

ASEAN

THE NEXT HORIZON



FOREWORD

The *ANZ Research In-Depth* series aims to provide an informed voice in the all-important conversation about Asia's future and its growing influence on the world. *ASEAN: The Next Horizon* is the fourth instalment in the series. This paper looks at ASEAN's journey towards an integrated economic community and the opportunity which ASEAN presents for Australia and New Zealand.

ANZ believes that Southeast Asia will eventually be as important to Australia and New Zealand as China is today. The ASEAN bloc has enormous potential, as both a manufacturing hub and a source of consumption for the world. A large, youthful workforce and strategic location are just some of ASEAN's many advantages, which should draw more companies to establish production bases in the region.

The ASEAN Economic Community (AEC) will help ASEAN realise its potential by removing barriers to trade and investment. In fact, good progress has already been made on goals such as tariff reduction and trade integration. While the AEC's goal of creating a single market and production platform across ASEAN may not be reached this year due to inadequate infrastructure and other impediments, ultimately we expect the process of economic integration to create economies of scale and lift intra-regional trade. By 2025, we project trade within ASEAN will exceed USD1trn in value.

ASEAN also presents rich opportunities for Australia and New Zealand (the Antipodes), particularly in relation to commodity exports. Agricultural exports should grow strongly for both countries as the standard of living rises in ASEAN and urbanisation accelerates. Australia's hard commodity exports will benefit too, as ASEAN moves to address its infrastructure deficit. This paper provides a detailed analysis of the trade and investment corridor between the Antipodes and ASEAN, including projections out to 2025.

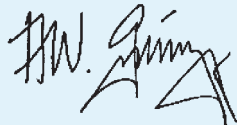
ANZ and its Research team are well placed to examine the corridor between the Antipodes and ASEAN, given our super-regional presence. ANZ is one of the few banks in the world with offices throughout Southeast Asia (including the frontier economies of Cambodia, Laos and Myanmar) as well as a deep understanding of its home markets in Australia and New Zealand.

I hope you find this paper informative. In terms of emerging economic opportunities, I truly believe ASEAN is the next horizon, not just for Australia and New Zealand, but for businesses and consumers around the world.

Andrew Géczy

CEO International and Institutional Banking

ANZ



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AUTHORS

Glenn B. Maguire
Chief Economist
South Asia, ASEAN
and Pacific

Toby Roberts
Director
Institutional

Justin Fabo
Senior Economist
Institutional

Weiwen Ng
Economist
ASEAN and Pacific

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ASEAN: THE NEXT HORIZON

This report is the fourth instalment in ANZ's *Research In-Depth* series and examines the Association of Southeast Asian Nations' (ASEAN) ongoing journey towards an integrated economic community and the opportunity it presents for its members, as well as Australia and New Zealand.

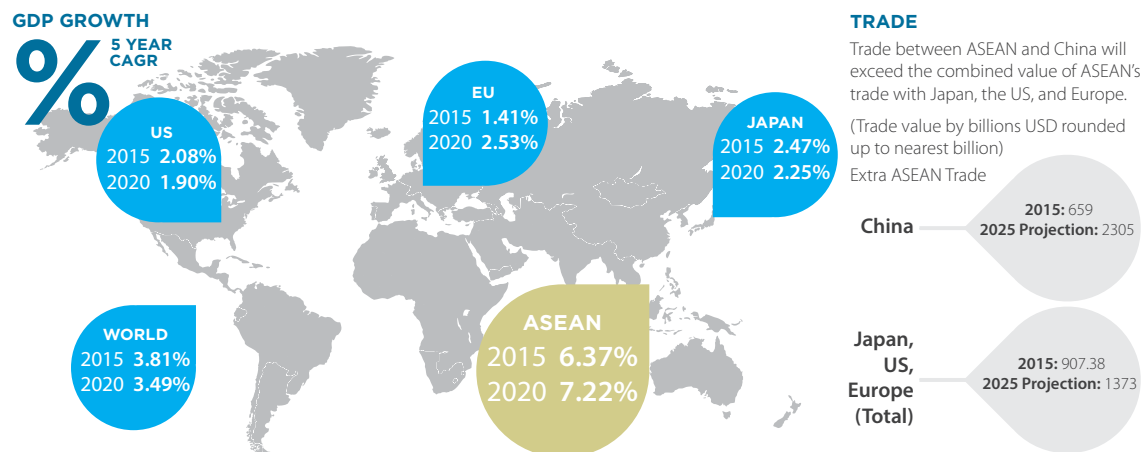
ANZ believes that Southeast Asia will eventually be as important to Australia and New Zealand as China is today. Over the next ten years, ASEAN has the potential to become one of the world's key manufacturing hubs and an emerging source of consumption for the world. A large, youthful workforce and strategic location are just some of ASEAN's many advantages, which should draw more companies to establish production bases in the region.

The ASEAN Economic Community (AEC) will help ASEAN realise its potential by removing barriers to trade and investment. In fact, good progress has already been made on goals such as tariff reduction and trade integration. While the AEC's goal of creating a single market and production platform across ASEAN may not be reached this year due to inadequate infrastructure and other impediments, ultimately we expect the process of economic integration to create economies of scale and lift intra-regional trade. By 2025, we project trade within ASEAN will exceed USD1trn in value.

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This flagship ASEAN publication provides an informed voice in the all-important conversation about ASEAN's future and its growing influence on the world. In terms of emerging economic opportunities, ASEAN is the next horizon for businesses and consumers around the world and is worthy of attention.

ASEAN on track to emerge as Asia's third engine of growth, alongside China and India



Source: CEPII, Haver, UN Comtrade, WITS, ANZ Research

ASEAN: THE NEXT HORIZON

As the Chinese economy continues to slow after offering over a decade of bountiful support to the Australian and New Zealand economies, many regional observers are looking for where the next key plank of economic support is likely to emerge. Fortunately, we note that just over the horizon, ASEAN will form the ASEAN Economic Community (AEC) from December 2015, laying the groundwork for the emergence of an integrated economic entity that should emerge as the third pillar of Asian growth alongside China and India.

Our research and analysis finds that over the next ten years ASEAN has the potential to become one of the world's key manufacturing hubs and an emerging source of consumption for the world. Factors in its favour include:

- Demographics – a large body of potential workers between 20 and 40 years of age;
- Comparatively lower wages – cheaper labour, especially around the Mekong, will attract more production platforms to the region;
- Production synergies – the strengths of the ASEAN member countries are often complementary. For instance, cheap labour in Myanmar, Laos, and Cambodia, combined with the production sophistication of economies such as Singapore and Malaysia should lift intra-regional trade;
- Scope for productivity improvement – initiatives such as the AEC should create economies of scale across the bloc and improve productivity by removing barriers to trade and investment; and
- Geography – strategically positioned at the junction of the Indian and Pacific Oceans, and sitting between China and India, ASEAN is uniquely placed to benefit from growing trade in the region.

Australia and New Zealand stand to gain from ASEAN's rise, particularly in relation to commodity exports, tourism and education. The trade and investment corridor between the Antipodes and ASEAN could exceed USD230bn by 2025.

Our analysis of the dynamic Asian region and the promise of the Asian Century has been a cornerstone of our thematic research for several years now. In ANZ Research's *Caged Tiger* report, we explored the implications of Asia's rise for the world. While China has captured the most attention to date as the main player in that shift, over time, the youthful economies of Southeast Asia will become the key drivers of Asian growth. By 2030, over half of the 650 million people in Southeast Asia will be under the age of 30, many of whom will be part of an emerging middle class with high rates of consumption. Beyond its role as the world's emerging consumer, we also believe Southeast Asia will take up China's mantle of the 'world's factory' over the next 10–15 years as companies move to take advantage of cheap and abundant labour in areas such as the Mekong.

The potential of this region has been enhanced by ASEAN – in particular the greater cooperation that ASEAN has engendered. We expect the establishment of the AEC later this year will hasten the process of economic integration between its ten member countries. This paper looks at the evolution of ASEAN, its plans for a fully integrated economic community, and the opportunities it presents for Australia, New Zealand, and the world as a whole.

ASEAN'S REMARKABLE JOURNEY

ASEAN has progressed a long way from its humble beginnings in the 1960s when its five original members banded together out of vulnerability – vulnerability to external security threats and internal threats like poverty and disease. Since then, ASEAN has grown to become one of the largest economic zones in the world, with a combined GDP approximately the size of the UK's, dramatically improving the standard of living for its people along the way, and demonstrating an enviable level of internal stability.

This gives us confidence that ASEAN will ultimately achieve its ambitious goal of becoming a single market and single production platform – the bloc has a track record of overcoming challenges.

Plans for a fully integrated community

In 2003, ASEAN's leaders resolved to establish an ASEAN Community by 2015, including an Economic Community with a comprehensive list of ambitious targets aimed at establishing a trade bloc where goods, services, capital, and labour are allowed to move freely between the member states. We don't believe all of those targets will be met this year, and there are many challenges to a fully integrated ASEAN bloc, including inadequate infrastructure linkages and comparatively low levels of financial integration in the region. In our view, a borderless economic community will not emerge for at least another 15 years, and even then it is unlikely to develop into a bureaucratically administered entity like the European Union. However, good progress has already been made in some areas such as trade integration and the reduction of tariffs, and ultimately we expect the AEC to unlock synergies within the region which will usher in a new era of higher potential growth.

Over the next 10–15 years, while the integration process evolves, we believe the following three sub-regions will form within ASEAN:

- 1. The Mekong Frontier** of Myanmar, Cambodia and Laos, which will provide cheap youthful labour to the new production platforms in the second group of countries below.
- 2. The Mid-Manufacturing Competitors** in Thailand, Vietnam, Indonesia, and the Philippines, which will all seek to be the most cost-effective mid-value manufacturer in Asia.
- 3. The High Income Economies** of Singapore and Malaysia, which will develop the higher value-added activities (such as designing electronic circuits), and will be the dominant finance and technology hubs.

ASEAN'S POTENTIAL

With a projected economic growth rate only marginally behind China and India, ASEAN is on track to emerge as Asia's third engine of growth, and it will be the fifth largest economy in the world by the end of the decade. Put another way, in 2000 the bloc constituted only 1.9% of world GDP, but by 2025 that share will have more than doubled. While the growth profile of the various economies within ASEAN vary widely, most members will chart a comfortable trajectory upwards.

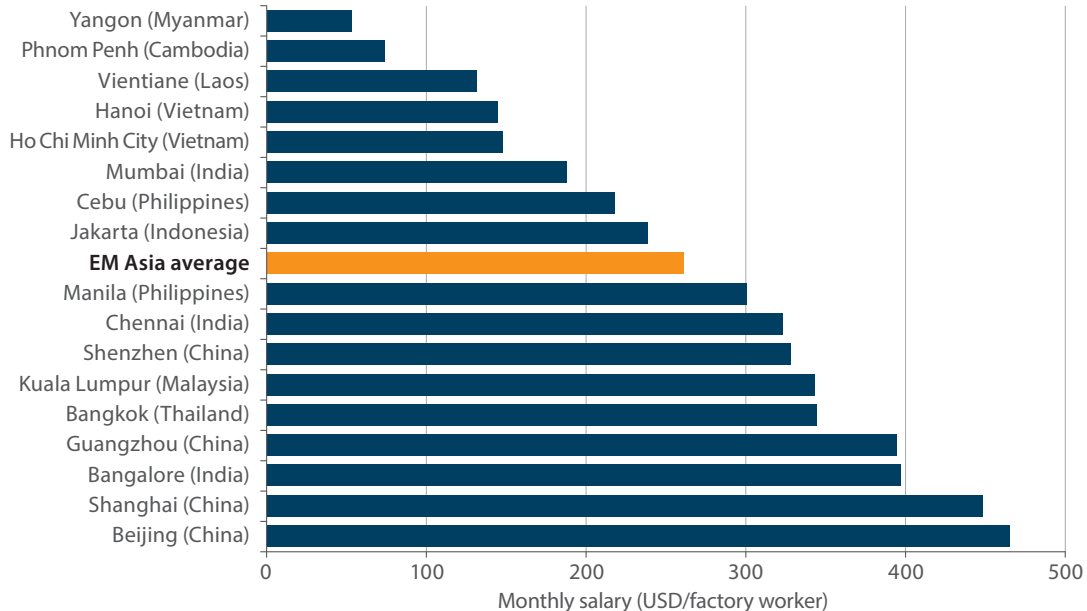
THREE KEY ASPECTS OF THE ASEAN PROMISE

1. ASEAN – the new factory of Asia

Productivity improvements and labour force expansions will drive most of the growth in ASEAN, along with increased trade fragmentation in the region. By fragmentation we mean the process by which multinational companies break up the manufacture of their more elaborate goods into components, leading to a rise in trade of those components, and an extension of global supply chains. Increased fragmentation in the ASEAN trade networks will spur trade within ASEAN and its key partners.

It will also spur Foreign Direct Investment (FDI) as companies seek to further utilise specialised pools of labour across the region. Over the medium term we believe more production platforms will migrate south from the expensive bases of north Asia to the cheaper markets of ASEAN.

Figure 1. ASEAN labour costs are amongst the lowest in Asia



Source: JETRO 2013 Comparison of Investment Costs, ANZ Research

2. ASEAN – home to the world’s newest middle class

A wave of consumption is set to break across the region, especially in the frontier economies. As a share of ASEAN GDP, we expect consumption to account for 75% of GDP in 2025, up from 62% in 2010.

There will be three key drivers of the ASEAN consuming class:

- 1. Demographics:** ASEAN’s demographic profile will underpin the rise of this large middle income cohort. Indonesia and Vietnam in particular are endowed with young populations that will become more productive as education levels and skills transfers increase.
- 2. Urbanisation:** Urbanisation is also a powerful factor in middle class formation. Governments are able to more efficiently provide public goods such as education and social services to urbanised populations compared to rural populations. Populations have more access to work opportunities in urban centres and generally enjoy a higher quality of life. Better transport connectivity and digital services improve job hunting and result in more efficient labour market matching.
- 3. Education:** For Asia, the move to middle income status has been achieved by the creation of high volume, low value-added manufacturing workforces. To move into the high income space, these workforces will need to be re-skilled so they can transition into higher value-added production. Education and skills transfer within multinational enterprises will be crucial to this process.

Figure 2. Rise of the ASEAN consumer

Population (m)				Middle income group (% of population)				Middle income population (m)			
Economies	2010	2015	2020	Economies	2010	2015	2020	Economies	2010	2015	2020
Brunei	0.4	0.4	0.5	Brunei	98	99	100	Brunei	0.4	0.4	0.5
Cambodia	14	15	16	Cambodia	9	15	21	Cambodia	1	2	3
Indonesia	240	252	263	Indonesia	21	26	30	Indonesia	50	64	79
Laos	6	7	7	Laos	11	17	23	Laos	1	1	2
Malaysia	28	31	33	Malaysia	40	42	45	Malaysia	11	13	15
Myanmar	52	56	59	Myanmar	9	12	15	Myanmar	5	7	9
Philippines	93	101	110	Philippines	34	37	40	Philippines	32	37	43
Singapore	5	5	6	Singapore	98	99	100	Singapore	5	5	6
Thailand	69	71	72	Thailand	45	47	49	Thailand	31	33	35
Vietnam	88	92	96	Vietnam	21	28	36	Vietnam	18	26	34
ASEAN 10	596	631	661	ASEAN 10	26	30	34	ASEAN 10	154	190	227
Asia	3344	3491	3619	Asia	26	31	37	Asia	850	1082	1325
World	6515	6871	7210	World	28	29	30	World	1844	2010	2177

Source: OECD, BCG, ANZ Research

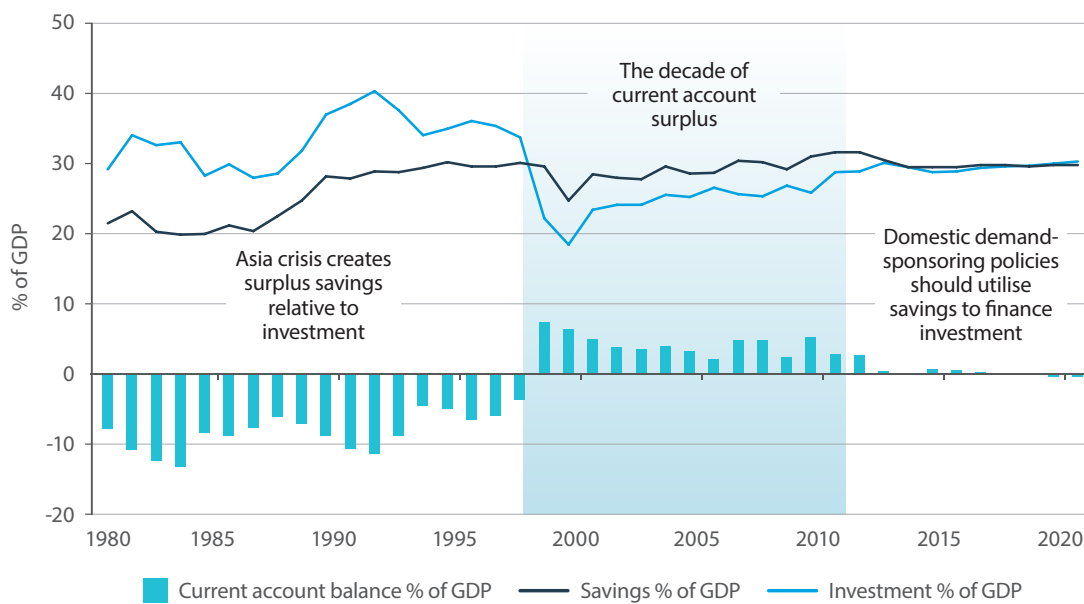
3. ASEAN – golden opportunity to close infrastructure deficit

A significant infrastructure deficit emerged across Asia after the 1997–98 Asia crisis, and this was exacerbated by the GFC a decade later. Investment as a share of GDP has still not returned to pre-1997 levels in most ASEAN economies. By some estimates, Asia’s infrastructure deficit could be as high as USD8trn through to 2020.

Nonetheless, we are on the cusp of a sweet spot where infrastructure financing and political will for new infrastructure collide. The huge ASEAN infrastructure deficit will close over the coming decade on account of a confluence of factors which form a virtuous self-reinforcing cycle. These factors include:

- (i) Favourable demographics in terms of working age populations prompting the shift of production platforms to ASEAN economies which necessitates the need to close the infrastructure gap;
- (ii) Structural decline in oil prices allowing economies to unwind fuel subsidies and free up between 2.5–3% of GDP for infrastructure spending; and
- (iii) The rise of multilateral institutions such as the Asian Infrastructure Investment Bank (AIIB), which would potentially use best practice to build infrastructure in the most efficient way for developing economies.

Figure 3. Golden opportunity to close the infrastructure deficit



Source: ADB, CEIC, ANZ Research

Another key element in ASEAN’s favour is its position at the intersection of major global shipping routes. Most of ASEAN’s member countries lie at the junction of the Pacific and Indian Oceans, and the land-based members of ASEAN sit between the two most populous countries in the world – China and India. Access to these land and maritime routes allows ASEAN to participate in Asia’s expanding production network.

Looking ahead to 2025 we expect intra-ASEAN trade to exceed USD1trn in value and extra-ASEAN trade with the G4 economies (US, Europe, Japan, China) to reach USD3.7trn. China will dominate that trade with ASEAN. In fact, our projections indicate that the value of trade between ASEAN and China will exceed the combined value of ASEAN’s trade with Japan, the US, and Europe. FDI into ASEAN from key partners such as the G4 will also grow strongly to around USD106bn in 2025, having eclipsed FDI into China for the first time in 2013.

THE OPPORTUNITY FOR AUSTRALIA AND NEW ZEALAND

China currently dwarfs ASEAN in terms of its significance as a trading partner for both Australia and New Zealand (the Antipodes), but that disparity may shrink over the next 10–15 years.

Already there are signs that ASEAN is assuming much greater importance for the Antipodes in certain industries such as agriculture, and overall exports to ASEAN are growing strongly.

Strong demand growth, rising standards of living, and a sizeable infrastructure deficit in the ASEAN region all present the following opportunities for businesses and consumers in the Antipodes:

- **Exports:** An expanding middle class in ASEAN will increase demand for food, tourism, education, energy, and hard commodities, not all of which will be satisfied within the region.
- **'On the ground' opportunities:** Antipodean businesses may establish operations (or expand existing operations) in ASEAN to benefit from its growth and its low costs production. Some of the profits from those operations will accrue as income flows to Australia and New Zealand.
- **Imports:** Increasingly, the Antipodes are importing low cost goods from ASEAN and we expect this trend to intensify as ASEAN becomes the new low cost manufacturer in the region. This could extend the current run of cheap goods for consumers by another two or even three decades.

For Australia, our projections show total trade and inbound FDI increasing from around USD90bn in 2013 to USD155–210bn in 2025. For New Zealand, that total is projected to increase from around USD13bn in 2014 to USD22–27bn in 2025.

However, the trading, business and investment opportunities won't come on a platter, because the rest of the world will also be contesting those opportunities. In fact, while Australia and New Zealand have been growing their exports to ASEAN at a strong rate, their share of ASEAN's total imports has barely held its line and in certain sectors like food, Australia's share has actually shrunk. Australia may have to adopt New Zealand's more structured approach to ASEAN trade and investment, as seen in the recent establishment of the *NZ Inc ASEAN Strategy*, in order to compete for these new opportunities.

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