing income gains for all ASEAN countries. Such a result would pave the way for deeper integration and what Dr. Bollard describes as "regulated openness".

This is a view that is supported, in part, by Humphrey at EU-ABC. He explains: "ASEAN and its six FTA partners have an opportunity to establish a new paradigm in global trade. RCEP has the ability to boost regional trade across Asia, if it is implemented in the right way, and if it goes deep enough in its scope. Indeed, a cobbling together of the existing arrangements that ASEAN has with its partners would not move the needle much in terms of trade and investment, and would probably do little to give an extra spur to the AEC."

Humphrey adds: "Perhaps more hope should be put on a potential region-to-region FTA between ASEAN and the European Union. That would link together the world's second and sixth largest economies, and an EU-style FTA would have to be very deep and very comprehensive in its scope. Such a deal would, inevitably, mean that ASEAN would have to advance economic integration in order to get the full benefits of the FTA."

Boon-Hiong Chan, Head of Market Advocacy APAC

Spotlight on ASEAN's currency and payments landscape

Developing an inclusive, integrated, and stable financial sector is a core aspect of the AEC 2025 vision.[3] Such an integrated and stable financial system is a prerequisite for stronger economic activity, and a robust payment infrastructure plays a critical role in providing stability. What does ASEAN's current landscape look like and where are the pain points and opportunities for enhancement?

The diversity of the ASEAN environment is reflected in its payment infrastructure: ASEAN consists of 10 different countries with 10 different clearing systems, currencies and regulations. As a result, corporates tend to have multiple banking relationships to meet their banking requirements, and thus face challenges in harmonising payments or reconciliation processes.

In the domestic market, several countries have previously undertaken, or are steaming ahead with, national clearing and payment infrastructure updates in response to anticipated future demands. Singapore's new real-time low-cost clearing system, known as FAST (for Fast and Secure Transfers), is now live; and most recently Thailand introduced a new digital payment system PromptPay (launched in January 2017) that allows highly cost-effective money transfers via mobile phones. We have also seen the entrance of fintechs within the payments space. These have mostly focused on consumer-to-consumer (C2C) transactions – Vietnam calling for a "cashless" consumer society, for example – but the region has seen some B2B movement, with blockchain-based trials for intra-bank group transfers, and experiments by Singapore with wholesale clearing and settlement. In many countries, the use of paper instruments is still highly prevalent, but such countries are trying to discourage their use and/or introduce new technologies to improve process efficiencies. The Philippines, for instance, introduced electronic cheque presentment and processing capabilities for banks and corporates in 2017.

There is currently no visible ASEAN cross-border payment system integration, but the ASEAN Working Committee on Payment and Settlement Systems (WCPSS) is reportedly looking at long-term recommendations for trade settlement, money remittance and retail payments.[4] Recently, the central banks of Thailand, Indonesia and Malaysia came together to encourage the use of local currencies for bilateral trade and direct investment settlement.

When it comes to FX, the lack of a cross-border local currency payment system has provided an innovation opportunity for fintechs to offer cost-effective retail remittances. In the corporate space, for ASEAN countries with currency exchange controls, cross-border transactions can still be paper-intensive, from form filling to submitting supporting documents. Deutsche Bank uses its technology to enable corporates to electronically execute their cross border FX payments, delivering local currency across the ASEAN region. For example, a Malaysian-based corporate could make a payment in IDR to an Indonesian corporate from their MYR account held with Deutsche Bank, enabling the Malaysian corporate to mitigate currency risk of paying in a third currency such as USD.

As noted by Serene Chen, Co-Head of Fixed Income and Currencies Sales Origination in Deutsche Bank Asia, ASEAN central banks remain vigilant on increased FX volatility and contagion risks across global markets. Hence, understanding the regulatory landscape in each of these markets and potential changes as they come about is critical for corporates to effectively and efficiently manage their FX and Rates exposures in the region.

[3] ASEAN Economic Community Blueprint 2025 - http://www.asean.org/storage/2016/03/AECBP_2025r_FINAL.pdf
[4] http://www.aseanwcpss.org/aseanwcpss/Pages/default.aspx

at Deutsche Bank, elaborates: "The idea of increasing co-operation between ASEAN and the EU is a compelling one. Certainly, with slowing growth in China and increasing uncertainty around US trade policies, there is potential for the EU to fulfil more of those emerging demand gaps in areas such as supply chains and technology."

Indeed, IKEA, which has a significant presence in Indonesia, could be a model for other European companies to follow – it not only has a manufacturing base in the country, from where it exports Indonesian-made products to stores in 48 countries, it has also opened local retail stores to tap the burgeoning local consumer market.[5] Undoubtedly, broader and deeper ASEAN-EU relations would also be a move that would help satisfy the AEC's fifth objective of establishing a "global ASEAN" by 2025.

Government support and policy the key enablers

So, putting any potential global FTAs to one side, what will make the AEC Blueprint 2025 a reality? Clearly, the regional-level policy statements and plans need to be supported by each country in the form of national policies that are coherent, timely and effective. Sound policy frameworks will not only encourage further co-operation among member states, they will also reduce the risks of policy reversal and back-pedalling in the long run.

Dr. Bollard explains: "There has been an understandable tendency for governments to hesitate before extensive regulatory reform, but it is important that they do the cost benefit analysis and push through change where possible and appropriate."

Progress is being made at a government level. The EU-ABC talks of a "renewed vigour" by those in the region to ensure that progress on the trade facilitation elements of the AEC are advanced and felt soon on-the-ground. Yet, clearly, vigour alone will not break down barriers. Policy is at the very heart of any economic integration, and it is crucial that policymakers not only promote their willingness, but back this up with action. More specifically, they must remove remaining non-tariff barriers, and develop financial markets to ease capital flow and long-term investments.

The 2025 vision also focuses intently on increasing and enhancing dialogue and co-operation with the private sector. Ambassador Michalak suggests this is likely to be well-received: "The private sector is increasingly seeking expanded opportunities, especially to diversify in the fact of slowing Chinese growth. It sees not only the opportunities afforded by doing business within ASEAN, but also by using ASEAN as a springboard to trade globally through its partner arrangements."

[5] http://www.ikea.com/ms/en_ID/ikea-collections/made_in_indonesia/index.html

Dr. Hew says: "While we are witnessing change, there doesn't seem to be wide enough public outreach to businesses and to other stakeholders as to what the 2025 vision is and how corporate strategies and expansion plans can benefit from it. There needs to be a concerted effort by ASEAN governments to educate private companies, and invest in the resources to do this efficiently."

ASEAN also needs to focus on the development of its small-medium sized enterprises (SMEs) – given their significant contribution to employment and GDP, and potential to become future industry leaders – especially in terms of plugging them into regional and global value chains. ASEAN has been very successful in attracting multi-nationals to invest and set up operations in the region, yet it has not facilitated widespread strong industrial links between these global firms and the local SMEs. Clearly, this is an area where SMEs require technical expertise from government agencies and financial institutions to allow them to understand market opportunities and overcome challenges in terms of accessing finance and new technologies.

To get buy-in from all key stakeholders, however, it is clear that ASEAN must address head-on issues of – and perception around – globalisation. Globalisation has brought everyone closer together in a "global village", it has broken down national borders, and it has been a significant generator of wealth. But not for all. Undoubtedly, globalisation has created winners and losers; a fact that has underpinned the up-swell of populist, anti-globalisation rhetoric, and increasingly government policy, in many countries.

ASEAN promotes the concept of globalisation, yet on a regional scale. It seeks to break down national borders, increase integration of supply chains and open up economies to foreign competition. But, in a world where protectionism, not globalisation, is the trend, how will ASEAN communicate, and convince, its population that increased wealth will be good for all? This remains a key challenge.

Diversification: an enabler or a barrier?

Promoting the benefits of regional integration is made more complex by the diversity of ASEAN; Singapore is 80 times richer than Myanmar, Indonesia geographically much bigger than Singapore. Disparity is everywhere. But should this be seen as a driver of integration or an immovable obstacle? This issue remains a matter of contention.

Dr. Hew is of the opinion that the development gap needs to be addressed if ASEAN is to avoid integration efforts creating a "two- or three-tier ASEAN".

He explains: "A cohesive ASEAN is simply not a reality without a concerted focus on shrinking that development gap. In Europe, they realised this early on – and they created EU stabilisation funds specifically to support less developed European countries and provide a level playing field for them to catch-up. It may be difficult for ASEAN to do exactly the same, but it does need stronger institutions."

However, uniformity is not the goal either – something Dr. Hew agrees with. Developed value chains and production networks in the region will flourish only if economies can assume varying positions to drive different value propositions and synergistic competitiveness.

Dr. Bollard drives home this argument: "The diversity of the region provides a wealth of opportunity – if we can increase economic integration. We have Singapore – a world-class financial and operational hub – while Vietnam and Cambodia are potentially world-class low cost assembly operation locations. At the same time, there are large volumes of soft commodities coming out of Malaysia and harder commodities coming out of Indonesia. ASEAN has always had that diversity and has set out an integrated future with that in mind."

At the same time, change is afoot; and many economies are trying to recalibrate their export models and move up the value chain to shield themselves against changing Chinese demand, volatile commodity prices and increasing wages.

Deutsche Bank's Chan remarks: "China's economic model had to transition from one centred on low wages to one driven by greater automation, digitalisation and mass manufacturing. As some industrialising ASEAN countries lose their comparative low-wage advantage we can expect a similar transition. It is important that each country assesses its approach to digitalisation and other knowledge-based industries to ensure that it can embrace the opportunities of an innovative ASEAN, and future-proof itself with new growth drivers – in ways beneficial to its society and demographics as a whole."

Dr. Hew comments: "You cannot always compete on lower wages, especially given new technologies – particularly in the area of robotics, for example, which puts manual labour under threat. It is one of the reasons why countries such as Vietnam are looking at human capital development, skills development and accessing digital technologies so that they don't lose out. Given these emerging trends, it may not be possible – or desirable – for Cambodia or Laos to go through all the same phases of economic and industrial development as Malaysia, Thailand or Singapore. They need to rethink their economic strategies and change focus."

On this point, it is interesting to note that some countries have managed to increase exports to China, despite its slowdown, by moving up the value chain. Cambodia has steadily exported more consumer goods (mainly textiles and clothing) and capital goods to China, while exports of raw materials softened. Vietnam is another case in point. Although its exports of raw materials to China have decreased continuously since 2011, exports of consumer, capital and intermediate goods increased significantly. Such examples provide a strong template for economic recalibration from raw material dependency to increasing exports of higher value-added products such as machinery and electronics and electrical products.[6]

The US-ASEAN Business Council also describes witnessing increasingly sophisticated, hi-tech bilateral trade between the US and ASEAN – especially with Vietnam. The Philippines are also taking advantage of technologies, and other competitive advantages, to increase its domination of outsourcing and back office procedures for many US companies.

Ambassador Michalak says: "Digital technology and automation – not low wages – are the keys to ASEAN's future success. If ASEAN is to take advantage of the digital economy and all of the opportunities of integration, what it needs most is human capital development. Every single country has a huge focus on education and they are all looking for ways to leverage partnerships with

[6] https://www.oecd.org/dev/asia-pacific/SAEO2017_PV.pdf

developed countries such as the US to create higher levels of education. Getting the human capital side right will help traction of the digital economy – allowing people to see the benefits of connectivity, integration and power growth."

Certainly, this focus on human capital development aligns very closely with the AEC's vision of a "resilient, inclusive, people-oriented, and people-centred ASEAN".

So, what does the future hold for ASEAN?

The EU-ABC has stated that the "key milestones for the AEC project will be in areas such as: the full operationalisation of the ASEAN Single Window for customs clearances; and the establishment of a firm and meaningful process for the removal of Non-Tariff Barriers; the full implementation of trade facilitation measures, including the WTO Trade Facilitation Agreement." So, clearly, there are several areas in which ASEAN needs to improve to truly meet its goal as a unified economic community. As a trade-driven block, as well as breaking down non-tariff barriers, it could also develop a single customs window to better facilitate trade. And, crucially, it must embrace e-commerce as a way of providing cheap and easy expansion opportunities for the region's corporates – something we look at in more detail in our special feature on digitalisation, Reimagining ASEAN: The digital journey to 2025.

Economic integration is a long process, and one that may not be achieved by the time we reach 2025. ASEAN must therefore look outwards as well as inwards – with the ultimate aim to be an economic bloc, deeply integrated into the global economy and global supply chains.

To answer all of the questions surrounding the AEC – and ASEAN's place in the global economic

landscape – in this one feature would simply be impossible. So we leave a number of questions on the table: How can ASEAN's diversity drive trade and supply chain changes? What most needs to be developed in the finance, payments and FX space, to facilitate an integrated ASEAN's economic activities? What do corporates and regulators envision as the ideal sequence of changes for realising the AEC goals? What factors would make ASEAN attractive to foreign investors? And, perhaps most importantly of all, beyond check-boxes, how should we measure the success of ASEAN and AEC come 2025?

We hope to address as many of these questions as possible over the rest of 2017 in our series of ASEAN special reports. Watch this space.

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